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**Retention of monthly tax
devolution at existing levels,
would back-end the release of a
third of the taxes budgeted for
FY2022 to March 2022**

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SUMMARY



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11.9% growth embedded in tax devolution for FY2022 appears realistic

Monthly devolution in April-May FY2022 contracted by ~15% to Rs. 392 billion

If the monthly CTD is retained at Rs. 392 billion in June-Feb FY2022, more than a third of the taxes budgeted for FY2022 would get back-ended to March 2022

This would be inefficient from a cash flow perspective for the states

The Central tax devolution (CTD) forms a substantial ~25% of the states' combined revenue receipts, although its share varies across various states. The monthly pattern of tax devolution used to be fairly stable in earlier years imparting predictability to the cash flows of the state governments. With the Covid-19 pandemic affecting the Government of India's (GoI's) tax inflows in FY2021, this monthly pattern of devolution underwent some change.

For FY2022, the growth of CTD embedded in the GoI's FY2022 budget estimates (BE; Rs. 6.7 trillion) relative to the FY2021 provisional actuals (Rs. 5.9 trillion) is moderate at 11.9%. While there have been concerns related to the impact the second wave of Covid-19 on tax revenues, the net direct tax collections of the GoI in Q1 FY2022 (as on June 15, 2021) were twice as high as the year-ago period. Even if the cesses on fuels are reduced to cool the inflationary pressures related to high fuel prices, since these are not shareable with the states, it will not affect the CTD. Therefore, in our view, the YoY growth of 11.9% in the tax devolution embedded in the FY2022 BE, appears realistic at present.

However, the devolution has contracted by 14.9% to Rs. 392 billion each in April-May FY2022 from Rs. 460 billion each in the year-ago period. This is because the CTD included in the BE for FY2022 (Rs. 6.7 trillion) is 15.1% lower than the Rs. 7.8 trillion that was budgeted for FY2021, and the GoI has released 5.9% of the budgeted CTD monthly to the state governments in April-May FY2021 and April-May FY2022.

If the monthly amount of CTD is retained at Rs. 392 billion in June-February FY2022, the release of more than a third of the taxes budgeted for FY2022 would get back-ended to March 2022 (presuming that the CTD for FY2022 is not revised below the budgeted level), which would be inefficient from a cash flow perspective for the states.

We have constructed two scenarios for stepping up the CTD in the remaining months of FY2021, assuming that the GoI will retain the gross tax revenues and the CTD in the revised estimates (RE) for FY2022 at the budgeted level. Under Scenario (1), the monthly CTD for June-February of this fiscal may be increased to one-fourteenth of the FY2022 BE (in line with the past practice), or Rs. 475 billion per month. This would leave a balance of Rs. 1.6 trillion to be transferred in March 2022, which would be a modest 5.6% higher than the amount released in March FY2021, although it would still be a substantial one-fourth of the annual CTD.

Under Scenario (2), the amount to be released in March 2022 has been placed at Rs. 1.0 trillion. Based on this, the monthly devolution to the states during June-February FY2022 would rise to Rs. 541 billion. This would ease the pressure on the state governments' borrowings in the interim months and allow them more flexibility in undertaking expenditure during the year, which would be growth-supportive in our view.

Mechanics of Central tax devolution: A portion of the divisible pool of the GoI (gross tax revenues excluding non-shareable cesses and surcharges) is transferred as CTD to the state governments based on the recommendations of the successive Finance Commissions. In line with the accepted recommendation of the Fifteenth Finance Commission (FC), the GoI would be transferring 41% of its divisible pool as CTD to the state governments during FY2022-FY2026, unchanged from the level in FY2021.

The CTD accounted for a substantial ~25% of the states' combined revenue receipts in FY2020, although its share varied across various states. For instance, excluding the north-east and the hilly states, the share of CTD in revenue receipts was the highest for Jharkhand at 35.3%, and the lowest for Haryana at 10.5% in FY2020.

Typically, the amount of devolution by the Central Government to the states for the months of April-January of a fiscal, is based on the BE of the GoI's gross tax revenues and CTD for that year. At the time of publication of the next fiscal's Union Budget during Q4, the GoI publishes its revised estimates (RE) for its gross tax revenues, based on the underlying trend of the actual taxes collected during the year. Reflecting the change in the later, the CTD for that fiscal is also modified. Subsequently, the GoI adjusts the amount devolved in February-March, to align the total tax transferred in that fiscal, with the RE for the CTD for that year. At the end of March, if the actual tax collections turn out to be lower than the amount included in the RE (as was the case in FY2020), the excess CTD transferred is adjusted from the subsequent year's devolution. In contrast, if by the end of March, the GoI's actual tax collections turn out to be higher than the RE (as was the case in FY2021), the GoI may devolve the additional CTD in the same fiscal or in the subsequent fiscal.

Tax devolution budgeted to grow by moderate 11.9% in FY2022, lower than our estimate of nominal GDP expansion: For FY2022, the GoI has projected its gross tax revenues at Rs. 22.2 trillion and the CTD at Rs. 6.7 trillion (refer Exhibit 1). These estimates are a moderate 9.5% and 11.9% higher, respectively, than the gross tax revenues (Rs. 20.2 trillion) and CTD (Rs. 5.9 trillion) in FY2021 (based on the recently released provisional actuals).

