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Issues and Perspectives

The improvement in State finances during 2004-05 and 2007-08 was the outcome of a confluence of factors. While the rule-based fiscal policy adopted by most of the States improved fiscal discipline, the correction in State finances was aided by high growth and the resultant increase in the buoyancy of the States' own tax revenues as well as Central transfers and the implementation of VAT during this period. With the overall macroeconomic slowdown and the implementation of the Sixth/State(s) Pay Commissions during 2008-09 and 2009-10, State finances suffered a setback but needed to revert to a fiscal consolidation path. The higher devolutions recommended by the Thirteenth FC will benefit State finances. Factors likely to have significant implications for fiscal consolidation at the States' level include implementation of GST, pace of economic recovery, States' own efforts towards mobilising non-tax revenues and prioritisation/rationalisation of expenditure. To make credible progress towards fiscal consolidation, States need to amend their FRBM Acts and workout a fiscal reform path. States also need to review their tariff policies especially those relating to the power and irrigation sectors. For the successful implementation of GST, the Centre and the States need to agree on certain issues and equip themselves with administrative capacity and IT infrastructure. Better allocation of expenditure along with improved transparency and accountability through stricter audit procedures is also necessary to ensure quality in fiscal management. States need to put in place the effective forecasting and monitoring mechanism for their cash inflows and outflows so that a need-based approach is followed for market borrowings and the interest cost of cash surpluses is minimised. The strengthening of State Finance Commissions is essential to ensure the allocation of resources to local bodies, keeping in view their developmental role for the purpose of inclusive growth.

1. Introduction

2.1 The period from 2004-05 to 2007-08 was marked by significant improvement in the consolidated position of State finances. The Twelfth FC put in place an incentive system, encouraging States to implement their own Fiscal Responsibility Legislations (FRLs) to enable them to be eligible for conditional debt restructuring and interest rate relief. However, the economic slowdown following the knock-on effect of the global financial crisis and the accompanying moderation in the pace of revenue growth adversely affected State finances in 2008-09 and 2009-10. After having implemented the expansionary fiscal policy to address the slowdown in the previous two years, the challenge before the State governments is to revert to the fiscal consolidation path from 2010-11 onwards. Against this background, this chapter highlights some immediate as well as medium-term issues

and challenges that State governments confront at this stage. While an immediate challenge is to revert to the rule-based fiscal consolidation following the roadmap outlined by the Thirteenth FC, there is a need to calibrate the exit from the expansionary fiscal stance in a manner so that its adverse impact on growth is minimised. Another issue gaining importance from the viewpoint of State finances is the uncertainty regarding the implementation of the goods and services tax (GST) due to lack of consensus on certain issues between the Centre and the States. Given the uncertain revenue implications of the proposed introduction of GST, it is important for the States to undertake a careful management of their finances in the next few years. In the medium term, improvement in the quality of States' expenditure management along with a move towards fiscal transparency and adoption/strengthening of fiscal rules needs attention.

2. Revised Fiscal Roadmap for States

2.2 During 2008-09 and 2009-10, the experience of fiscal authorities at the Central and sub-national levels showed that the crisis can be dealt with better when adequate fiscal space is available to them. In the Indian context, the fiscal consolidation process undertaken during the pre-crisis period provided fiscal headroom to initiate stimulus measures not only by the Central government but also by a number of State governments. Many State governments announced tax cuts and increased expenditure to provide a boost to their State economies. Although there was some deterioration in key fiscal indicators at the State level in 2008-09 and 2009-10, the overall fiscal position of States remained under control. Looking forward, an important issue in the context of State finances is to resume the rule-based fiscal policy from 2010-11 onwards, supported by the evidence that appropriate fiscal rules can facilitate swifter fiscal consolidation. For instance, State finances, which had witnessed a deterioration during the low growth phase of 2000-01 to 2002-03, improved significantly from 2004-05, following the implementation of rule-based fiscal framework, supported by growth acceleration during this period.

2.3 Taking into account the deterioration in State finances in the recent past, the Thirteenth FC has outlined a fiscal roadmap for both the Centre and the States in the medium term. For State governments, the Thirteenth FC has adopted a differential approach, instead of prescribing a uniform roadmap, based on the past fiscal performance of States (till 2007-08), which prescribes different timelines for different groups of States². The States would need to show credible progress in their finances as some of the benefits recommended by the Thirteenth FC are linked to their fiscal performance. For instance, the release of State-specific grants would depend upon compliance to the fiscal reform path worked out by the Thirteenth FC.

