

Reforming State Finances: An Agenda

Tapas K. Sen^{1,2}

1. INTRODUCTION

Problems with State finances in India reached their peak at the turn of the century (1999-2000) with their gross fiscal deficit (FD) reaching 4.7 per cent of the Gross Domestic Product (GDP). The factors underlying the progressively worsening fiscal position of the States and various facets of the issue have been discussed in several places [see, for example, Rao (2002), Fardoust and Lahiri (2003), Ahluwalia (2000) and Sen (2000)]. There was some improvement in the next three years – going by the combined FD of the states (4.4, 4.2 and 4.1 per cent) – only to show deterioration again in 2003-04. According to the revised estimates for the year, the FD had risen beyond the 1999-2000 level of 4.7 per cent to 5.1 per cent. Budget estimates for 2004-05 peg the combined FD at a lower level of 3.6 per cent, but these estimates of deficits have a tendency of growing substantially by the time revised estimates are available.

A complementary indicator reflecting the cumulative fiscal deficits is the outstanding debt (or liabilities) of the State governments. This has been continuously rising as a proportion of GDP since 1996-97, when it stood at 17.75 per cent (Table 1). By the end of 2003-04, it had reached the level of 29.24 per cent.³ If we compare this level with the level that obtained in 1990-91 (19.03 per cent), the threat to the sustainability of State finances in general in India becomes clearer.

There are, of course, large inter-State variations in these indicators. Table 2 clearly shows that, among the non-special category States, the fiscal situations of Orissa and Bihar are clearly the worst, while Haryana and Tamil Nadu are the least fiscally stressed States. A study of the variations can be instructive, and we take it up in the next section. Section 3 examines the revenue receipts while section 4 discusses issues related to public expenditure and its management. Section 5 summarizes the fiscal trends in the special category States and highlights some broad issues. Section 6 provides a brief summary of the identified issues in Center-State financial relations in India. After a brief discussion of State-local issues in section 7, the subsequent sections discuss some of the central initiatives to encourage State-level reforms, and ways of financing reforms. Section 10 concludes.

2. DOES DISAGGREGATION TELL US SOMETHING?

Plotting the data in Table 2, some patterns are discernible that possibly indicate towards a broad direction of reform. In Figure 1, States are arranged in descending order of their per capita GSDP along the horizontal axis, and their FD/GSDP ratios are plotted along with debt/GSDP ratios. The inverse relationship between per capita GSDP and the fiscal stress indicators are immediately noticeable⁴, at least at the lower end of per capita GSDP. The negative and statistically significant rank correlation between deficits and debt with per capita GSDP also confirm the inverse relationship. This could hardly be a coincidence. Nor is it likely that the explanation lies in the efficiency in fiscal management, since such an explanation raises another question: why would the low-income States be particularly inefficient in managing their public finances? A more likely explanation lies in systemic factors that result in such an outcome.

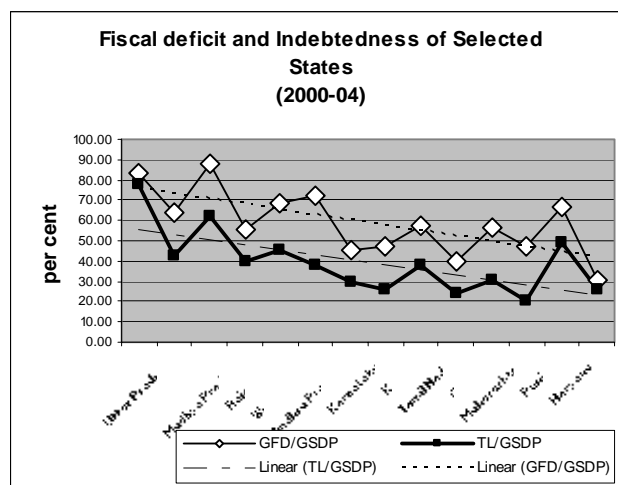
¹ Senior Fellow, National Institute of Public Finance and Policy (NIPFP)

² This report was prepared by consultants for the Asian Development Bank. The views expressed in this report are the views of the authors and do not necessarily reflect the views or policies of the Asian Development Bank (ADB), or its Board of Governors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use.

³ These figures do not include contingent liabilities, which can be substantial. Thorat and Roy (2004) show that in 1999-2000, the debt-GDP ratio of 21.5 per cent jumped up to 26.9 per cent when contingent liabilities were also considered.

⁴ The case of Punjab is clearly an aberration.

Figure 1



GFD: Gross Fiscal Deficit; GSDP: Gross State Domestic Product; TL: Total Liabilities
 Note: The GFD/GSDP percentages have been scaled up by a factor of ten.

In general terms, the basic reason seems to be that the poorer States are also historically late starters in the process of development and have a substantial part of the population that require special attention of the government. Level of human development is also typically low in these States. Coupled with the fact of higher levels of poverty in general, the revenue raising capacity of these States is limited, while for the same reasons, the expenditure needs are high. With higher incomes, public supply of various services can be substituted by private supply to some extent. But with high levels of poverty, that option may not be a feasible one for a large part of the population in the poorer States. This fundamental imbalance is further strengthened by the fact that the socio-economic backwardness results in limitations in the sphere of political economy as well. Thus national policies as a package do not help them to overcome their handicap, although there are always specific elements that do so. The lower efficiency alleged in managing their public finances is possibly only a symptom of the same socio-economic backwardness and resultant lack of appropriate public scrutiny and accountability.

All this, however, is not unique to India. In general, similar factors operate in almost any large federation. Whether these factors are allowed to determine even long-term trends of convergence/divergence depends on the specific features and institutions of the federal system in operation. This is elaborated later in section 5 of this paper. For the present, the point to be noted is that all general policy prescriptions must undergo the acid test of whether they are feasible and appropriate for the poorer States and whether they promote the cause of regional equality or not. There may be certain policies appropriate for a subset of States only; such policies need to be explicitly characterized as such, and the implementation mechanism designed accordingly.

In the narrower area of public finance, the poorer States face the dilemma of persistent deficits and consequent high levels of indebtedness if they push hard to raise their developmental performance through public action, or allow the gap between them and other States to widen while maintaining fiscal prudence. Typically, the short time horizon of policymakers coupled with some institutional features including those of planning in India has tilted the choice in favor of the former strategy.

To be sure, it is not true that only the low-income States exhibit signs of severe fiscal stress. Fiscal indicators of Punjab obviously put it in a category of high fiscal stress. But in most of these cases, the causes are State-specific. Thus, the necessary reforms also have to be State-specific. There are certain other problems regarding State finances that can be considered universal; in such cases, the reforms can potentially be applicable to all States. In

what follows, we shall try and tag the suggested reforms into one of the above (three) categories.

Continuing the broad assessment of State finances in India, Tables 3 and 4 examine the recent trends in a little more detail, essentially to see whether special emphasis is needed in a (some) particular area(s) of the States' finances, either in general, or for subsets of states. To begin with, it is necessary to remind ourselves of the basic rules of fiscal prudence: that (a) revenue surpluses need to be generated to finance capital expenditure and (b) borrowing is permissible as a supplementary financing mechanism provided at least the long-term returns are enough to service the loans. In practice, rule (a) did not hold for all the States taken together, or any individual State among the selected ones, except for Goa and NCT of Delhi, two rather atypical States. Among the others, only Haryana had a surplus on an average on the revenue account in the period 1995-2000, but slid into a deficit in the 4-year period of 2000-2004. The implication is that even if all the earlier debt were wiped off today (but not interest dues), the States will start accumulating debt again, and will be back to square one after some time. Clearly, elimination of this trend has to be a major objective of fiscal reform.

Of course, past debt shows up in the revenue accounts via interest payments that are a part of the revenue expenditures. If all debt to States were written off, related interest payments also can be expected to disappear. Does the revenue account balance or generate a surplus in such a hypothetical case? It would, for all States taken together, but not in the case of each of the States individually. West Bengal, Uttar Pradesh, Kerala and Madhya Pradesh would have had a revenue deficit in both the periods even without having to pay interests. In other words, they have a primary revenue deficit in both the periods. Orissa, Tamil Nadu and Haryana had similar deficits in the first period, but have improved their position in the more recent period to primary revenue surpluses, while the reverse holds for Gujarat, Maharashtra and Punjab. Thus, while any step to reduce the interest liability would be useful for all the States, even its total elimination is not enough to generate revenue surpluses in seven States in the more recent period. These States need to adopt an all-out strategy to contain primary revenue deficits, apart from debt management to reduce interest payments. In three States, Haryana, Tamil Nadu and Orissa, some fiscal consolidation has obviously taken place; the relative emphasis has to now shift to reducing interest payments.