The growth embedded in the budgeted gross tax revenues and CTD for FY2022, relative to the FY2021 provisional actuals, is lower than ICRA's forecast of nominal GDP expansion of 15-16% for FY2022. The latter factors in the impact of the second wave of Covid-19 on the economic activity, as well as ICRA's projections for the CPI and WPI inflation for FY2022. While there have been concerns related to the impact the second wave of Covid-19 on tax revenues, the net direct tax collections of the GoI in Q1 FY2022 (as on June 15, 2021) were twice as high as the year-ago period.¹ Even if the cesses on fuels are reduced to cool the inflationary pressures related to high fuel prices, since these are not shareable with the states, it will not affect the CTD. Therefore, in our view, the YoY growth of 11.9% in the tax devolution embedded in the FY2022 BE, appears realistic at present.

Exhibit 1: GoI's gross tax revenues and CTD during FY2021-22 BE

Amount in Rs. Trillion	FY2021 BE (A)	FY2021 RE (B)	FY2021 Prov. Actuals (C)	FY2022 BE (D)	Growth (%) D/C
Gross tax revenues of the GoI	24.2	19.0	20.2	22.2	9.5%
CTD for all states	7.8	5.5	5.9	6.7	11.9%

Source: Various state budgets; Union Budget; ICRA research

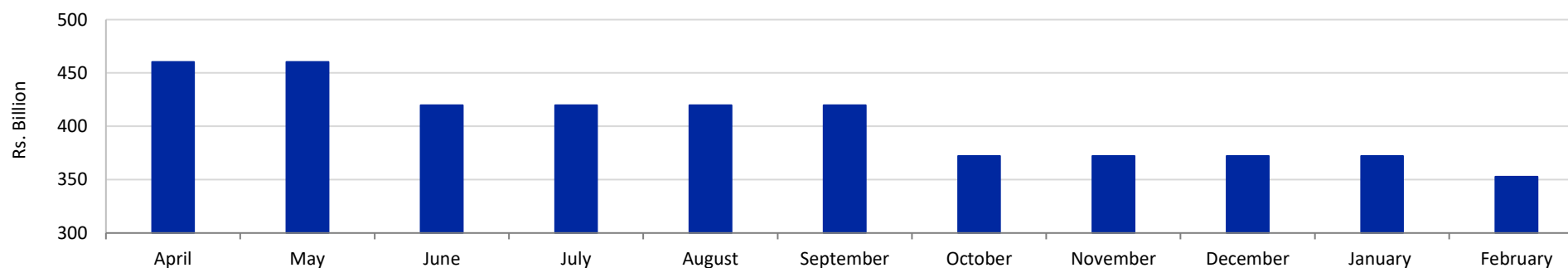
¹ Refer to Press Information Bureau release dated June 16, 2021

CTD in April-May 2021 was 15.1% lower than April-May 2020: Despite the realistic CTD for FY2022 BE, the actual taxes devolved in April-May 2021 (Rs. 392 billion each), are 14.9% lower than April-May 2020 (Rs. 460 billion each). We observe that the monthly tax devolution in both these periods has remained steady at 5.9% of the budgeted CTD in both FY2021 and FY2022. Therefore, the reason for the YoY decline in the amount devolved in April-May 2021, is that the budgeted CTD for FY2022 (Rs. 6.7 trillion) is 15.1% lower than the CTD budgeted for FY2021 (Rs. 7.8 trillion).

Monthly devolution of taxes had undergone step down between April-May FY2021 and February FY2021: The Covid-19 pandemic led to a substantial variation in the Gol's gross tax revenues as well as CTD in FY2021 relative to the budgeted level. Moreover, the monthly volume of such transfers underwent a step down from May 2020 to February 2021. In April-May FY2021, the Gol had devolved Rs. 460 billion to the state governments or 5.9% of the budgeted CTD of Rs. 7.8 trillion for that year (refer Exhibit 2). However, the lockdown-led disruption in economic activity dented the tax inflows of the Gol and subsequently, it devolved a lower Rs. 420 billion to the states during June-September FY2021 (5.4% of the budgeted CTD). The CTD was further lowered to Rs. 372 billion during October-January FY2021 (4.7% of the budgeted CTD).

In the Union Budget FY2022 presented on February 1, 2021, the Gol revised its gross tax revenues for FY2021 by a sharp 21.6% to Rs. 19.0 trillion from Rs. 24.2 trillion that was budgeted prior to the onset of Covid-19 pandemic and the CTD was revised by a deeper 29.9% to Rs. 5.5 trillion from Rs. 7.8 trillion for the same period. In February FY2021, the Gol devolved Rs. 353 billion to the states, which was 6.4% of the revised CTD of Rs. 5.5 trillion for that fiscal.

