

Fiscal Rules: Lessons from the States

“Lord, give me chastity and continence but not yet.”

– **St. Augustine**

Most states achieved and maintained the target fiscal deficit level (3 percent of GSDP) and eliminated the revenue deficit soon after the introduction of their Fiscal Responsibility Legislation (FRL). However, the FRL was not the sole impetus behind this impressive fiscal performance. Acceleration of GDP growth, increased transfers from the Centre, decline in interest payments and increased central CSS expenditure contributed significantly to such consolidation. Desisting from splurging rather than belt-tightening was probably the real contribution of the States. Fiscal challenges are mounting because of the Pay Commission recommendations, slowing growth, and rising payments from the UDAY bonds. Moreover, macro-economic conditions will not be as favorable to states as they were in the mid-2000s. Going forward greater market-based discipline on state government finances will be a major imperative. And, the Centre must take the lead not only in incentivizing fiscal prudence by states but also by acting as a model through its own fiscal management.

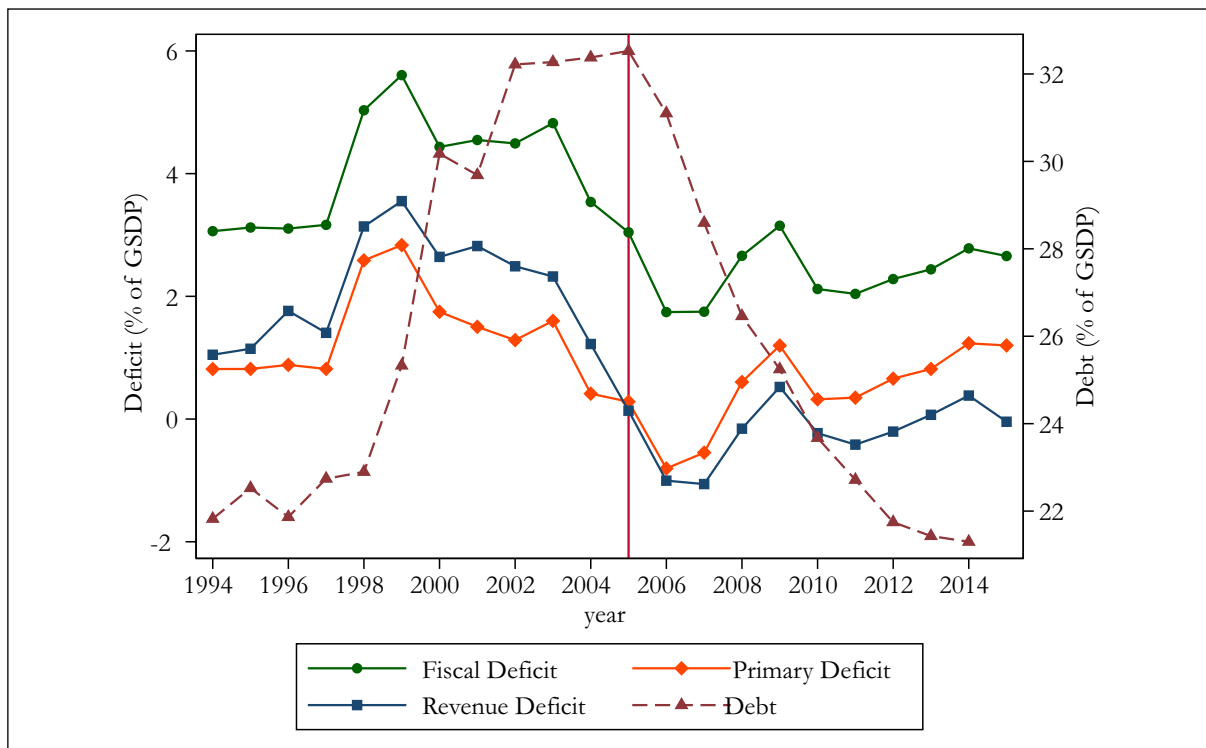
I. INTRODUCTION

6.1 The problem of fiscal management is the lure of eternal procrastination. To advance rather than defer the desirable goal of fiscal prudence, India like several other countries, embarked in the mid-2000s on an ambitious project of fiscal consolidation, adopting fiscal rules aimed at curbing fiscal deficits. The most well-known and best-studied part of this project was the Fiscal Responsibility and Budget Management (FRBM) Act, adopted by the centre in 2003. This Act was mirrored by Fiscal Responsibility Legislation (FRL) adopted in the states, laws that were no less important than the FRBM, since

states account for roughly half the general government deficit. Other work has shown that states' fiscal position improved after 2005 and that some of this improvement can be attributed to the FRL (see Topalova and Simone, 2009, Chakraborty and Dash 2013). This chapter extends this analysis using more recent and novel data on state finances, budgeting procedures and off-budget expenditure.

6.2 At first blush, the FRL seem enormously successful. The financial position of the states improved considerably after 2005, based on any measure (Figure 1). The average revenue deficit was entirely eliminated, while the average fiscal deficit

Figure 1. Trend in Deficits, Debt 1994-2014



was curbed to less than 3 percent of GSDP, just as the FRL had mandated. The average debt to GSDP ratio accordingly fell by 10 percentage points to a mere 22 percent of GSDP in 2013.

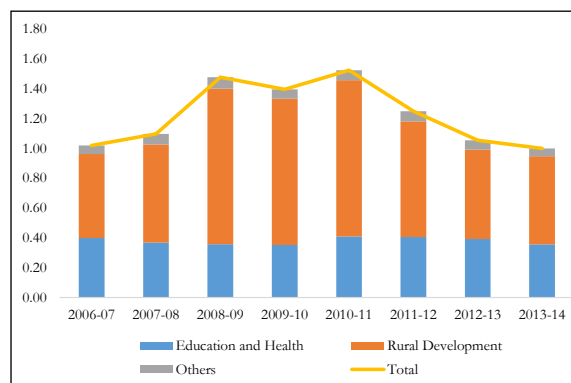
6.3 Yet just because fiscal progress followed the introduction of the FRL doesn't mean the FRLs were *responsible* for this progress. To begin with, the deficit reduction owes much to favorable exogenous factors:

- An acceleration of nominal GDP growth (of 6 percentage points on average) helped boost states' revenues by about 1 percent of GSDP;
- Increased transfers from the centre of about 1 percent of GSDP both because of the 13th Finance Commission recommendations and the surge in central government revenues;
- Reduced interest payments of about 0.9 percent of GSDP on account of the debt restructuring package offered by

the centre; and

- Reduced need for spending by the states—estimated at about 1.2 percent of GDP—as the centre took on a number of major social sector expenditures under the Centrally Sponsored Schemes (CSS) (see Figure 2). From the states' perspective, this amounted to off-budget spending.

Figure 2. Centre's Contribution to Centrally Sponsored Schemes (CSS) (as % of GDP)



6.4 Accordingly, two questions arise, which this chapter attempts to address:

- To what extent did the FRL really make a difference – and in what ways?
- What are the lessons for future fiscal rules?