For all States as a whole, total revenue receipts as a ratio of GDP rose in the more recent period as compared to the earlier one, but so did revenue expenditures, and a little more than the former. This is also the case in general with the individual States, but the exceptions may be noted along with some general observations on relative emphasis in the reform strategy for some of the States.

In only Haryana and Kerala, revenue receipts show a drop from the first to the second period considered as a ratio of GSDP. Clearly, these two States need to examine this aspect and take corrective measures. In the following section, revenue receipts are examined in greater detail to determine the direction of reform. Apart from these two, West Bengal and Maharashtra also need to pay attention to their low levels of revenue receipts. Their ratios are the two lowest, barring NCT of Delhi.

3. REVENUE RECEIPTS

3.a Reforms in Taxation

Examination of the components of revenue receipts (Table 3) yields further insights into the direction of necessary reforms. The major component is, of course, *own taxes*. Greater efforts in this area are clearly indicated for Bihar, Orissa, Uttar Pradesh and the most obvious case of West Bengal. To begin with the last, the *case of West Bengal is the most glaring one*, since it not only has a very low ratio of own taxes to GSDP, but is also slipping in terms of the same ratio. It has to immediately take measures to boost its tax effort significantly. The trends in the case of Bihar are positive as its tax ratio shows a rise, but even with that the ratio is very low. To a lesser extent, the same holds for Orissa and Uttar Pradesh, although the rise in the ratio

in Orissa is encouraging. In Gujarat, the problem is the relatively milder one of lack of buoyancy.⁵

Issues in taxation are many, but the basic concern is to raise additional resources without adversely affecting economic development. States are more or less like open economies, where changes in taxation policy can have significant effects at the margin. In this sense, the first issue to be resolved was that of *inter-State tax competition* through various tax incentives. This problem is hopefully behind us, at least as far as sales tax – the major vehicle for the tax incentives – is concerned. Also, tax competition through tax rate changes has also been controlled through mutually agreed floor rates. The revenue impact for most States has been positive. The other issue that remains to be resolved is that of Central sales tax, the primary channel of *tax exportation*. This again is very much on the reform agenda and is being actively debated. Alternative schemes for its abolition have been proposed; implementation of a final outcome is awaited. *The most important reform, that of changing the present sales tax to something akin to value added tax (VAT), is already implemented in several States, starting with Haryana.*⁶ The implementation has been announced and postponed a few times, but the majority of the States have now taken the plunge.

Other important taxes, in terms of collections, at the State level include State excise, stamp duties and motor vehicle taxes. *State excise* collections are primarily from alcoholic beverages (particularly country liquor) and are generally believed to be particularly *bedeviled by substantial evasion* despite varying systems adopted by different States. In general, the system combines full control on production, movement and sale on excisable commodities, auction/ rent of liquor vends, and a pure tax. By its very nature, it *requires a high degree of vigilance*; the *scope for collusion* among taxpayers and departmental staff is also large due to substantial payoffs from evasion. This has been exacerbated by the excise policy of various States that have driven out small dealers by bundling together a number of excise circles for sale and/or production permits. Even where this is not the case, renewals are resorted to, with or without enhancement in payments to the government. While this makes the administration of excise easier, it robs the system of a built-in check against the negative fallout of *cartelization and development of vested interest groups*. The other issue relates to *partial or full prohibition*. The only State to have consistently adopted a prohibition policy is Gujarat. Other States have flirted with it, only to abandon it quickly. For most States, experience shows that while the objectives may be laudable, prohibition policy does not work in practice because of the ever-present danger of illicit liquor production and its attendant evils. Excise administration also has to deal with a perpetual dilemma: a high tax regime or a policy of limited outlets carries with it the risk of increased smuggling and illicit liquor supply, while a low tax regime or a liberal licensing policy incurs social displeasure and protest. A possible solution is to adopt a high tax and limited licensing policy for ‘hard’ (high alcohol content) liquor, while using the opposite policy for liquor with low alcohol content.

Motor vehicle tax is relatively simple to administer in that its *enforcement is based on physical verification* for tax payment for on-road vehicles. The system of such verification is well-established in most States. In the area of enforcement, some States have yet not made a choice between mobile checking and permanent checkpoints. While the latter may be necessary at the State borders for various reasons, those States still using internal checkpoints would probably do well to shift to mobile checking completely. The latter has the advantage of surprise, and therefore more effective. One aspect that may need special mention is that of national permits. Issuing national permits is a fully decentralized process, but the permits are usable across the country. This often makes verification of authenticity difficult and encourages forgery. Perhaps a system of uniform and security printed form for national permits can solve this problem. The major innovation in the last several years in this tax was the *one-time taxation* of smaller vehicles. It is now realized that such a system ties up the buoyancy of the tax with new registrations of such vehicles. Next, the usual specific duty was substituted by *ad valorem taxation* to impart some buoyancy to the tax collections.

⁵ Gujarat has had a few unfortunate incidents (earthquake and riots) in the second period that might have contributed to it.

⁶ Haryana introduced its VAT-type sales tax in 2003. Reports suggest that the experience of the first year was revenue positive. However, the case of Haryana may not be a guide to likely immediate outcomes of such reforms in other States, since Haryana (and Punjab) had an atypical sales tax system earlier.

Actually, given the burgeoning vehicle population across the country and the traffic congestion in many urban areas that are becoming more and more serious, some further innovative schemes to tackle this problem, simultaneously raising additional revenues, may be devised.⁷ *Road tolls* have come to be used much more than before, particularly to recover the costs of new roads/bridges. This is perhaps one way of raising resources that cannot be objected to because of the obvious link with the service provided.

Stamp duty is another tax that is ripe for reform, and a blueprint is already available. Like in the case of sales tax, there is an official committee that has made its recommendations. *There are two major aspects of reform in this case, the tax rate and the system of valuation.* Tax rates are generally high, and these are said to cause widespread tax evasion. Thus, the recommendation is to lower rates to more reasonable levels. Second, almost universally, the reported values of transaction heavily under-report the true value of transaction. These can be tackled only through an independent system of valuation that can provide market value benchmarks for the registering authorities. However, a fully satisfactory system for such independent valuation is conspicuous by its absence. One more administrative problem relates to emergence of new type of instruments, or use of an existing type of instrument for purposes that it was not originally meant for. In most cases, these relate to sale of property under various guises, and there is no option for the concerned department but to be constantly on their toes, and regularly amend the relevant provisions to deal with new developments.

The other taxes in the armory of the States have either lower revenue significance or are not being used at all; some of them have become almost extinct in terms of revenue. But this is not as it should be. Take *land revenues* for example. The revenue collections have dwindled into insignificance in all States except West Bengal, where it is other levies and not the land revenue proper that brings in the bulk of the collection. This is partly because of administrative apathy and partly because of the lack of built-in buoyancy in the system. These are not insurmountable problems if one is keen to revive it. A single measure, that of disposing applications to change the type of land from 'agricultural' to 'homestead' quickly, will substantially increase the flow of revenues, since there is a charge attached to such a change. The best bet for raising revenues from this tax may be to transfer it to the local governments along with strict penalties for non-levy or lack of effort. Another possible tax on the agricultural sector, the *agricultural income tax*, has been little used, mainly on account of the political clout of the farmers' lobbies. This has to be levied by the State government, if at all, and at least in the States where plantations form a significant part of the agricultural landscape, it needs to be rejuvenated to yield additional revenues. Some of the States, however, levy *Mandi* (market) fees that garner substantial revenues. One suspects that this form of tax is preferred because the tax gets exported via the purchases of the public procurement agencies at tax-inclusive prices, to be sold eventually outside the State.

Entertainment taxes are another set that has lost its revenue significance. There was a good reason for this in the 'eighties and the early 'nineties, but that is not valid any more. Much of the entertainment tax is collected from cinema tickets; the gate receipt of cinema halls itself had drastically fallen earlier. But the cinema exhibition industry has managed to turn itself around to a considerable extent using new ways of organizing business and technical innovations; unfortunately, both the cinema exhibitors in the majority of cases and the tax authorities refuse to rekindle their interest in this source income that they had lost earlier.

Profession tax has been a steady source of revenue in Maharashtra earlier, though several States did not levy it at all, and those that did had rather low collections. This is one of the few direct taxes in the States' domain, and is very close to a payroll tax. Like in Maharashtra, it is *ideally suited to fund an employment guarantee program*, and can neutralize the all-too-frequent opposition to the introduction of this tax. In the search for higher revenues, several States have introduced this tax in the last five years, often in the face of stiff opposition by potential taxpayers. But in most of these cases, revenue collections have not reached their potential since sections of potential taxpayers are yet to be covered.