2.4 Progress along the lines of the fiscal roadmap prescribed by the Thirteenth FC would largely depend on (i) the overall macroeconomic performance of States, (ii) devolutions from the Centre and (iii) the efforts by States to mobilise own revenues effectively and compress the least productive revenue expenditure. It may be noted that there was a substantial rise in revenue expenditure of States in 2009-10 on account of fiscal stimulus measures and the phased implementation of the recommendations of the Sixth/State Pay Commissions (CPC/SPCs). The Thirteenth FC has recommended that States should avoid structural shocks emanating from payment of arrears on account of upward revision of salaries under the Pay Commission awards by making the pay award commence from the date of acceptance. However, this would require that both the Centre and the States initiate the process of setting up their respective Pay Commissions well before the expiry of the previous Pay Commission(s). In addition, the States would also need to identify items of revenue expenditure which can be compressed without hampering the growth process. To make non-tax revenues a more durable source of revenue, States need to study the commercial viability of certain State-provided services, viz., power and irrigation, in a medium to long-term perspective.

3. Implications of Recommendations of the Thirteenth FC

2.5 The Thirteenth FC has continued with the incentive-linked approach followed by the Twelfth FC. The incentive framework has been recommended for general performance grants, special area performance grants and State-specific grants, and also for extending the benefit of interest relief on NSSF and the write-off. With the enactment of the FRBM Act,³ West Bengal and Sikkim may also benefit from the extension of the debt consolidation facility as recommended by the

² Under the revised roadmap, 24 States would need to achieve either revenue balance or surplus by 2011-12 and maintain it thereafter; while the remaining four States would have to achieve the same by 2014-15. All special category States with fiscal deficit of less than 3 per cent of GSDP in 2007-08 could incur a fiscal deficit of 3 per cent in 2011-12 and maintain it thereafter. Manipur, Nagaland, Sikkim and Uttarakhand would need to reduce their fiscal deficit to 3 per cent of GSDP by 2013-14. Jammu and Kashmir and Mizoram need to limit their fiscal deficit to 3 per cent of GSDP by 2014-15.

³ For details of FRBM Acts in West Bengal and Sikkim, see Chapter III.

Thirteenth FC. Besides these, the Thirteenth FC has identified reforms in areas pertaining to accounting, budgeting, transparency and disclosures, tariffs and user charges of services provided by State governments. The implementation of these recommendations would accelerate the fiscal reform process at the State level.

2.6 Another notable change suggested by the Thirteenth FC is with regard to the horizontal distribution formula. Recognising the differences in the tax base of different States, the Commission has emphasised the adoption of 'fiscal capacity distance', instead of 'income capacity', as one criterion for *inter se* distribution of shareable union taxes. Therefore, States with a lower tax base and a lower per capita income would get a larger share. The criterion neutralises to some extent the fiscal disadvantage of special category States in terms of tax capacity. This bodes well for ensuring horizontal equitable distribution of shareable taxes.

2.7 Taking cognisance of the fact that the buoyancy of Central taxes has been higher than that of State taxes, the Thirteenth FC has also recommended (i) a rise in the share of net proceeds of shareable taxes from 30.5 per cent (Twelfth FC) to 32 per cent for the award period of 2010-11 to 2014-15, and (ii) a rise in the indicative ceiling on all revenue account transfers to the States from 38.0 per cent to 39.5 per cent of the Centre's gross revenue receipts. Following the treatment of proceeds of services tax as part of the divisible pool and increasing the importance of taxes on services, the States may further benefit in terms of higher devolution. In short, the Thirteenth FC recommendations are likely to supplement States' efforts towards fiscal correction and consolidation.

4. Introduction of Goods and Services Tax

2.8 One upcoming tax reform that has implications for the tax structure at the States' level is the proposed introduction of GST. The underlying objective of GST is to eliminate the cascading effect of some taxes, rationalise the cost structure, and reduce the effective tax rates on most goods while

also aiming to reduce transactions and payment costs. This could enhance the competitiveness of Indian industry and trade. With the introduction of GST, there would be a major reshuffle in the tax bases of both the Centre and the States. Various Central and State indirect taxes are likely to get subsumed under GST. The Central GST portion may subsume Central excise duty and additional excise duties, service tax, additional customs duty (countervailing duty) and all surcharges and cesses, *etc.* Similarly, the States' GST is expected to subsume value added tax, entry tax (not levied by local bodies), luxury tax, taxes on lottery, betting and gambling, entertainment tax (unless levied by local bodies), advertisement tax, State excise duties, and all State cesses and surcharges insofar as they relate to supply of goods and services.