II. SUMMARY OF THE FISCAL RESPONSIBILITY LEGISLATION

6.5 The FRL aimed to impose fiscal discipline through a number of mechanisms:

- Fiscal targets were established, which were the same for all states: the overall deficit was not allowed to exceed 3 percent of GSDP at any point, while the revenue deficit was to be eliminated by 2008/9 (later extended to 2009/10).
- The 12th Finance Commission allowed states to borrow directly from the market, in the hope that investors would also exercise some discipline, by pushing up interest rates on states whose fiscal position had not improved.
- Finally, broad public discipline was enhanced by introducing new reporting requirements. States were required to publish annual Medium-Term Fiscal Policy reports, which would project deficits over the next three to four years, accounting for growth in big ticket expenditure items like pension liabilities.

6.6 The fiscal deficit target was relaxed temporarily to 3.5 percent of GSDP in 2008/9 and to 4 percent of GSDP in 2009/10 in light of the global financial crisis (RBI, 2010). By FY 2010, the targets were set to the original FRL level of 3 percent. Subsequently, the 14th Finance Commission (FFC) recommended that fiscal deficit limits were to be relaxed by 0.5 percentage points for states which meet three conditions: (1) zero revenue deficit in the previous year; (2) debt to GSDP ratio lower than 25 percent; and (3) interest payments to GSDP ratio less than 10 percent of GSDP.

III. ASSESSMENT METHODOLOGY

6.7 One reason why figures on fiscal progress since 2005 give a misleading impression of the impact of the FRL is that not all states adopted FRL in that year. For example, five early adopters – Karnataka, Kerala, Uttar Pradesh, Punjab and Tamil Nadu -- enacted their legislation even before the central government did so in 2003. Many others adopted FRLs in 2005/6, while in a few states legislation did not fall into place until 2010 (Figure 3).

6.8 During this period, many other developments occurred that had a profound impact on fiscal positions (Figure 4). States adopted value added taxes (VAT), the 6th Pay Commission wage awards were granted, the 12th and 13th Finance Commissions made substantive changes to central government transfers to states. This was also a period of high nominal GDP growth, which averaged 15.8 percent between 2005 and 2010. So a second challenge is to distinguish the impact of the FRL in imposing fiscal discipline from the impact of these concurrent policy changes and macro-economic trends.

6.9 To deal with these issues, the assessment takes the following approach. We calculate using “FRL time”, based on the number of years before or after the particular FRL was adopted. For example, Kerala passed their FRL in 2003 while Haryana adopted theirs in 2005. So year 1 following the FRL is 2004 for Kerala and 2006 for Haryana. This methodology has the advantage that it allows one to answer questions about the first-year and longer-term impacts of adopting an FRL.

6.10 Using FRL time has a second advantage, in that it helps isolate the impact of FRL from other factors affecting fiscal deficits, such as the 6th Pay Commission. This isolation is not complete, of course, but neither is it negligible. For example,

Figure 3. Fiscal Responsibility Legislation by States

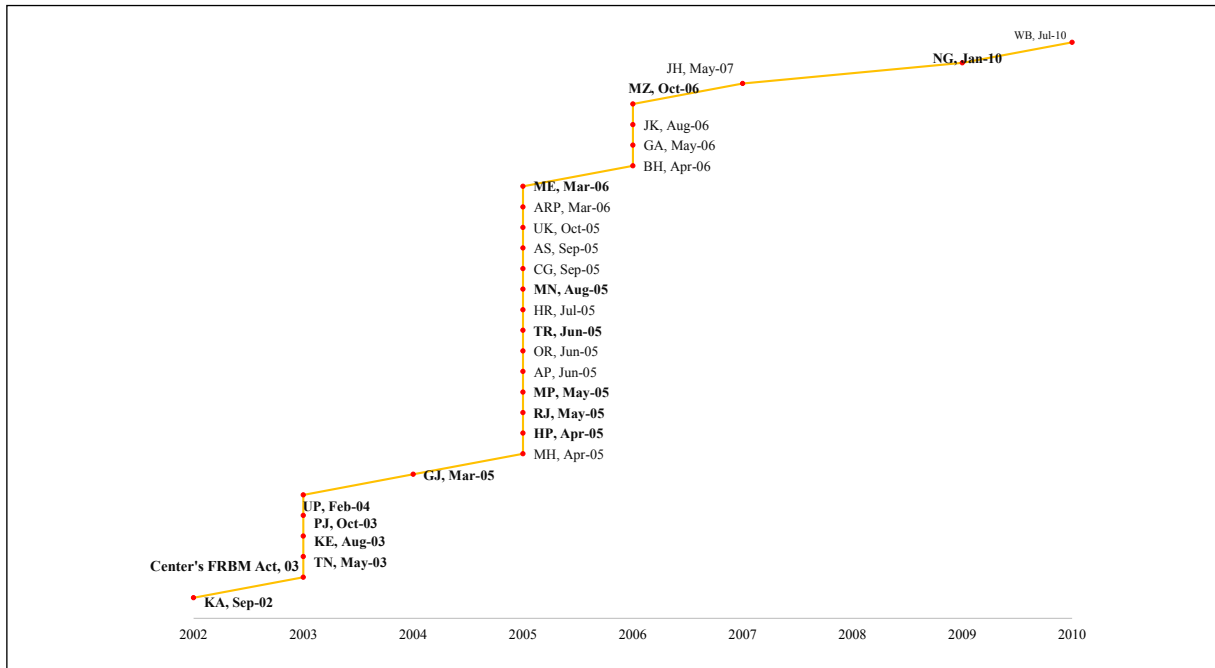
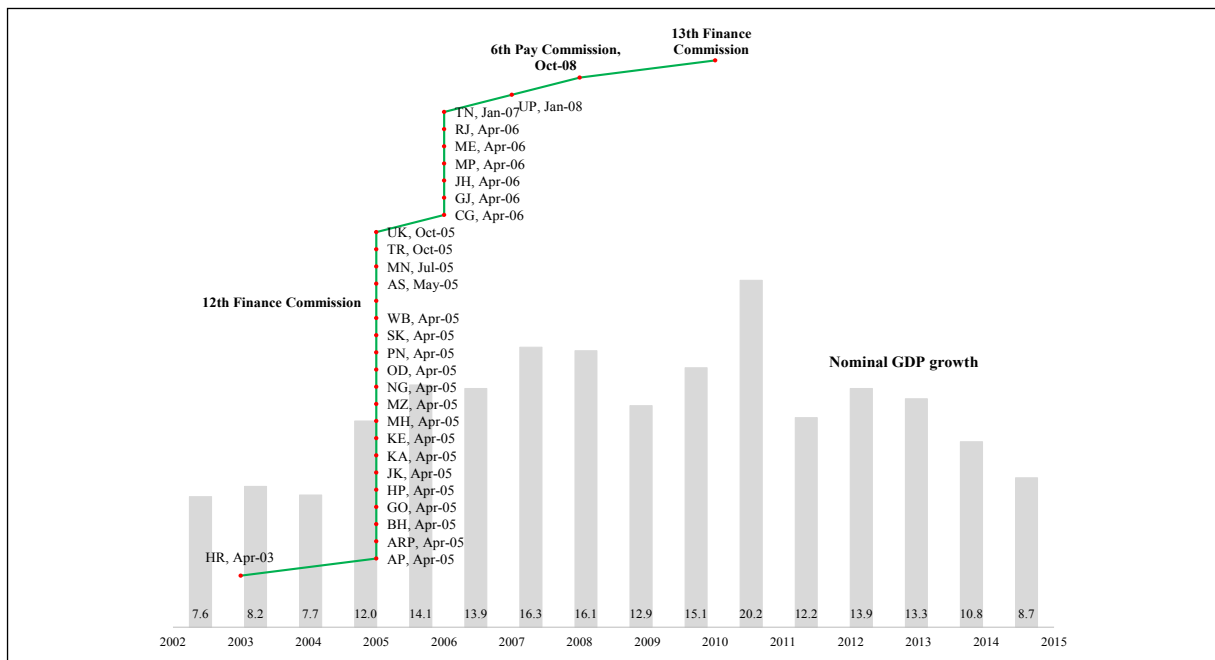