⁷ The potential, however, lies more with the local bodies than the State governments. For example, provision of proper parking places can help ease traffic congestion, but these are best provided, with adequate fees, by the local bodies.

3.b Sectoral Issues And Non-tax Revenues

This is probably the most critical area of reform at the State level for several reasons including:

- The performance of any government is judged on the basis of its ability to deliver various services in adequate quantity and of reasonable quality;
- The developmental impact of the government's policies are most important in these areas;
- The performance of these sectors can literally make a difference between life and death for the citizens – specifically the poor – even in the short run;
- There is a desperate need for a clear policy on closure/ privatization/ restructuring of the large number of State public enterprises that were meant to supply public services; and
- From the point of view of State finances, this is the area that has significant untapped potential that can be converted to additional resources.

The ratio of non-tax revenues to GSDP shows a marginal increase from the second half of the nineties to the next four years for all States taken together. It is therefore not surprising that some decline can be noticed in several States individually. Only Andhra Pradesh, Goa, Gujarat, Haryana, Delhi, Punjab, Tamil Nadu and West Bengal have managed to either raise it or at least maintain it at the same level as earlier. However, four cases need special mention. *Bihar, Madhya Pradesh and Rajasthan show significant drops in the ratio*, higher than in any other State. Obviously, there is need in these States to analyze this in greater detail and take corrective action. Kerala also needs to do the same, since its ratio was quite low to begin with and has fallen further in the recent period. In West Bengal, the ratio shows a rise, but only from a very low level to a still low level (the lowest among all the selected individual States). While West Bengal needs to mount an all-out effort to raise revenues from this source too, the case of Maharashtra is a little different. It has reasonably high tax-GSDP ratios, but its revenue receipts are low due to low levels of the other components. Being a relatively high-income State, it is unlikely to receive a significantly higher level of grants or tax devolution. Its additional revenue raising efforts must therefore concentrate on non-tax revenues.

Since many of the issues in this broad area have *highly State-specific aspects*, it is not easy to make general policy recommendations. For example, both Punjab and Orissa at present rely heavily on private provision of passenger transport service. While this has been so in Punjab for a long time, in Orissa this came about mainly through the policy decision to cut off budgetary assistance to the concerned public enterprise and consequent privatization by default. However, the results are very different in these two States, mainly due to the differences among the citizens of these two States to back up their demand for the service with the necessary ability to pay the price.

But that is not to say that there are no lessons to be learnt by anyone from others' experiences. Further, there are some observations that hold true for possibly each of the States, perhaps to varying degrees, but true nonetheless. As the series of empirical estimations of state level subsidies [Rao and Mundle (1992), Srivastava and Sen (1997), Srivastava *et al* (2003)] show, *practically every State is providing a very high level of subsidies even in areas that cannot be termed as "merit goods"*. Reforms in this area need to be two-pronged: the inefficiency costs in providing services need to be brought down and /or the quality of service improved, at the same time effecting better cost recovery through user charges. Also, it is important to *reassess the need for government intervention* in a wide array of services, and consider the option of *decentralization*. For example, there have been experiments in various States on giving autonomy to health/educational institutions along with a freezing of government assistance; this has had positive results. To be sure, rough edges remain in these policies, but these can be smoothed out if given due consideration.

The supply of *infrastructure services* has special importance in this area because of the obvious link with development. Due to poor financial health, States – the low income ones in particular – have found it difficult to invest in infrastructure. Worse, even the existing infrastructure is poorly maintained, often causing new investment resulting from lack of maintenance for an extended period. In some cases, the States have tried to get around the

problem by floating special purpose vehicles with government guarantees. This tendency has given rise to large contingent liabilities, with a high degree of risk that the liabilities will devolve on the concerned governments sooner or later. Many States are also actively exploring the possibilities regarding private investments in infrastructure. Despite some successes, however, a lot more needs to be done to find a happy marriage of financial concerns of the private sector and the social responsibilities of the government. In particular, *there is a need to develop expertise within the State governments to work out schemes that would attract private investment*, while denying them unfair advantages. One area where reforms have been associated with substantial new investments made in recent years (and continue to be made) is *road construction*. These reforms span a wide spectrum. There have been cases of the government making investments itself, but actual construction package being awarded to agencies through global tenders (instead of the usual method of asking the Public Works department, which then employs small contractors for part of the work and carries out the rest itself). In other cases, the government did not make the investment and the contractors have constructed the road under a variety of arrangements, including toll collection for an agreed period of time.

Irrigation is another important component of the infrastructure provided by the State governments that requires large investments, regular maintenance, and a good delivery system that would be able to collect appropriate user charges. Some States are experimenting with *water users' associations*, which may alleviate some of the problems in this sector. However, unless the financial situation in the States looks up and/or adequate cost recovery is effective, it will be difficult to raise the resources for necessary investments. The thin spread of resources is often most noticeable in this area, since a large number of incomplete projects can be observed in most States. *Selection of the 'last mile' type of projects only for funding would be most useful practical strategy in this case*. It should be noted here that irrigation projects often have complementarities with respect to other services like power or water supply; prioritizing within the irrigation sector will obviously need to take the complementarities into account.

Within infrastructure, the most important sector is undoubtedly the *power sector*. A number of reforms in this area have actually been implemented, or are on the anvil. From the point of view of State finances also, this is probably a key area of reform because of the massive liabilities that have accumulated over the years. However, it is difficult to claim any of the reforms undertaken so far as an unqualified success. Fortunately, this issue has drawn attention from several quarters including the GOI (which has implemented its own initiatives through several schemes), and the search for an improved model is an ongoing affair. So far, the key elements of reform have been unbundling generation, transmission and distribution functions (with or without privatization), setting up tariff regulatory commissions and revamping the concerned State Act. Privatization, despite being a desired goal, is proving difficult to achieve in some cases, while in other cases it has given rise to a series of unforeseen problems. Large overdue payments from some States to centrally owned public enterprises that sell power to the State level bodies have further complicated the picture. The reforms have given rise to controversies too, giving impetus to the search for better alternatives. One can only hope that this process of churning will ultimately throw up a useful solution.

In the social services, the three major sectors that have a long term impact are education, health and water supply. In the area of education, the usual recommendation is to focus on primary education. While this is still valid in several States, in some States the next stage of secondary education may also claim attention now. In some States like Kerala, and to a lesser extent, Tamil Nadu and West Bengal, primary education is now more or less universal among children of the relevant age group. Moreover, falling birth rates have changed the age distribution of the population in these States, so that the demand for primary education has stagnated or actually fallen. Hence, secondary education may share the focus in these States. In other States with comparatively low literacy rates, the problem in the primary level is often with high dropout rates and not enrolment. Thus, policy must attack the problems of quality of education (possible response: teacher's training, and better monitoring) and school facilities (possible response: planning for school within a defined maximum distance of each habitation, better school buildings, quality control in mid-day meals and well-designed,

children-friendly textbooks). Some increase in cost recovery at the secondary and higher level of education is also called for; this can be combined with a scheme of greater autonomy for the institutions, particularly in the use of funds for school improvements. A similar strategy has been applied for hospitals in some States, with encouraging results. However, primary health services, particularly in rural areas not contiguous to urban areas and in urban slums are still inadequate in several States. The problem is not so much due to lack of funds as because of apathy and logistics. A reform that may help is to choose health workers from within the communities concerned, train them in basic health services, provide them with a basic health toolkit (including drugs) and work out a referral system for more serious cases. In the case of water supply, which has a strong complementarity with health sector because of the water-borne nature of some of the major causes of morbidity, three issues are important: investment, pricing (for piped water supply) and maintenance. While investments will continue to depend on budgetary allocations (or loans, in the case of non-departmental organizations), these can be reduced through proper maintenance. Maintenance will depend to some extent on cost recovery and/or the administrative mechanism for the purpose. The best bet would be to involve the community itself in maintenance and cost recovery through organizational innovations and/or decentralized governance. Even a nominal charge would be advisable, to drive home the point that water is fast becoming a scarce commodity, especially potable water. Further, investments in feasible metering should pay dividends.

Two special issues that need mention because of their revenue significance for some of the States are royalties on minerals and revenue from forest products. Before the apex court ruling that stopped it in 1984, the levy of cesses on royalties from major minerals used to be a major revenue source for some of the States. It was hoped that regular and adequate revision of royalty rates by the GOI will compensate this loss to some extent. This hope has, however, been belied. If the center is indeed keen on improving the finances of States, particularly the poor ones which also happen to be minerally rich, this is one aspect it can attend to.⁸

In the area of forest products, environmental concerns again prompted the apex court to limit felling of trees for timber, which hit some of the States heavily dependent on this source for revenues rather hard. However, felling was not entirely banned, but only made subject to a plan for adequate regeneration. The concerned States could not initially produce such a plan and thus suffered large revenue losses; but this was gradually taken care of. But the revenue generation is clearly not the same as before, and the concerned States have not really been able to compensate this loss from other sources. The inability to exploit non-timber forest products adequately has also not helped the cause of revenue-raising in these States.