Exhibit 2: April-Feb CTD transferred to states during FY2021



Source: Controller General of Accounts (CGA); ICRA research

However, the subsequently released provisional actuals for FY2021 revealed that the Gol's gross tax revenues stood at Rs. 20.2 trillion, 6.6% higher than the Rs. 19.0 trillion included in the RE for FY2021. The provisional actuals for FY2021 have pegged the CTD to all states at Rs. 5.9 trillion, 8.2% higher than the Rs. 5.5 trillion included in the FY2021 RE. Accordingly, the Gol devolved Rs. 1.5 trillion to the states in March FY2021, or a substantial 25.4% of the provisional CTD of Rs. 5.9 trillion for FY2021.

Maintaining monthly CTD at Rs. 392 billion over the coming months may be cash flow inefficient for the states: Unless the monthly amount of CTD is imminently increased from Rs. 392 billion, the balance left to be devolved in Q4 FY2022 would be substantial, which would be inefficient from a cash flow perspective for the states. **For instance, if the GoI continues to devolve Rs. 392 billion during June-February FY2022, then a massive Rs. 2.4 trillion (36% of the FY2022 BE) will be left for devolution in March 2022, assuming that the CTD for FY2022 is retained at Rs. 6.7 trillion in the FY2022 RE. Accordingly, we believe that the monthly amount of CTD could be stepped up in FY2022, unlike the situation in FY2021.**

We have constructed two scenarios in this note (refer Exhibit 3), both of which assume that the FY2022 RE for CTD will be the same as the FY2022 BE.

Exhibit 3: Monthly CTD in FY2021 and projected monthly CTD in FY2022

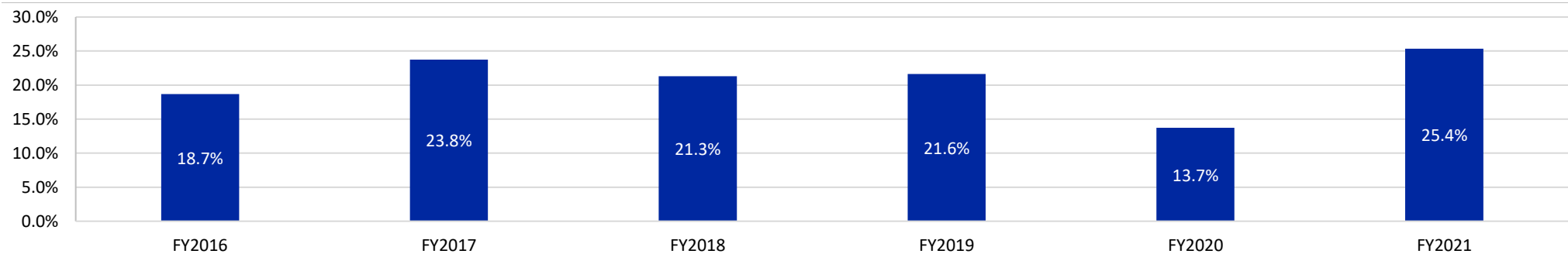
Amount in Rs. Billion	April	May	June	July	August	September	October	November	December	January	February	March	Total
FY2021	460	460	420	420	420	420	372	372	372	372	353	1,508	5,950
FY2022 (Scenario 1)	392	392	475	475	475	475	475	475	475	475	475	1,594	6,656
FY2022 (Scenario 2)	392	392	541	541	541	541	541	541	541	541	541	1,000	6,656
YoY Growth (%)													
FY2022 (Scenario 1)	-14.9%	-14.9%	13.3%	13.3%	13.3%	13.3%	27.7%	27.7%	27.7%	27.7%	34.7%	5.6%	11.9%
FY2022 (Scenario 2)	-14.9%	-14.9%	29.0%	29.0%	29.0%	29.0%	45.4%	45.4%	45.4%	45.4%	53.4%	-33.7%	11.9%

Source: CGA; Union Budget; ICRA research

Scenario (1): Prior to FY2019, the GoI typically used to devolve one-fourteenth of the budgeted CTD in April-February of each fiscal year and made adjustments based on the RE in March. If the GoI chooses to modify the monthly CTD for June-February of this fiscal to one-fourteenth of the FY2022 BE, this would imply a monthly devolution of Rs. 475 billion during these months. Adding the Rs. 392 billion each released during April-May 2021, would entail a cumulative release of Rs. 5.1 trillion in 11M FY2022. Assuming that the FY2022 RE for CTD would be unchanged at the FY2022 BE, the balance amount to be devolved in March 2022 would be Rs. 1.6 trillion, which is a modest 5.6% higher than the amount released in March FY2021. However, even this will entail that the amount released in March 2022 would be one-fourth of the annual CTD, similar to the situation in FY2021 (refer Exhibit 4).

Scenario (2): The amount of CTD to be released to the states in March 2022 has been placed at Rs. 1.0 trillion (~15% of the FY2022 BE). Assuming that the FY2022 BE for CTD does not need to be revised, the monthly amount to be devolved to the states during June-February FY2022 would rise to Rs. 541 billion. This would ease the pressure on the state governments' borrowings in the interim months and allow them more flexibility in undertaking expenditure during the year, which would be growth-supportive in our view.

Exhibit 4: Share of amount devolved in March in the total CTD during FY2016-21



Source: CGA; ICRA research



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ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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