Figure 4. State-wise Adoption of Value Added Tax and Other Major Fiscal Events 2002-2015



Haryana's year 1 deficit (in 2006) includes the effect of VAT adoption, upward trend in GSDP growth and central transfers while Kerala's (in 2004) does not. So an average across all states in FRL time reduces the role of external factors, compared to averages based on calendar time, particularly if the

factors apply to specific years (such as pay awards). The regression analysis (Appendix Tables 1 & 2), we account for some of these major external factors more rigorously.

6.11 There is one factor that cannot be isolated, however. As an incentive for states to adopt fiscal rules and to enable

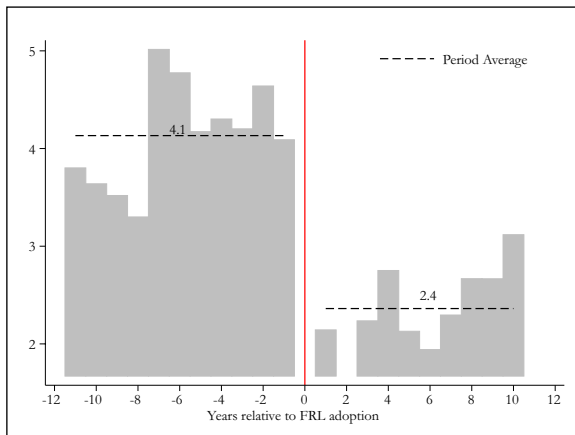
them to achieve these fiscal targets, the central government provided a conditional debt restructuring window, the Debt Consolidation and Restructuring Facility (DCRF). So states could substantially lower their interest payments in the same year that they adopted the FRL. The change in deficits and other fiscal indicators in FRL time should consequently be seen as a result of both the FRL targets as well as the debt restructuring facility.¹

IV. IMPACT ON DEFICITS

6.12 The first thing to note is that states essentially achieved the fiscal targets right away, years in advance of the target year of FY 2008 (extended to 2009/10 due to the financial crisis). Within the first two years, states on average lowered their deficits to target levels -- 3 percent for fiscal deficit and 0 for revenue deficits – while the primary balance shifted into surplus (Figures 5-6).

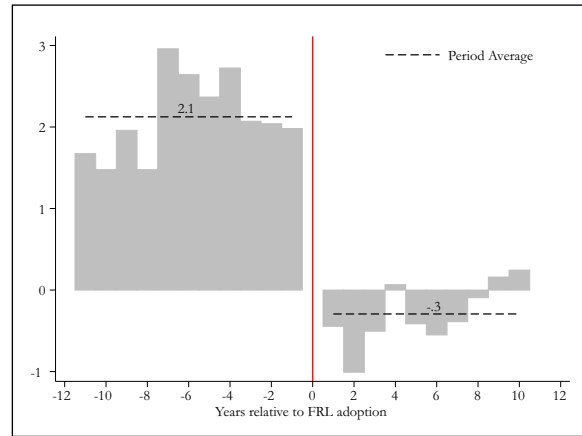
6.13 Moreover, this progress has proved reasonably durable. Comparing the 11 years before FRL to the 10 years afterwards (the period for which we have a balanced sample of states), fiscal deficits fell by almost half – from an average of 4.1 percent of GSDP on average to 2.4 percent of GSDP. Revenue deficits also fell sharply from 2.1 percent of

Figure 5. Fiscal Deficit (% of GSDP)



¹ One exception: the early adopters like Karnataka and Kerala did not receive this facility concurrently with adoption of the FRL.

Figure 6. Revenue Deficit (% of GSDP)



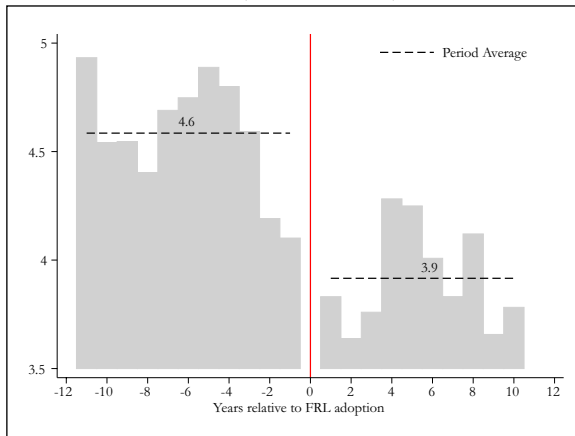
GSDP on average to -0.3 percent of GSDP after the FRL.

6.14 These reductions in deficits mask considerable variation across states. Appendix Figure 7 and 8 show the state-wise change in fiscal and revenue deficits between the 3 years before and the 3 years after the FRL. The largest reductions in fiscal deficits came from states like Orissa, Punjab, Madhya Pradesh and Maharashtra which lowered their deficit by more than 3 percentage points. These states also showed some of the largest reductions in revenue deficit.

6.15 Another indication that the FRL had a significant impact is that states kept a tight rein on wage and salary expenditure (Figure 7). Instead, they expanded more discretionary spending, which would be easier to scale back if needed to achieve the deficit targets (see Appendix Figure 5).

6.16 At the same time, the path of primary deficits hints at an underlying problem (Figure 8). A decade into the FRL, the average primary deficit was just as large as it was before the law – and the only reason this slippage hadn’t shown up in the other deficit figures was that interest payments had fallen sharply, in large part due to the centre’s debt relief.

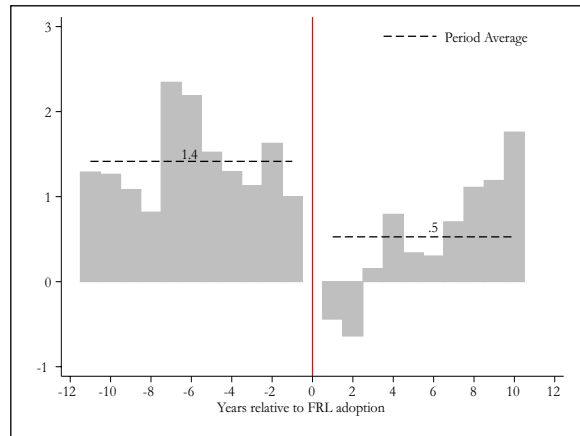
Figure 7. Wage and Salary Expenditure (% of GSDP)



6.17 One can see further indications that external factors played a large role if we break down the improvement into its constituent components. Figure 9 shows the average change in fiscal, primary and revenue deficit of states as a share of GSDP, comparing the average of the 10 years following the FRL and the 11 years prior. The figure reveals that:

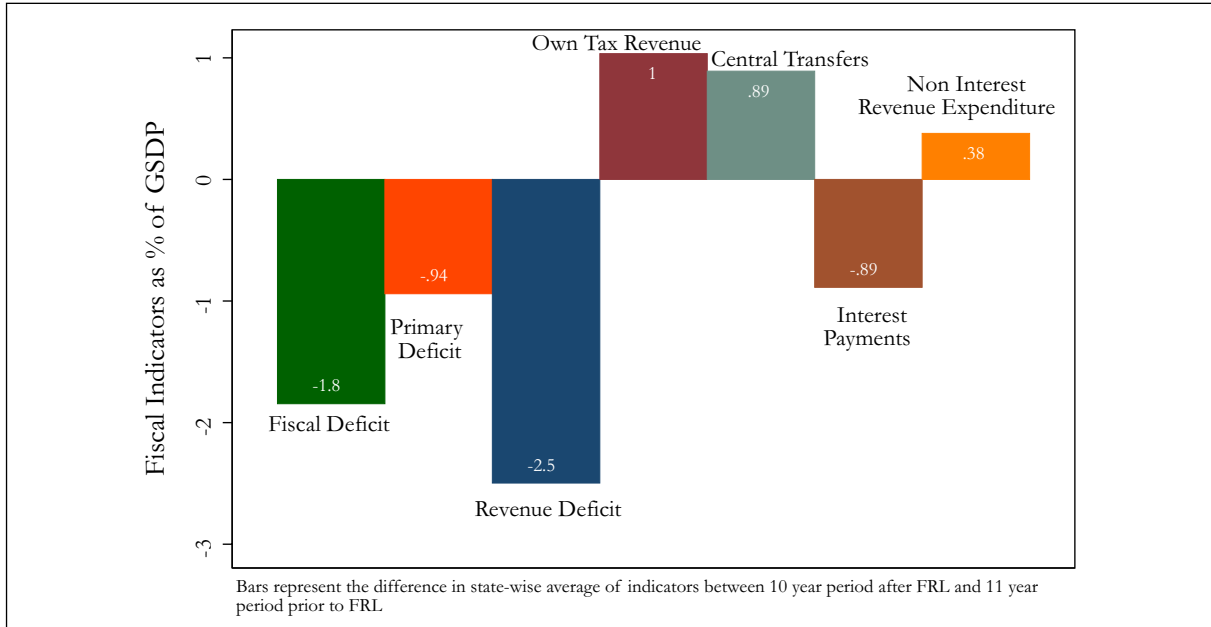
- Central transfers as a percent of GSDP increase by 0.9 percentage points over this time period. This is more than half of the reduction in the fiscal deficit and about half the change in revenue deficit.
- Own tax revenues as a percent of GSDP increase by 1 percentage point, largely due to high GDP growth and adoption of VAT.
- Interest payments as a percent of GSDP fell by 0.9 percentage points, owing to debt restructuring.
- Non-interest revenue expenditure shows a modest increase of 0.4 percentage points, suggesting that states used the revenue gains to bring down deficits rather than ramping up spending. This is despite the fact that the post-FRL period includes the Global Financial Crisis of 2008/09.

Figure 8. Primary Deficit (% of GSDP)



6.18 The appendix, presents the pre- and post-FRL trends of these various sub-components of state revenue and expenditure, such as revenue receipts, own tax revenue, central transfers, capital expenditure and others (Appendix Figures 1 – 6). These figures show a sharp change in the trend of revenues coinciding with the FRL. Revenue receipts increase from about 12.3 percent of GSDP on average prior to the FRL to 14.2 percent of GSDP post-FRL (Appendix Figure 1). Much of this increase comes from a similarly sharp change in own tax revenue (Appendix Figure 2) and central transfers (Appendix Figure 3). Expenditure on the other hand does not show a corresponding increase (Appendix Figure 5). Only capital expenditure rises sharply after the introduction of the FRL (Appendix Figure 6).

6.19 An even stronger impact from exogenous factors can be seen in our regression results, which are in line with other studies that have examined the FRL (see Chakraborty and Dash, 2013 and Simone and Topalova, 2007). Table 1 shows the change in fiscal indicators in intervals of three years after the FRL relative to their levels prior to the FRL, accounting for GSDP growth, state and time specific shocks and whether the VAT was in place. The table reveals:

Figure 9. Decomposition of Change in Deficits before and after FRL

- there was a statistically significant 0.86 percentage point decrease in revenue deficit that can be attributed to the FRL in the first two years (column (1)).
- Similarly, there is a 0.7 percentage point decrease in the fiscal deficit in the first two years (column (2)).
- The primary deficit does not exhibit a significant decrease even in the first two years and in fact rises in later years (column(3)). This is consistent with the hypothesis that the major decreases in the fiscal deficit came from the reduction in interest payment – which as column (8) suggest decreased significantly in the first two years by 0.3 percentage points.

6.20 A second specification, also controls for the increase in central transfers. Appendix Table 1 excluded this as a control, since central transfers might have increased both revenue and expenditure and therefore might have had no effect on deficit. The trends in fiscal, primary and revenue deficit hold even when controlling for the increase in central transfers (see Appendix Table 2, columns (1) – (3)), although the magnitude of change

in revenue deficit attributable to the FRL is slightly smaller. There is no evidence of a significant increase in expenditure.

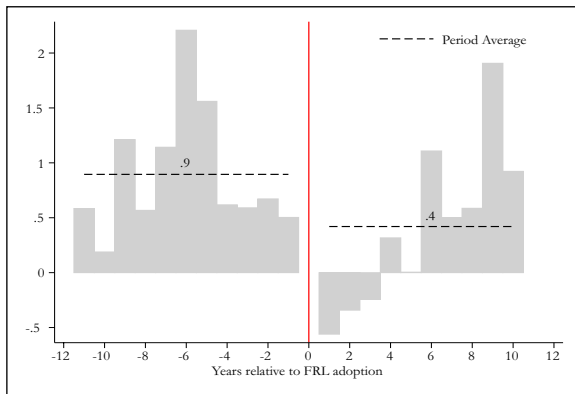
V. OFF-BUDGET EXPENDITURE

6.21 A crucial concern with any fiscal rule is that it would encourage governments to shift spending off budget. By their very nature, these off-budget items are difficult to measure since the instruments may vary by state, are difficult to quantify and are not centrally compiled and accounted. These expenditure channels undermine the power of fiscal rules.

6.22 Here the change in two indicators of off-budget expenditure for which there is data are examined: explicit guarantees by state government and borrowing by state PSUs. The results are encouraging. Prior to the FRL states added guarantees worth on average 0.9 percent of GSDP each year (Figure 10). But in the first three years after FRL adoption the flow of explicit guarantees actually turned negative, meaning that states actually reduced the stock of guarantees outstanding as they allowed old ones to

expire without giving commensurate new ones.