The other two components of revenue receipts constitute the Central transfers to States: grants and shared taxes. Issues relating to these are discussed later in the section dealing with Centre- State finances. Suffice it to say here that grants have shown a rise in every State (except Goa) between the two periods, but for all States as a whole, as well as for most individual States, *shared taxes have been a letdown in the recent period.*

4. EXPENDITURES

The two main components of expenditures are revenue and capital expenditures. Within revenue expenditures, in the budgetary classification, there are three major and distinct categories: the largest one is that of expenditures on various functions of the government, interest payments and transfers to local bodies being the other two. Issues relating to expenditures on various functional heads have been dealt with under subsection 3.b on sectoral issues. But the issues of rising interest payments and of fast-rising pensions and other retirement benefits bill are of general import for the States and a strategy to deal with these must be an integral part of the reform strategy of each State.

Interest payments, being contractual obligations along with repayment of loans, would not normally be amenable to any reform. However, it is possible to attack the problem in two

⁸ The cesses levied by West Bengal government, however, were allowed to continue. A recent (January 2004) Supreme Court judgment upholding these cesses has again raised hope among States that it may be possible to tap even major minerals as a tax base once again, provided the Acts fulfill the conditions set down by the Court. Orissa has actually made an Act for this purpose, which is now being implemented.

ways: by reducing indebtedness, and by substituting cheaper loans for expensive ones. Indebtedness can be reduced in the long run only by eliminating fiscal deficits altogether, since net borrowings equal fiscal deficits in the context of the States. However, in the short run, disinvestment and sale of other assets can generate funds to repay existing loans and reduce indebtedness. Prudent use of the disinvestment strategy has two benefits. It can generate much needed resources to repay loans, simultaneously getting rid of some public enterprises that have been financial burdens on States with their regular requirement of budgetary assistance without any significant developmental contribution. Of course, disinvestment itself can be sometimes costly; under the present circumstances, these can be undertaken only with help.

The relatively low interest rates prevailing in the market provide a window of opportunity for the other strategy to reduce interest outgo. To the extent feasible, old, expensive loans need to be repaid using new, cheaper market borrowing. Since much of the former are owed to either the Government of India (GOI) or public sector financial institutions, such prepayment must either be permissible under the terms and conditions governing those loans or has to be specially allowed by them. The debt swap scheme announced by the GOI two years ago has yielded some benefits in terms of savings in interest (by the end of March 2004, the total debt swapped was Rs. 58,331 crore with Uttar Pradesh topping the list with Rs. 6906 crore followed by Maharashtra with Rs. 6525 crore), but not large enough to make a noticeable impact. Further savings will be available if necessary permissions were granted to the States to facilitate pre-payment,⁹ along with commensurate adjustments in the entitlement for market borrowings.

A recent (April, 2004) Planning Commission proposal suggested one time waiver of all existing GOI loans to States along with the interest due thereon, coupled with discontinuation of such loans in future. As per this proposal, the States will be required to access the market directly for their debt floatations. While this is an attractive set of suggestions in the present context, its implications during a high-interest regime are, at best, uncertain. Despite several flaws in the present system, one positive aspect of it is the fact that the poorer States do not have to pay any additional interest to the GOI even when their repayment capacities are clearly less than the other States. The market, however, will demand a risk premium, which can destabilize their finances further. This may not happen in times of easy availability of loans, but will certainly be the case once demand for loans picks up. If market discipline has to be invoked, it must be supplemented by a mechanism to moderate its adverse impact on the poorer States arising from their low incomes. Above all, the key question is: will the GOI be willing to give up the substantial amounts involved, especially when it is subject to the targets set by the Fiscal Responsibility Act?

The States had often complained that assistance from international community flowing through the Center as Additional Central Assistance (ACA), had unduly disadvantageous terms and conditions imposed by the Center even when the original terms were more preferable. The other side of this contention was that the States did not have to bear the foreign exchange risk associated with servicing and repayment of such loan assistance. The States have now been given a choice by the GoI to either opt for the existing system or for a system of 'back-to-back' provision of such assistance under the original terms, but along with the foreign exchange risk. Management of this risk also can now be handled by the States themselves, or by the GoI if the concerned State so desires. Whether this will reduce the interest burden of the States or not will be keenly watched.

The issue of *pensions and retirement benefits* has already drawn some attention (see, for example, Dave, Palacios and Bharadwaj, 2003) and the Reserve Bank of India set up a Group to Study Pension Liabilities of the State Governments in 2003. Certain elements are common to most of the recommendations. For example, it is generally agreed that *the current system of non-contributory defined benefits pensions is not viable any more*, and the basis of any reform must be beneficiary contributions. For immediate implementation, the usual suggestion is to make some parametric changes including changing the definition of the salary base for pension calculations, lowering the ceiling for commutation, and raising the

⁹ Chhattisgarh and NCT of Delhi have been permitted to pre-pay some loans already.

discount rate. Almost all States are aware of this ticking time bomb now and some of the States have already implemented some of the above recommendations. Sooner rather than later, all States are expected to follow these recommendations, with possibly some variation regarding the exact type of contributory pension scheme applied.

Capital expenditures are almost determined as residuals in the present scheme of State finances. While it cannot be argued that all capital expenditures are good, it cannot also be denied that the *long term growth of the State economy crucially depends on appropriate capital expenditures*. However, a large part of the capital expenditures may be considered as disguised revenue expenditures, both because of no future stream of returns as well as the loans and equity investments of States that are really in the nature of grants. Clearly, these need to be weeded out and future investments carefully scrutinized. There is also a tendency to start a large number of investment projects at the same time because of the high visibility of such projects and the consequent political goodwill that the starts are expected to generate. Such a tendency, however, results in a thin spread of available resources and resultant time slippages. The delays eventually result in higher project costs, as of course, the lost use of the asset intended to be created. In practice, the policy that generates the maximum returns is that of small 'last mile' investments, i.e. the investments that are required to complete "almost completed" projects. Another pertinent issue here is the inadequate attention paid to maintenance of capital assets that often lead to much larger renewal investments. This is partly because of the fact that in the system of budgeting adopted, no link is established between capital expenditures and the operation and maintenance (O & M) expenditures that such expenditures may entail subsequently. If this is done, and the O & M expenditures are taken to be committed expenditures like say, interest payments, then capital expenditures can be considerably rationalized. *One reform that may help here is to create a small and specialized group to assess all investment project proposals carefully and prioritize, and determine O & M requirements of existing assets*; a project may be considered for inclusion in the budget proposals only after such screening awards high priority to it. This institutionalized procedure can act as a check against the problems outlined above.

One major category of expenditure that cuts across the entire budgetary classification is that of *salaries and wages*. *A rapid rise in this category of expenditure has been repeatedly identified as an important reason for the deterioration of the States' financial health*. This is hardly surprising, since these now constitute about half of the revenue expenditures on an average, and in some States, these along with interest payments and pensions exhaust the entire current receipts. Since the salary and wage bill of a State depends upon the level of salaries and wages, and the number of employees, both these aspects have received attention for the purpose of containment. Since the levels of salaries and wages (and pensions, in fact) have received substantial boosts triggered by the recommendations of the last two Central Pay Commissions, eschewing the next one may provide some breathing space to the State governments. This is what the Eleventh Finance Commission also suggested. Several States have imposed *restrictions on fresh appointments*, with varying degrees of severity. There have also been attempts to lower staff costs by *lowering the effective salary levels accompanied by lowering the skill requirements* in cases considered appropriate. Examples include *Shiksha Karmis* or para-teachers, or sometimes multi-skilling existing staff instead of new appointments (example: primary level health workers in some States). In many of the special category States (as perhaps in some of the other States too), the State government happens to be the *largest employer in the organized sector*; *cutbacks in employment can have serious political and social repercussions* in such States, which can be an inhibiting factor. The only practical solution would be to create alternative employment opportunities through appropriate policies, coupled with social safety nets, to rationalize number of employees in such States.

4.a Expenditure Management

Issues in expenditure management of States have become important because of the relatively small discretionary expenditure now available as a result of the preemption of the bulk of available resources by contractual and committed expenditures. It is now essential to do everything possible to get the maximum benefit out of the meager resources available, and

'everything' spans budget preparation to execution, monitoring and auditing. Some of the major issues are outlined below.

- One of the reasons for persistent fiscal problems of the States is the short time horizon of the policy makers, institutionalized by the single year budget. To lengthen the time horizon, *it is necessary to embed the one year budget in a medium term framework (MTF)*. Many States have adopted a medium term framework primarily to meet the obligations under Medium Term Fiscal Reform Program (MTFRP) contained in the Memorandum of Understanding (MOU) with the Central government. However, these are essentially worked out by the Finance departments of the States, and do not have any counterparts in other departments. The need is for a more participatory MTF, with each department providing a detailed one. All these can then be consolidated by the Finance department. The MTF of various departments should contain, apart from the revenue and capital expenditures planned for a number of years, the progress expected to be achieved in terms of measurable performance indicators and build in the future budgetary implications of current-period expenditure program, particularly in the case of capital expenditures.
- *Better projections and forecasts* are needed even for a single year budget, certainly for an MTF. The deviations between budgeted values of receipts and expenditures and the actual outturns are at present large, causing uncertainties, interruptions in implementation of schemes and projects, distortion of priorities, lobbying and cost overruns. This will probably require substantial capacity building. The practice of *using supplementary budgets as a routine tool also needs to be discouraged* by introducing more stringent conditions, to prevent deliberate window dressing of the budget.
- *The budgets need to be comprehensive* and off-budget financial activities discouraged. As an interim measure, off-budget financial activities like guarantees should at least be fully reported in the budget. This is also required in the interest of *transparency that can bring accountability* in its wake.
- *Overall fiscal targets* need to be built into the budget; the present system of budgeting is essentially a bottom-up system, with departments providing their own budgets that are put together to arrive at the overall budget after which the departmental allocations become a matter of political muscle-flexing. This system needs to be modified to formally take into account the overall fiscal targets through an iterative system.
- *Institutionalizing fiscal responsibility* through appropriate legislation may provide the necessary incentives for the above. The Twelfth Finance Commission has now provided the necessary incentives to encourage such legislation in the form of debt consolidation and rescheduling at lower rate of interest.
- Steps should be taken to *discourage financial practices of dubious nature*; these include the March spending rush, using book transfers to park unspent balances in the Public Accounts and accumulating current liabilities (unpaid bills). The time is ripe for a complete clean up of the Public Accounts and possible merger of a substantially curtailed version of it in the Consolidated Fund. The office of the Comptroller and Auditor General of India is currently examining this aspect in detail.
- The *departments need to be given more flexibility* regarding the detailed composition of expenditure. The present practice of line item budgeting is probably a hurdle in the way of efficient public spending. Moreover, while large wage bills are recognized as a major problem, financial rules in most States protect salary expenditures in the sense that even departmental heads are not authorized to reallocate salary expenditures to other heads, once the budget is approved. The requirement is to *move away from detailed input based monitoring to a system that establishes accountability in terms of outputs*.
- At present, even input based monitoring system is weak in most States. The first prerequisite for such monitoring, a *comprehensive information system* (whether computerized or not) is often absent. Unless regular monitoring at the departmental level and a collated monitoring at the Finance department takes place, it is difficult to identify implementation slippages in time and make within-year adjustments to conform to overall fiscal targets. A more mundane reason, of course, is to allow appropriate cash flow management. *Computerization* can help in making this relatively easy to implement.
- *Treasury reforms, mainly computerization and elimination of cash transactions* through the help of commercial banks have either been implemented or are in progress in some States. Apart from enhancing transaction efficiency, these reforms can greatly aid monitoring, enforcement of ceilings, and reconciliation of accounts. It also paves the way

for the treasuries to modify their role and assume budget control responsibilities. However, the issue of keeping some of the departments like public works, forest and minor irrigation outside the purview of the treasury needs to be reconsidered; the rationale for this distinction probably has disappeared in the present financial system.

- The system of *procurements* in most States is riddled with various kinds of malpractices. *Non-transparency and subjectivity* are the main screens behind which malpractices grow. The system needs to be revamped to improve transparency by making available relevant information and forms freely, and reduce subjective assessments of tenders/bids by specifying clear and objective rules for assessments *a priori*. Rules limiting competition are often used in the name of encouraging local entrepreneurship, but such rules are always open to misuse and better dispensed with in the interest of promoting a common market.
- It is important to *assess the efficiency of public spending and examine its success in meeting the objectives* from time to time. Tools like public expenditure tracking system (PETS) and expenditure incidence studies for selected departments can be used. The government itself may not have the necessary skills at its disposal at present, but for most States, technical assistance for these tasks is relatively easy to organize. On a more regular basis, performance monitoring on the output basis needs to be introduced.
- Finally, the institutions for proper auditing and legislative monitoring are well-established; steps need to be taken to make the most of these institutions. For example, *executive responsiveness to audit results is often tardy; a mechanism to tighten up the system would enhance the usefulness of audits*. The audits can themselves widen their scope beyond examination of procedural propriety, and assess expenditure effectiveness and budget discipline. Similarly, legislative oversight can probably be made more effective through some measures like sub-committees to examine detailed demands for grants.

5. SPECIAL CATEGORY STATES

The fiscal problems in the special category States show symptoms that are very similar to those exhibited by the low income States. However, the symptoms arise from different causes, which ought to argue for a different set of reforms.

Table 5 provides data on fiscal aggregates of the special category States as a ratio of their respective GSDP. Since the latter data are not available for the latest years for some of these States, the period of coverage is not uniform for all the States. Also, in the case of these States, the data on revenue receipts and expenditures have not been adjusted for receipts from and expenditures on State lotteries because of lack of necessary details from the source used, which distorts the figures somewhat. However, this is a serious problem for only Sikkim. In Sikkim, in 2002-03 for example, the revenue expenditures would fall from Rs. 1882.62 crore to Rs. 710.14 crore after expenditures on lotteries are netted out and the revenue receipts drop from Rs. 2080.53 to Rs. 823.81 crore after only net receipts of lotteries are taken into account.

Most of the special category States exhibit high levels of fiscal deficit. Only Assam (4.3 per cent), Meghalaya (5.6 per cent) and Sikkim (5.7 per cent) have fiscal deficits that are not very high, but this is achieved in Assam through low capital outlay. In several cases, the recorded fiscal deficits are despite low revenue deficits (Nagaland and Tripura) and even revenue surpluses (Arunachal Pradesh, Meghalaya and Sikkim), mainly arising from substantial capital outlay. From this point of view, Jammu & Kashmir and Himachal Pradesh exhibit the more troublesome problem of high fiscal deficits even without large capital outlays, obviously driven by revenue deficits.

Total liabilities are above 50 per cent of respective GSDP in all but three of the States – Assam, Meghalaya and Tripura. Of these three, Meghalaya has the lowest level of liabilities, at least considering only those included in the budget. This level of indebtedness has been reached despite the fact that plan loans, which account for a substantial part of the indebtedness of non-special category States, are much smaller in these States due to the favorable composition of normal State plan assistance (Gadgil formula assistance) – only 10 per cent is given as loan while 90 per cent is received as grant. In fact, central transfers (grants and share in central taxes) account for the bulk of revenue receipts of these States.

They are therefore in a position to avoid borrowings by tapping their own revenue sources better. This has clearly not happened. The high levels of indebtedness are reflected in the fact that in all these States, interest payments are above 10 per cent of their revenue expenditure (net of lottery-related expenditures). While this is not as high as the non-special category States, it is higher than expected in view of the low weight of loans in the central plan transfers.

Why have things come to such a pass in these States? The problem has been interestingly described as that of the “missing multiplier”. Government expenditures at the scale that these States exhibit rather consistently should normally have pushed up the growth rate of the economy and thereby made own revenue raising an easy job. If that has not happened, it is obviously because of ‘leakages’ that have not allowed the multiplier to operate. This happens when much of the expenditures are consumption expenditures in effect (irrespective of what these may be accounted as), and/or flow out of the system, i.e. get consumed/invested elsewhere. The obvious response would be to encourage investment within the State and cater to the demand raised within the States. But this is easier said than done, since these are in effect open economies, and if cost of production cannot be kept at a competitive level, there is little likelihood of viable investment. Thus, the fiscal policy should aim at (a) finding investment opportunities that have competitive edge and encouraging such investment, and (b) reducing costs of production (e.g. through investments in infrastructure). Further, as a long term policy, the governments must add to their own revenues, essentially as a way of converting consumption expenditure to investments. But for that, governments must themselves ensure that a reasonable part of the government expenditures are truly investments, not only accounted as capital expenditures.