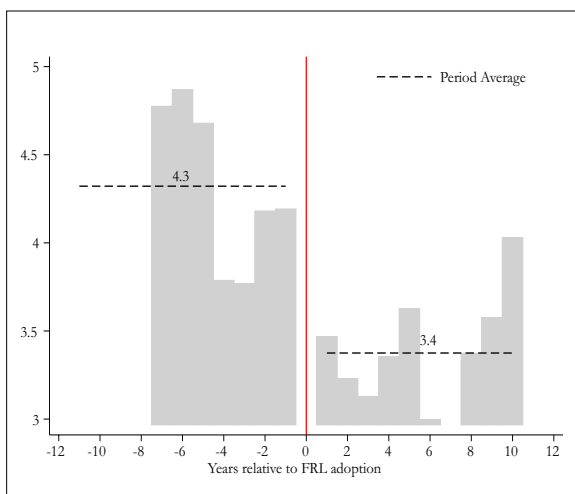
Figure 10. Flow of Guarantees (% of GSDP)



6.23 That said, once again there were signs of decay: after three years, states began to add guarantees, at about the same pace as before. It is therefore encouraging that FFC recommended the notion of “extended debt”, which includes guarantees to public sector enterprises.

6.24 Borrowing by state utilities also fell after the FRL from 4.3 percent of GSDP to 3.4 percent of GSDP (Figure 11). This was particularly encouraging, since the centre had negotiated a major debt restructuring agreement in 2002/03 amounting to Rs. 28,984 crores, which restored state utilities’ financial capacity to borrow.

Figure 11. Utilities Loans (% of GSDP)



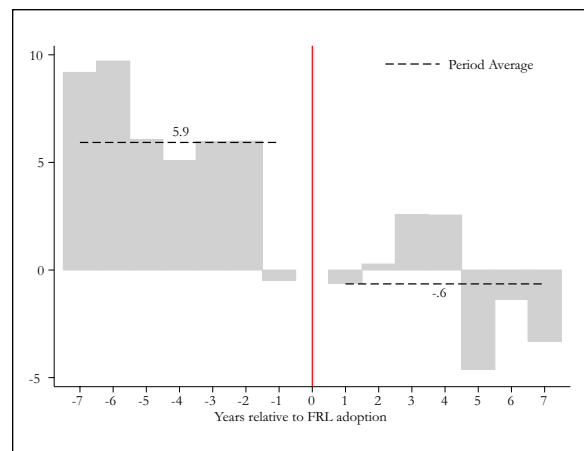
6.25 The caveat remains that these measures do not provide a complete picture as spending may have shifted to other unobserved channels – borrowing by other state PSUs, public private partnerships etc.

VI. BUDGET PROCESS

6.26 Another area of positive impact was on the states’ budgeting process. If states were truly committed to their FRL, we would expect that they would try to generate accurate forecasts of revenues and expenditures, so they would not be forced to make large spending adjustments at the end of the year to meet their deficit targets. This did in fact happen.

6.27 Figure 12 compares the difference between budget estimates and actuals as a proportion of actuals before and after the FRL. In the pre-period budget estimates of own tax revenue are on average 5.9 percent higher than actual own tax revenue. This means that states were on average very optimistic when preparing their budgets.

Figure 12. Percent Difference between BE and Actual Own Tax Revenue

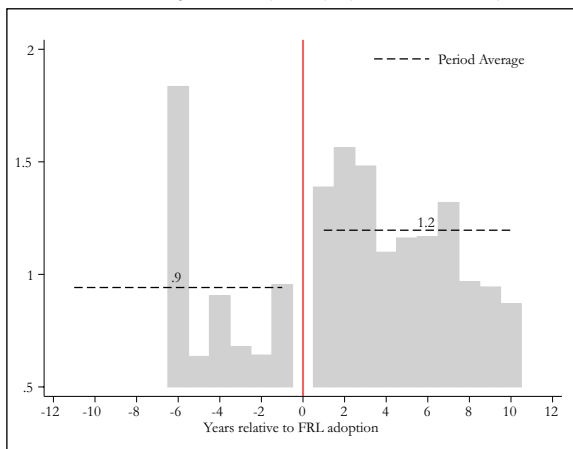


6.28 After the FRL, there is sharp drop in the magnitude of the revenue forecast errors. Strikingly, the errors actually turn negative, which means the budget projections are pessimistic – budget forecasts of own tax

revenue, for example, are on average 0.6 percent lower than the actuals after the FRL. The same caution is seen in estimates of expenditure. These are all encouraging signs that FRL actually made a difference to the way states approached their budgets.

6.29 Another sign of increasing caution is the rise in state cash balances. As states have become increasingly dependent on central transfers, which can be delayed or arrive in lumpy amounts far exceeding the immediate requirements, they have tried to smooth their expenditures by holding large cash balances. Holding of intermediate treasury bills (ITBs) have accordingly increased from 0.9 percent of GSDP to 1.3 percent of GSDP between 6 years before and 10 years after the FRL (Figure 13). On the other hand, this trend is also consistent with a mechanical decrease in expenditure by states resulting from the increases direct expenditure by the Centre through the CSS. Unspent funds are converted to ITBs. One could view this sudden increase in cash balances as a sign of poor fiscal management. States could be making use of their cash balances first before taking on additional borrowing.

Figure 13. Outstanding in Intermediate Treasury Bills (ITB) (% of GSDP)



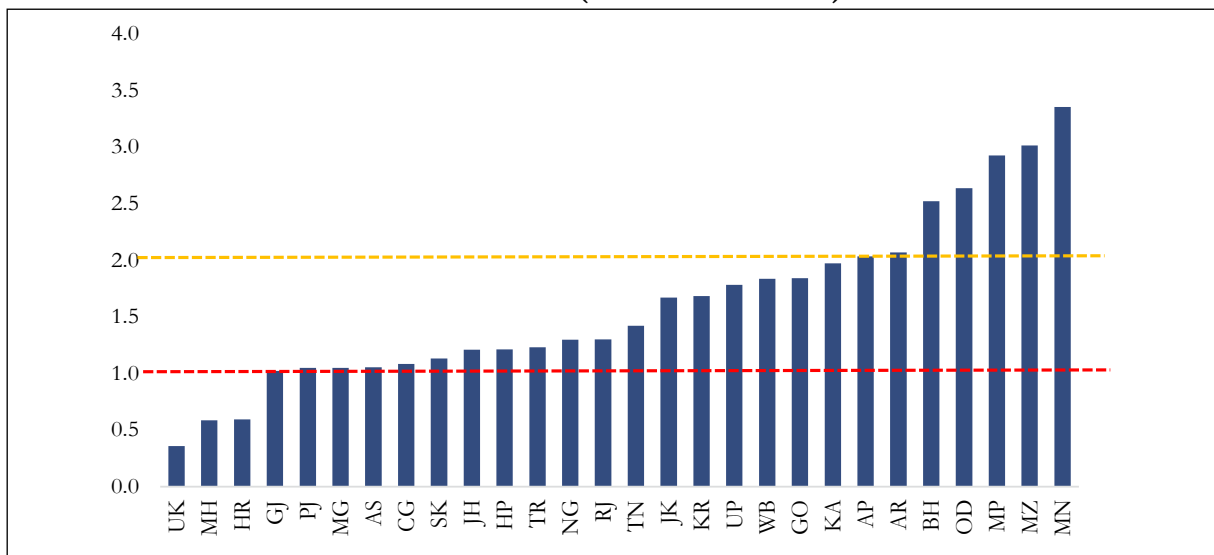
VII. ASSESSMENT

6.30 Turn now to the questions posed at the outset. To answer the first question, FRLs clearly made an important difference, both in terms of outcomes and behaviour. States kept their average fiscal deficit at 2.4 percent of GSDP in the 10 years after the FRL, well below the prescribed ceiling of 3 percent of GSDP. And there was also a striking change in behaviour: budget forecasting procedures improved, and there was a more cautious approach to guarantees, a build-up of cash balances, and a reduction in debt.