6. CENTRE –STATE FISCAL RELATIONS

At the outset, it is necessary to mention that the 12th Finance Commission (TFC) has completed its deliberations and its recommendations contained in their report already tabled in the Parliament as accepted by the Central government, are likely to define the contours of a large part of the issues relating to Centre-State financial relations in the immediate future. Also, there is a substantial literature on this subject in India.¹⁰ The main issues can be subjectively summarized as given below:

- Reallocation of resources between the Centre and the States in a manner that fulfils the States resource requirements without adversely affecting the Center's ability to meet the given fiscal targets;
- Maintaining the right incentives in the system, so that neither the Centre nor the States are tempted to undertake fiscally imprudent policies and are actually encouraged to undertake fiscal reforms;
- Decide on the principles governing the combination of grants and tax devolution, particularly the need or otherwise of insuring the States against unforeseen drops in overall resource transfers;
- Possible rearrangement of taxation powers, particularly in view of the growing share of the services sector in the economy;
- Solutions to the problem of high indebtedness of the States;
- Ensuring horizontal equity in the system.

The first issue essentially relates to *vertical imbalance*, and in essence, the determination of the size of the overall kitty of central transfers to states. The basic problem here is that in practice, both the Centre and the States are running deficits, so that reallocation automatically raises the deficits of one of the parties concerned. The obvious solution, then, is to estimate the *normative* revenues and expenditures of both, assess reallocation possibilities, and suggest desired expenditure control or additional revenue effort by one or both sides to create a match between required transfers and assessed surplus. Clearly, this obvious solution is far more easily recommended than implemented, due to the various difficulties involved including the problems of making normative estimates of GOI revenues and expenditures, but ways

¹⁰ See, for example, Rao and Sen (1996) and Srivastava (2000).

have to be found around this problem. The onus here is more on the Finance Commission than the Planning Commission due to the adjudicatory role of the former.

Maintaining the right incentives is a matter of exactly how the above task is accomplished and, with respect to the States, the design of the transfer mechanism. At the extreme, equal grants for all States has no incentive for fiscal prudence, while a system of transfers fully conditional upon achieving given fiscal objectives will be highly incentive-compatible. But issues of State autonomy and several other considerations like horizontal equity may not allow an extreme solution, requiring a balancing of various objectives. The overall approach of both the Finance Commission and Planning Commission appropriately combines these objectives; the details of doing this, however, have attracted comments. For example, tax effort is rewarded by both bodies, but how tax effort is reckoned can make a large difference to the implicit incentive system.

The *appropriate combination of grants and tax devolution* has shot into prominence primarily due to the slow growth of central tax revenues, and the consequent shortfalls in the expected resource transfers to States that created severe problems in many States (Rajaraman, 2004). This has made the States realize that transfer through tax devolution is not the unmixed blessing that they thought it to be. The States had actually asked for and had got increasing parts of their transfers through tax devolution in the past. But the States as a whole still think that the solution is a higher share of central taxes; the alternative solution of a greater share of grants in the total kitty is not popular among all the States as some States may be excluded from it. However, it may be useful to combine the estimated tax devolutions with the grants to be given and convert the total to grants. That way, a single formula can govern the entire transfers through the Finance Commission, all States will receive some transfers and will not feel excluded, and the system can be better targeted at the same time. This will also provide insurance to States against cyclical risks that will be entirely assumed by the Central government. Such a solution, however, is considered too radical to be feasible at the moment; the TFC has raised the share of States in Central taxes by one per cent, but has tried to reverse the trend of falling share of grants in total current transfers from the Centre to the States.

In the area of taxation, *the largest potential tax base is now the services sector*. The States had access to a few services that they have failed to tap to the extent possible. For example, passenger and goods tax has been converted in most states to an additional motor vehicle tax. Entertainment tax and electricity duty do not yield a steady and buoyant source of revenue for various reasons. Even the potential of taxing the income of some hard-to-tax groups like professionals through profession tax has not been tapped by most States adequately. However, the central taxation of the services sector has now caused adverse reactions from the States. *To be sure, introducing a proper VAT would require integration of goods and services taxation*. The suggestion by the Kelkar task force on the implementation of the FRBM Act to levy an integrated tax is therefore correct. But where it becomes controversial is the suggestion to let the GOI levy the integrated tax by itself with a sharing mechanism thrown in. The States are almost certain to see it as a transgression of their autonomy. Despite an indifferent record of limited service taxation of States, they would be the logical collectors of a more ambitious service tax from the administrative point of view. Further, if integration with goods taxes is a desired goal, then again it meshes better with the VAT clone that the sales tax is slated to become. This would also go a long way to generate additional resources for the States. If felt necessary, the Centre may retain the power to legislate.

The solution to *high indebtedness* should probably come through a strategy of

- gradual reduction of central loans to States (allowing them greater access to market borrowing at the same time)¹¹,
- conditional debt write-off to ensure improvements in the public finance fundamentals, and
- a rule-based system of allowing market access for debt (Sen, 2003).

¹¹ This has also been suggested by the Planning Commission.

The TFC has actually recommended the first two steps, but poorer States are a little worried about their likely success in raising the amount of market borrowing required. Since a large number of States are likely to tap the financial market with their issues, there is a strong likelihood of the market ranking these issues according to risk, and of demanding a rate of interest commensurate with the risk involved. If this happens, it will be the poor States like Bihar, Orissa and Madhya Pradesh that may have to pay out larger interest on their loans, which will further dent their ability to improve their financial situation. Unfortunately, the TFC is silent on this issue. It has kept the door open for bailouts by suggesting that the Centre could borrow on behalf of the 'weaker' States for the purpose of onlending, but provides no rule on which such bailouts – for that is what it amounts to – can be based. It does, however, provide fairly simple conditions for determining the eligibility for debt write-offs.

To implement the third element of rule-based market access, the Reserve Bank of India will probably have to play a significant role as the banker of most of the States. Full disclosure of financial status should be mandatory for all States to allow appropriate market assessment. Since debt write-offs other than those recommended by the TFC cannot be altogether ruled out, a way has to be found to neutralize the moral hazard problem and politicking on this issue. This can perhaps be achieved by a specialist agency examining individual applications on the basis of pre-decided guidelines. Agencies like the NDC or the Inter-State Council can also be empowered to examine and recommend cases of bailouts; this will have the advantage of a collective decision. As discussed in Anand, Bagchi and Sen (2004), imposing a hard budget constraint has become a pre-requisite for improvements in State finances. This has to be, of course, combined with measures to arrest the growth of deficits and financially sound utilization of the borrowed resources.

7. STATE-LOCAL FISCAL ISSUES

Apart from the rather obvious fact that the finances of both these levels of government are highly interdependent through transfers, the implication that needs to be fully appreciated is that *State level reforms must encompass local finances also*. This is not only to ensure a lower burden of transfers from the State to the local level, but also to improve locally supplied public services that have complementarities with State government supplied services. For example, an improved water supply system reduces the load on the State's health services. Better local services will also improve prospects for economic development of the State that can in turn yield financial dividends for the State government.

There are few States that have really encouraged healthy growth of both urban and rural local bodies, devolving an appropriate combination of expenditure responsibilities and fiscal powers and/or transfers, while maintaining their autonomy befitting their status of the third tier of democratic government. State level organizations are increasingly taking over functions traditionally undertaken by local bodies (e.g. water supply and sanitation, and primary health services). At the same time, they have not been given much of taxation powers, nor the incentives to exploit the available handles fully. The local bodies themselves have also taken the soft option of under-exploiting available taxation powers, even to the extent of not levying "compulsory" taxes (in Rajasthan, for example). The State Finance Commissions, in general, have not addressed this issue and have tried to ensure adequate resources for the local bodies through transfers from the State governments.

8. SOME CENTRAL INITIATIVES

The financial problems at the State level put some pressure on the center too, as the center has to come to the rescue of the States in view of their role as supplier of some important public goods and services. Moreover, both State governments and the GOI are parts of the same constitutional setup, and governance is a joint responsibility. In this perspective, if one level has problems, the other has to come forward and try and mend matters. This is particularly true for the GOI as the 'senior' government. Perhaps in recognition of this role, the GOI has taken several initiatives to help the State governments to implement their reform agenda. Some of these are outlined below.

- Fiscal reform facility: This initiative originated with the National Development Council (NDC) some time ago, with the GOI setting apart some funds to

assist States that agreed to spell out their medium term fiscal reform program (MTFRP) in an MOU signed with the GOI. Several States gradually joined this program, and the Eleventh Finance Commission, in response to an additional term of reference given to it after its formation, worked out a scheme to tie up part of the awarded deficit grants with fiscal reforms carried out by the States concerned. This was to be judged by a single criterion of relative revenue deficit reduction. This was called the Fiscal Reform Facility (FRF). Both MTFRP and FRF having similar objectives, the monitoring had a lot in common. While MTFRP may go on, the FRF program has just ended, and the TFC has decided not to continue it in view of some of the shortcomings. Instead, it has introduced consolidation and rescheduling of central loans to states conditional upon the passing of a fiscal responsibility legislation and a partial write off of repayment of the consolidated debt based on reduction in revenue deficit.