6.31 That said, much of the improvement in financial positions was possible because of exogenous factors, most notably assistance from the centre in the form of increased revenue transfers, the assumption of state debt, and the introduction of centrally sponsored schemes. As a result, the contribution of the FRL may really have been much more subtle than the headline deficit numbers suggests. Rather than encouraging states to tighten their belts, the role of the FRL may really have been to prevent them from spending all of their windfall.

6.32 In addition, the uniqueness or one-off character of the FRL experience is suggested by the relatively quick “decay.” That is, a few years after the FRL, all indicators of fiscal performance—deficits, expenditures, and especially off-budget activities—started deteriorating. It is possible that the Centre has also prevented this deterioration by exercising Article 293 (3) of the Constitution. Under this clause, States must take consent of the Centre for additional borrowing since they all had borrowing outstanding throughout the post-FRL period (Figure 14).

Figure 14. States' Outstanding Loans from Centre as on March 2014 (Percent of GSDP)

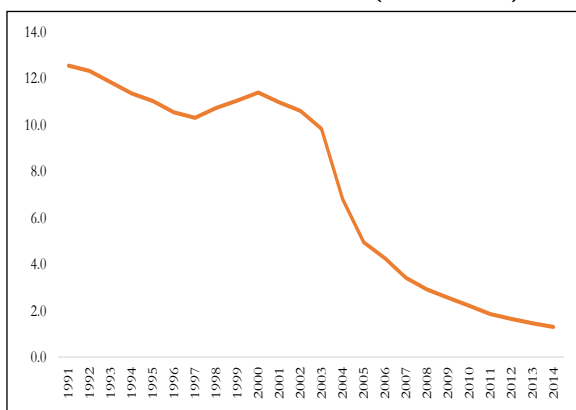


VIII. LESSONS FOR FUTURE FISCAL RULES

6.33 As the fiscal challenges mount for the states going forward because of the Pay Commission recommendations, slowing growth, and mounting payments from the UDAY bonds, there is need to review how fiscal performance can be kept on track. There may need to be greater reliance on incentivizing good fiscal performance not least because states are gradually repaying their obligations to the centre, removing its ability to impose a hard budget constraint on them (Figure 15).

6.34 The Fourteenth Finance Commission (FFC) attempted to shift toward incentives

Figure 15. States' Outstanding loans from Centre as on 31st March (% of GDP)



by relaxing some of the FRL limits for better-performing states. But there was an element of tension in its recommendations. On the one hand, the relaxation itself was an incentivizing mechanism; on the other, the Commission abolished entirely the other more broad-based incentive mechanism deployed by the Thirteenth Finance Commission (TFC) of allocating resources across states (the so-called “horizontal” criteria) based on states’ own fiscal performance (proxied by own tax revenue collections). This criterion had a weight of 17 percent in the TFC recommendations. There may be considerable merit in going back to such an important incentive mechanism.

6.35 In addition, greater market-based discipline on state government finances is imperative. At present, this is missing, as reflected in the complete lack of correlation between the spread on state government bonds and their debt or deficit positions. Figure 16 shows the average spread between the coupon rate of State Development Loans (SDL) auctioned by the RBI over comparable government securities in a given financial year and the corresponding debt to GSDP ratio of the state in that year (covering all SDLs

auctioned between May 2009-December 2014). If markets rewarded prudent states, one would expect a positive relationship between the coupon rate and debt. Highly indebted states would have to offer a higher yield to make their bonds attractive. Instead, there is a flat relationship between the spread and the indebtedness of states – states are neither rewarded nor penalized for their debt performance (Figure 16). Similarly, there is no relationship between the coupon rate and the fiscal deficit of states (see Figure 17). This owes in part to the manner in which auctions are conducted, which will have to be reviewed if a modicum of discipline is to be introduced into the conduct of state government finances.

6.36 Above all, however, incentivizing good performance by the states will require the centre to be an exemplar of sound fiscal

Figure 16. State Development Loan (SDL) Spread and Outstanding Debt of States

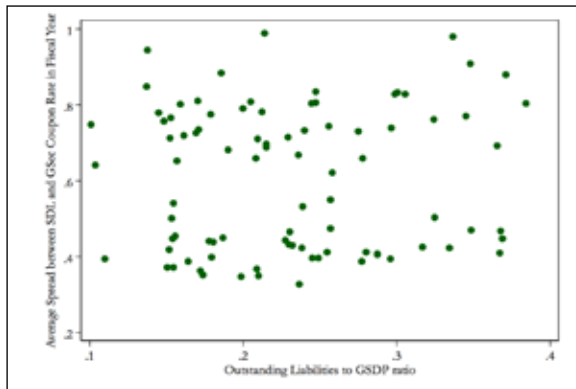
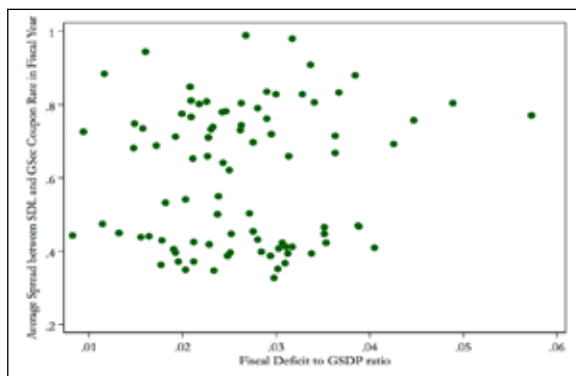


Figure 17. State Development Loans (SDL) Spread and Fiscal Deficit to GSDP Ratio



management itself. The chequered fiscal history of India of the last 15 years has been a saga of fiscal prudence on the part of the states and fiscal profligacy by the center (until the last two years). States have alleged that the centre has not only been imprudent but at the same time been the instrument of forcing prudence upon the states. This chapter suggests that that saga of state prudence has been over-stated but the underlying asymmetry has some intrinsic truth. That is why the path of fiscal prudence embarked upon by this government is critical: in itself but also as a model for the states.