However, the MTFRP had some arbitrariness built into its monitoring mechanism that was sought to be minimized by involving a suitable group. Whether this mechanism indeed made the system less arbitrary or not is difficult to assess at this point, but some displeasure was voiced. On the positive side, the MTFRP had the advantage that the reform programs were essentially worked out by the concerned States and thus did not suffer from any 'ownership' problem. However, the main weaknesses were in setting up benchmarks and objective criteria for monitoring. The assessments had to fall back on purely financial criteria, which are not always a good indicator of the States' efforts. This was precisely the problem with the FRF too, and particularly troublesome in view of the single criterion. A single criterion is also open to manipulation, but the main problem was that there is a substantial exogenous element in the fiscal outcome indicators at the State level in India. A *post facto* example is the sharp drop in shares in central taxes (as a ratio of GDP) for all States, which hit the poorer States harder both because of their greater dependence on these devolutions and their larger relative share. Despite efforts, the results in terms of fiscal consolidation were not commensurate in many States. Moreover, the FRF should have been independent of or in addition to the usual transfer channels of the Finance Commission. Superimposing it on the deficit grants undermined the Finance Commission's own assessment of required *unconditional* grants for the selected States. While incentive mechanisms for fiscal reform are probably useful, the two lessons that may now be noted for future reference relate to (a) better defined benchmarks and milestones in MTFRPs to aid objective assessment and monitoring, and (b) a well-designed, multi-faceted criterion to assess fiscal reform that would be independent of the exogenous factors.

- Debt swap scheme: The GOI announced a scheme of debt swap four years ago that exchanged high cost GOI loans to States with low cost market borrowings and small savings loans. This was devised consequent upon the recent drop in the market and other interest rates to allow States to lower their interest burden. Most States have taken advantage of this scheme. To begin with, only debt with interest rate of 13 per cent or more was to be swapped. There is a demand from States to now continue the same program for debt with lower interest rates that may be higher than the market rate.
- Sarva Shiksha Abhiyan: In the area of education, this scheme has subsumed several smaller schemes and is an ambitious program aiming for full literacy everywhere in a given time frame. Under this program, matching grants are available to Societies set up by the State governments to administer this program. The State governments are expected to provide the matching amounts to these Societies.
- Reproductive and Child Health Program: In the area of health, this is one of the major programs that provides for assistance to the States for the purposes of maternal and child health and safe delivery. In rural areas the States can also use funds received under Prime Minister's Gramodaya

Yojana (PMGY).

- Securitization of power dues: To allow State governments to make a one-time settlement of their accumulated dues to the centrally owned public enterprises supplying power, a scheme of securitization of the dues was introduced. It provided for no payment for a five year period, 8 per cent rate of interest and a fixed period of further 10 years over which the amount could be paid out. Besides, the GOI has executed MOUs with several States that spell out power sector reforms. Some central assistance for power sector reforms are also available through the Accelerated Power Development and Reform Program (APDRP). For rural electrification, besides the funding from Rural Electrification Corporation (REC), funds from PMGY and Rural Infrastructure Development Fund (RIDF) can be used.
- Central Road Fund: States are eligible to receive resources from the Central Road Fund, which includes the proceeds of the earmarked cess on selected petroleum products. The National Highways are fully financed by the GOI, while the other funds can be used for State Highways and district roads. Besides, funds from Prime Minister's Gram Sadak Yojana (PMGSY) and RIDF can be used for laying, renewing and maintaining rural roads.

9. FINANCING COSTLY REFORMS

Most of the reforms that have been discussed above are either costless or only moderately expensive. All the taxation reforms that have been talked about above are either revenue neutral or revenue enhancing; rationalization measures like removal of tax incentives and avenues of tax exportation may have some short-term costs for some States, but these also are either zero or negligible for the States collectively. However, computerization may have moderate costs. Similarly, substantive changes in any area including taxation should be accompanied by information campaign, capacity building and necessary administrative reorganization, which also may entail some costs. But none of these costs are large enough to deter any State from carrying out the reforms, if they are otherwise decided. In the same way, purely organizational or administrative reforms suggested in expenditure management and social and physical infrastructure areas are either costless or entail moderate costs only, which ought to be self-financing over the medium term.

There are, however, some reforms that entail substantial costs, at least in the short run. These are of two types in general: enhancing expenditure in priority areas, and privatization. The latter, being in the nature of disinvestment, should not normally be expensive, but in fact do carry large costs because of two reasons. First, a majority of the public enterprises being privatized can be expected to have large financial liabilities that will generally have to be cleaned up before privatization. Second, privatization may entail substantial downsizing of employees, and to achieve that expensive compensation packages have to be offered. Options for financing these costs need to be considered carefully to ensure consistency with the ultimate objective of these reforms. In general, these options can be categorized as:

- Internally generated resources and
- External funding.

Internally generated resources include additional taxes, reallocation of budgeted expenditures, and user charges. In general, these should constitute the first option for enhancing expenditure in priority areas. In the cases where there is also reason to eliminate inefficient use of a particular service, user charges in particular should be employed judiciously to achieve this objective. External funding for enhancing revenue expenditures would in general be inadvisable, unless (a) the increase is planned to be for a limited period and (b) the external funding is in the form of a grant. It should be emphasized here that a permanent increase in revenue expenditures (e.g. inducting new employees) should never be undertaken on the strength of external funding, even grants. In fact, in capital expenditures with expected negative rates of return (where maintenance costs exceed possible revenue earnings) also fall in this category.

One time large costs like capital investments, downsizing employees and cleaning up the books in public enterprises are ideal candidates for external funding, if no internal funds are available, or are insufficient. External funds may be available from the following sources:

- *Government of India:* As outlined above in the previous section, there are some funds available from the GOI to undertake various types of reform at the State level; barring the Fiscal Reform Facility, these are generally loans of various types with reasonable terms and conditions.
- *Special Financing Institutions:* These include institutions like Power Finance Corporation, Housing and Urban Development Corporation, National Cooperative Development Corporation, Infrastructure Development Finance Corporation and Life Insurance Corporation. Most of these agencies would provide loans for particular purposes, but the terms and conditions may be commercial or concessional, depending on the agency concerned. A major problem with many of these agencies is that if the loan is actually taken by a formally autonomous agency of the State government, then a State government guarantee is required.
- *Commercial Borrowing:* These are those borrowings where the government or its agencies are treated in the same way as any commercial borrower, e.g. loans from commercial banks. Since the terms and conditions of these loans are not advantageous for the government, such loans should be taken only when funds from other sources are not available, payoff from the utilization of the funds is expected to be large and the loan is to be taken for a short period only.
- *Bilateral/ Multilateral international agencies:* Funds from these agencies are negotiated as packages usually including grants and/or loans and accompanied by an agreement to observe a set of conditions for full disbursement. Often, these are preceded by technical appraisal/assistance that helps to identify the action areas, which are subsequently incorporated in the conditions integrated with the agreement. These assistance packages usually flow through the GOI, under conditions determined by the GOI from time to time. These packages can be sectoral or general budget support, but even the sectoral assistances are increasingly flowing through earmarked budgetary support programs.
- *Private capital:* Finally, of course, the government can tap private capital for various projects. This can be done either by leaving a project for the private sector entirely, or by developing some form of public-private partnership. Such projects have to be carefully planned to attract private investment, and need to be skillfully negotiated to ensure that the basic purpose of undertaking the project is served. After all, if a newly constructed stretch of road is so highly priced that it does not reduce the congestion in the free alternative route, then how useful is the project? One benefit of inviting and employing private capital is that such investment usually brings in professional skills, particularly managerial. But, private investment flows in only when there are adequate returns (risk-adjusted), and this is difficult to guarantee in the case of public goods or 'merit goods', which are the ones in which the government should be interested. Thus, the government may have to work out (financial) mechanisms to ensure *a priori* profitability for the private agency concerned, without assuming a financial burden that it would not be able to bear. Clearly, the skills required are somewhat different from what is usually available with the public sector and have to be developed.

10. CONCLUSION

In conclusion, it may be said that several steps have been taken in the recent past to bring sanity to State finances, but their impact has been limited, if at all. The reforms introduced by States include:

- better financial reporting (e.g. consolidated fiscal aggregates reported in the Karnataka budget, White Papers on State's finances in several states)
- Fiscal Responsibility legislation or executive ceilings on debt and/or guarantees in several States
- establishment of guarantee redemption funds through collection of guarantee fees and budgetary allocations
- sinking funds for debt redemption (in a deficit situation, it can at best be considered as a firmer allocation of expenditure only)
- legislation for effective recovery of outstanding loans (Public Demand Recovery Act, 2003 in Manipur)

- setting up a high level agency to screen investment projects (e.g. Board of Investment in Sikkim)
- State-level advisory bodies for policy on economic development that include non-government members (e.g., in Uttar Pradesh and Rajasthan).