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Figure 1. Revenue Receipts (% of GSDP)

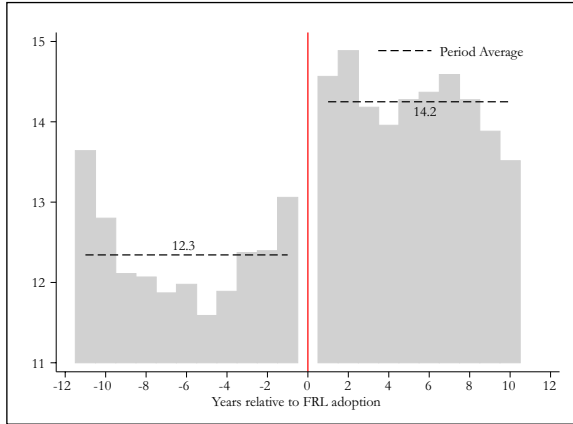


Figure 2. Own Tax Revenue (% of GSDP)

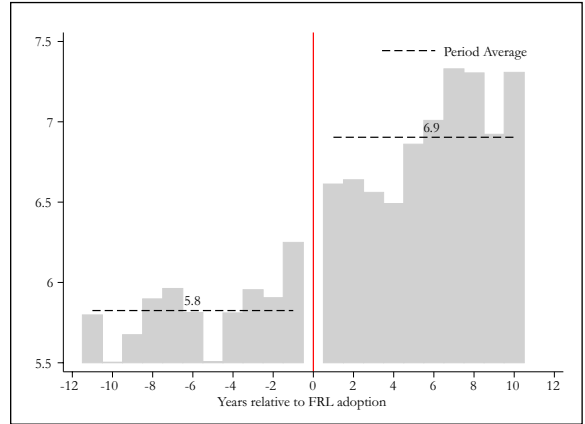


Figure 3. Central Transfers (% of GSDP)

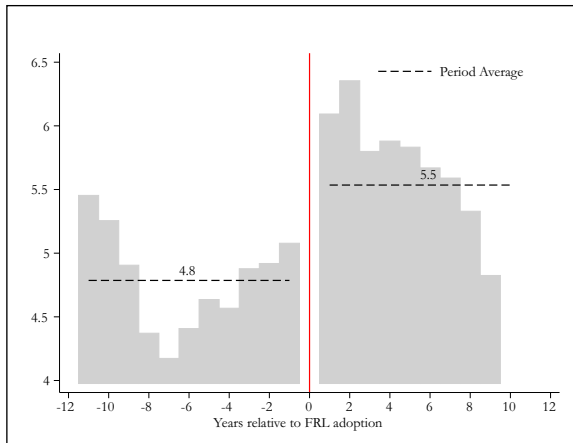


Figure 4. Interest Payments (% of GSDP)

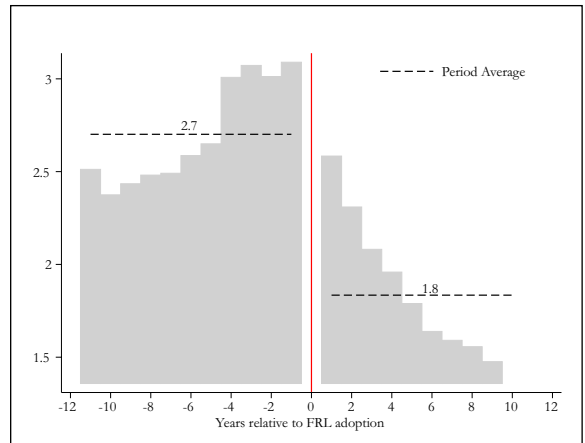


Figure 5. Non Interest Revenue Expenditure (% of GSDP)

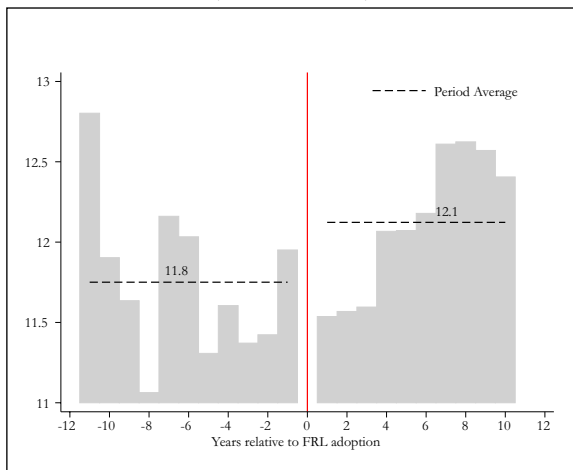


Figure 6. Capital Expenditure (% of GSDP)

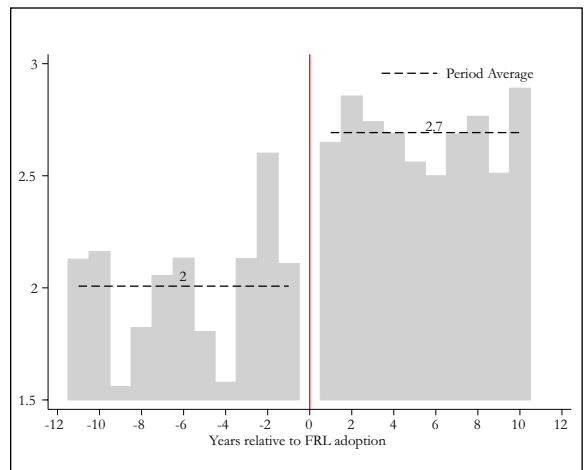


Figure 7. Change in Fiscal Deficit to GSDP Ratio (3 years prior vs 3 years post)

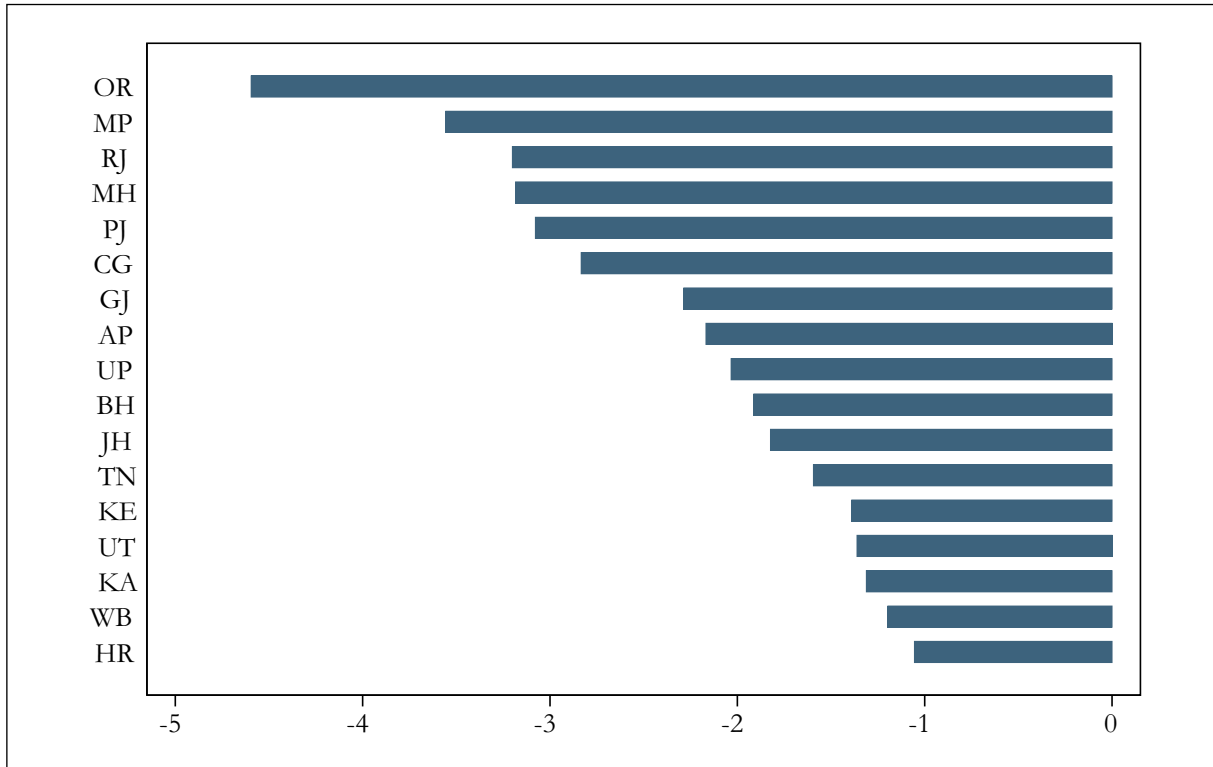


Figure 8. Change in Revenue Deficit to GSDP Ratio (3 years prior vs 3 years post)