The Medium Term Fiscal Reform Plans originating in the National Development Council and later given shape by the 11th Finance Commission, the Fiscal Responsibility legislations enacted by some States are all designed to achieve the same objective: that of improvement in State finances. Unfortunately, alongside these initiatives, practices like free power to farmers and lax collection of water rates still result in inadequate resources, with a substantial part of the revenue expenditures being accounted for by wages and salaries and interest payments only, leaving very little for real developmental work. Leakages from the small developmental government expenditures continue unabated. The last elections have, if anything, set fiscal reforms back due to the association of electoral reverses with some reforms and reversal of these reforms in the post-election scenario. It is therefore necessary to redouble the efforts at convincing the State governments and their citizens about the reform imperatives.

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(per cent)		
Year	GFD/GDP	Total Liabilities/GDP
1990-91	3.30	19.03
1995-96	2.65	17.86
1996-97	2.72	17.75
1997-98	2.90	18.47
1998-99	4.27	19.64
1999-00	4.72	21.69
2000-01	4.28	23.84
2001-02	4.21	25.71
2002-03	4.15	27.88
2003-04 (RE)	5.11	29.24

Source: The budgetary data are from Reserve Bank of India (2005),
And the data on GDP (market prices) are from Economic Survey, 2005.

(per cent)			
State	GFD/GSDP	TL/GSDP	PCGSDP (Rs.)
	1	2	3
Andhra Pradesh	4.58	29.28	20659
Bihar	8.31	77.72	6355
Gujarat	5.63	30.29	26169
Haryana	3.04	26.37	29773
Karnataka	4.70	26.30	20791
Kerala	5.70	37.78	24231
Madhya Pradesh	5.54	39.99	13795
Maharashtra	4.76	20.69	28599
Orissa	8.79	62.07	11900
Punjab	6.65	48.77	28986
Rajasthan	6.82	45.40	15267
Tamil Nadu	3.98	24.23	24259
Uttar Pradesh	6.40	42.55	11473
West Bengal	7.21	37.71	19830

Rank correlations: column 1 with 3 = -0.6044
column 2 with 3 = -0.6176

Source: Budgetary data are from the same source as in Table 1, while the GSDP data are the State's own estimates compiled by CSO.

GFD: Gross Fiscal Deficit; TL: Total Liabilities; GSDP: Gross State Domestic Product
PCGSDP: Per Capita Gross State domestic Product

Table 3: Budgetary Aggregates in Selected States: Revenue Receipts										
(percentages of GSDP)										
	Total Revenue Receipts		Own Tax Revenue		Own Non-Tax Revenue		Grants from Centre		Shared taxes	
	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04
All States	11.94	12.60	5.77	6.29	1.56	1.60	1.74	2.14	2.66	2.57
Andhra Pradesh	13.04	14.45	6.54	7.86	1.84	2.10	1.64	1.91	3.02	2.59
Bihar	15.23	21.65	4.28	5.33	1.75	0.90	2.18	2.90	7.02	12.52
Chhattisgarh	--	15.60	--	6.60	--	2.66	--	2.44	--	3.91
Goa	20.41	21.14	7.01	7.41	5.44	11.48	1.16	0.85	1.80	1.40
Gujarat	12.05	12.89	7.27	7.24	2.39	3.04	0.85	1.45	1.55	1.16
Haryana	14.34	12.69	6.77	8.19	2.28	2.77	0.93	0.89	1.19	0.84
Jharkhand	--	22.22	--	7.03	--	3.26	--	4.88	--	7.05
Karnataka	14.03	15.28	8.52	9.50	1.79	1.68	1.18	1.59	2.49	2.52
Kerala	13.45	13.12	8.60	8.86	0.90	0.86	1.21	1.21	2.57	2.19
Madhya Pradesh	13.04	15.53	5.53	6.78	2.40	1.91	1.68	2.11	3.43	4.73
Maharashtra	10.41	11.34	6.85	7.97	1.77	1.64	0.65	0.79	1.13	0.94
NCT Delhi	8.10	8.85	6.92	7.03	0.43	1.12	0.75	0.69	0.00	0.00
Orissa	14.52	18.07	4.42	6.03	1.83	1.83	3.36	3.85	4.91	6.36
Punjab	12.21	15.04	6.30	7.68	4.00	5.13	0.76	1.27	1.15	0.95
Rajasthan	13.09	15.09	5.60	7.02	2.16	1.89	2.16	2.71	2.87	3.47
Tamil Nadu	12.94	13.25	8.60	9.11	1.01	1.14	1.01	1.01	2.28	1.99
Uttar Pradesh	12.67	14.22	5.21	6.12	1.06	0.96	1.68	1.67	4.55	5.46
West Bengal	8.91	9.43	4.59	4.37	0.43	0.58	1.23	1.62	2.65	2.86

Note: Figures for total revenue receipts and own non-tax revenue include only net receipts from State lotteries.

Table 4: Budgetary Aggregates in Selected States: Expenditures								
(percentages of GSDP)								
	Revenue Expenditure		Interest Payments		Capital Expenditures		Capital Outlay	
	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04	Average 1995-2000	Average 2000-04
All States	13.68	15.34	2.25	3.06	2.93	4.05	1.52	1.84
Andhra Pradesh	14.73	16.41	2.23	3.38	3.66	5.21	1.39	2.10
Bihar	17.38	25.77	3.10	5.41	2.77	6.09	1.21	2.67
Chhattisgarh	--	16.43	--	2.35	--	3.91	--	2.38
Goa	16.65	23.32	2.52	3.25	3.23	4.99	2.51	2.84
Gujarat	13.84	16.60	2.13	3.31	3.15	4.67	2.06	2.08
Haryana	13.46	13.95	2.26	2.82	3.05	2.92	1.60	1.41
Jharkhand	--	22.31	--	2.89	--	6.83	--	4.72
Karnataka	15.13	17.33	1.93	2.71	2.77	4.32	1.89	2.43
Kerala	16.39	17.45	2.67	3.53	2.60	2.89	1.28	0.80
Madhya Pradesh	15.00	18.71	1.96	3.10	2.19	4.26	1.32	2.33
Maharashtra	11.71	14.39	1.61	2.42	2.68	2.85	1.57	1.84
NCT Delhi	6.18	6.48	0.77	1.43	4.39	7.11	1.08	1.19
Orissa	19.14	23.31	3.76	6.37	4.29	7.22	2.43	2.14
Punjab	15.69	19.72	4.00	4.43	3.22	4.75	1.20	1.47
Rajasthan	15.52	19.06	3.04	4.62	4.49	4.90	2.88	2.45
Tamil Nadu	14.96	15.67	1.82	2.53	2.02	3.04	0.93	1.43
Uttar Pradesh	16.27	19.02	3.49	4.29	3.28	5.36	1.28	2.88
West Bengal	12.90	14.76	2.64	4.42	2.59	4.05	1.00	0.66

Note: Expenditure on State lotteries has been excluded from revenue expenditures

Table 5: Fiscal Aggregates of Special Category States*

	Period	(as percentages of GSDP)								
		Fiscal Deficit	Revenue Deficit	Total Liabilities	Revenue Receipts	Share in Central Taxes	Grants from Centre	Revenue Expenditure	Interest Payments	Capital Outlay
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Arunachal Pradesh	1999-2002	10.11	-7.91	54.62	56.77	9.17	42.39	51.65	5.88	15.18
Assam	-do-	4.31	2.84	33.74	17.72	5.08	6.30	20.07	3.15	1.59
Himachal Pradesh	1999-2003	10.00	6.85	60.75	25.19	3.58	12.97	31.63	6.28	4.50
Jammu and Kashmir	1999-2002	9.66	2.59	58.66	39.82	5.93	26.89	42.42	6.20	6.61
Manipur	1999-2003	12.11	4.58	54.57	36.33	7.20	26.18	41.43	5.86	6.95
Meghalaya	1999-2002	5.58	-0.03	29.77	29.24	5.74	17.88	28.49	3.17	4.85
Mizoram	1999-2002	18.63	6.75	64.92	53.20	10.09	39.73	59.96	6.66	10.33
Nagaland	1999-2002	9.46	0.12	56.81	39.89	8.40	28.56	40.00	5.69	9.01
Sikkim	1999-2003	5.71	-10.37	74.00	148.34	8.74	43.61	138.64	7.67	15.47
Tripura	1999-2002	7.90	0.47	41.51	31.18	6.66	20.42	31.66	4.18	7.38

* Excludes Uttaranchal