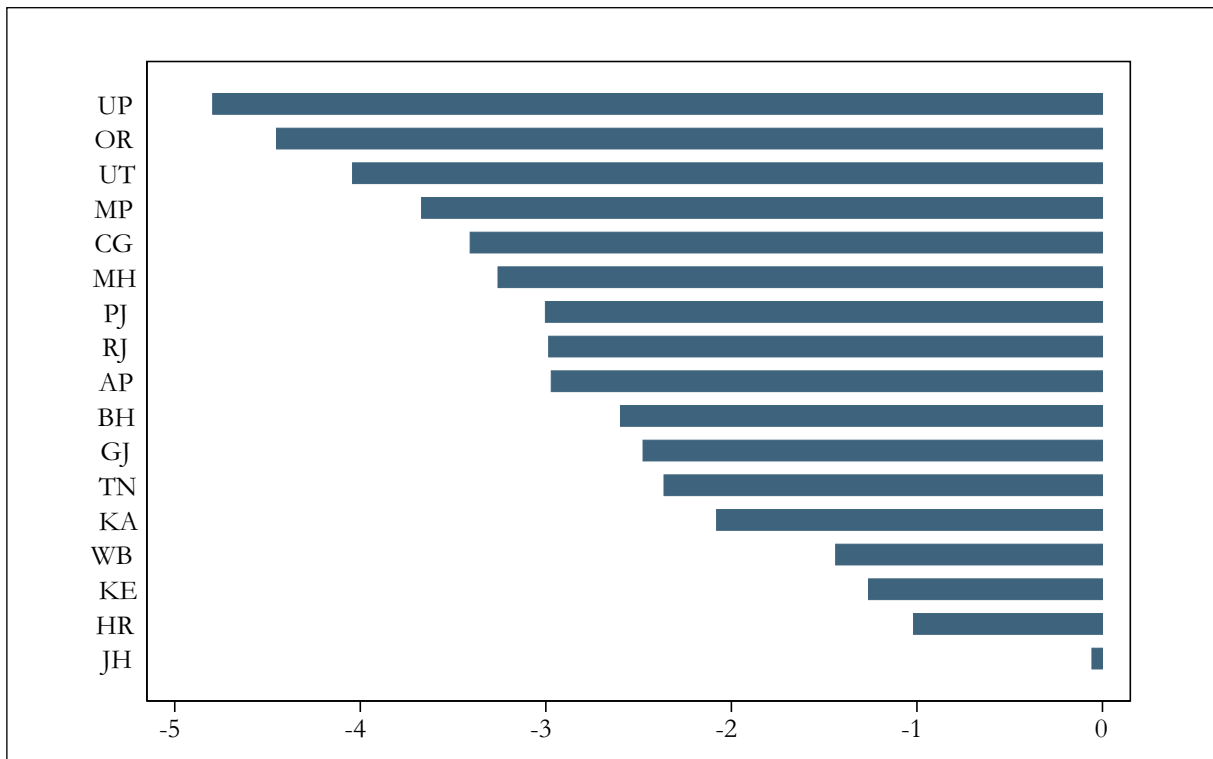


Table 1. Effect of FRL on State Finances

	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue	Own Tax Revenue	Revenue Expenditure	Capital Expenditure	Interest Payments	Non Interest Revenue Expenditure	Flow of Guarantees
0 to 2	-0.0086** [0.0038]	-0.0068*** [0.0023]	-0.0041 [0.0032]	0.0105*** [0.0031]	0.0044*** [0.0013]	0.0019 [0.0047]	0.0015 [0.0051]	-0.0032** [0.0011]	0.0046 [0.0042]	-0.0082 [0.0083]
3 to 5	-0.0082 [0.0097]	-0.0019 [0.0055]	0.0033 [0.0049]	0.0087 [0.0050]	0.0068** [0.0027]	0.0005 [0.0078]	0.0048 [0.0081]	-0.0060*** [0.0017]	0.0057 [0.0065]	-0.007 [0.0082]
6 to 8	-0.0089 [0.0130]	0.0017 [0.0060]	0.0092* [0.0045]	0.0078 [0.0072]	0.0085* [0.0044]	-0.0011 [0.0091]	0.0083 [0.0105]	-0.0086** [0.0034]	0.0064 [0.0069]	0.0026 [0.0064]
9+	-0.006 [0.0163]	0.0005 [0.0104]	0.0088 [0.0073]	-0.0055 [0.0160]	0.0054 [0.0064]	-0.0116 [0.0148]	0.0064 [0.0138]	-0.0099 [0.0062]	-0.0033 [0.0106]	0.0094 [0.0120]
R-squared	0.72	0.6	0.45	0.86	0.87	0.82	0.57	0.8	0.8	0.25
N	278	278	278	278	273	278	278	279	278	245

Standard errors in parentheses, * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$. Controls include state and time fixed effects, dummy for VAT and GSDP growth. Standard errors clustered at state level.

Table 2. Effect of FRL on state finances, controlling for central transfers

	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue	Own Tax Revenue	Revenue Expenditure	Capital Expenditure	Interest Payments	Non Interest Revenue Expenditure	Flow of Guarantees
0 to 2	-0.0071** [0.0032]	-0.0070** [0.0024]	-0.0044 [0.0033]	0.0071 [0.0041]	0.0038** [0.0017]	-0.0001 [0.0063]	0.0004 [0.0047]	-0.0026* [0.0015]	0.0025 [0.0057]	-0.0086 [0.0083]
3 to 5	-0.0092 [0.0077]	-0.0025 [0.0050]	0.0024 [0.0046]	0.0126* [0.0060]	0.0075** [0.0028]	0.0034 [0.0115]	0.0059 [0.0068]	-0.0049** [0.0020]	0.0083 [0.0101]	-0.0087 [0.0095]
6 to 8	-0.0111 [0.0104]	-0.0001 [0.0058]	0.007 [0.0044]	0.0153** [0.0055]	0.0100** [0.0038]	0.0041 [0.0135]	0.0102 [0.0084]	-0.0071* [0.0038]	0.0113 [0.0108]	0.0128 [0.0103]
9+	-0.0084 [0.0131]	0.0036 [0.0080]	0.0103* [0.0055]	0.0065 [0.0092]	0.0071 [0.0053]	-0.0019 [0.0165]	0.0113 [0.0109]	-0.0067 [0.0059]	0.0048 [0.0114]	0.0341** [0.0144]
R-squared	0.75	0.64	0.5	0.94	0.88	0.86	0.62	0.82	0.85	0.29
N	273	273	273	273	273	273	273	273	273	219

Standard errors in parentheses, * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$. Controls include state and time fixed effects, dummy for VAT, central transfers and GSDP growth. Standard errors clustered at state level.