2.9 There was some initial consensus on basic issues like dual GST rate on goods for an initial two years with a convergence to a single rate in the third year. In fact, the dual structure of GST is considered desirable for preserving India's federal structure. In addition, there have been other issues with regard to the design of GST which seemed to have been delaying the implementation of GST. These issues mainly pertained to the power to determine the tax rate structure, dispute resolution mechanisms, compensation structure (if required), inter-State transactions and information systems. However, the areas of divergence between the Centre and the States on GST seem to be narrowing down. Accordingly, as a step towards the roll-out of GST, the Central government has introduced a Constitutional Amendment Bill for GST on March 22, 2011. This Bill, apart from providing the list of Central/State taxes to be subsumed, confers simultaneous power upon Parliament and the State Legislatures to make laws governing goods and services tax. The Bill also proposes levying of Integrated GST on inter-State transactions of goods and services. In addition, the Constitutional Amendment Bill attempts to provide clarification on some of these issues. As per the Bill, the proposed Central and State goods and services tax would be levied on all transactions involving supply of goods and services except those

that are exempt or kept out of the purview of the goods and services tax⁴. The Bill also envisages the setting up of a Goods and Services Tax Dispute Settlement Authority, which may be approached by the affected Government (whether the Centre or a State) seeking redressal for any loss caused by any action due to a deviation from the recommendations made by the Goods and Services Tax Council or for adversely affecting the harmonious structure and implementation of the goods and services tax.

2.10 With introduction of GST system, the vertical imbalance is expected to reduce, as States will have the power to tax the services sector which is the largest and a growing sector of the Indian economy. Nonetheless, the revenue implications are likely to vary across States. Since States still do not have an accurate assessment of their respective tax bases, it is difficult to infer the revenue implications for States. It may, however, be noted that with the introduction of VAT, the tax-GDP ratio at the State level improved significantly. One important issue to be finalised is the compensation structure in case of revenue loss to States. Since the GST rates being discussed are higher than initially envisaged and that recommended by the Taskforce of the Thirteenth FC, the issue is whether the Centre should fully compensate States in case of revenue loss. Harmonising the GST laws at the State level would also be important in order to ensure reduced compliance costs and increase efficiency in tax collections.

2.11 The implementation of GST also involves other issues such as enhancing administrative capacity and improving the IT infrastructure of States to ensure better compliance with the expanded tax base. An Empowered Group (Chairman: Nandan Nilekani) with representation from the Centre and States has been constituted to assess the IT infrastructure needs at the Centre and State levels. Adequate IT infrastructure is a pre-requisite for the successful implementation of GST as it would enable seamless GST registration and electronic filing of returns and payment of taxes. Being a destination-based tax, accurate determination and efficient transfer of input tax credits across tax

jurisdictions need to be ensured in the case of inter-State transactions. Some progress seems to have been made in this regard as key business processes of registration, returns and payments are in advanced stages of finalisation. As indicated in the Union Budget 2011-12, National Securities Depository Limited (NSDL) will set up a Pilot portal in collaboration with eleven States prior to its roll out across the country by June 2011. There are other practical challenges with regard to (i) distinguishing between goods and services, (ii) taxation of bundled or composite supplies comprising both goods and services and (iii) taxation of software and telecom services. Similarly, in view of the large list of exempted goods and a three-way classification of rates, viz., lower rates for basic goods, standard rate for all other goods and a single rate for services, disputes relating to classification and valuation cannot be ruled out. There needs to be a clear policy on the treatment of such issues. Nevertheless, the successful implementation of GST is crucial for States to benefit from such reforms and make smooth progress towards fiscal correction.

5. Expenditure Management

2.12 In the context of State finances, the quality of expenditure has always been an important issue. At present, revenue expenditure accounts for around 80 per cent of States' aggregate expenditure, which is in the nature of current consumption rather than investment and has implications for the growth prospects of States. It may be argued that revenue expenditure is not altogether unproductive and *vice versa* for capital expenditure. Nevertheless, States need to identify unwarranted items of revenue expenditure which have low growth and welfare implications.

2.13 Expenditure reforms are an important driver of the Thirteenth FC's approach to the fiscal roadmap for the future. The major thrust of the proposed expenditure reforms is to improve the supply of public goods, which is also inclusive, through a reduction in the existing untargeted and

⁴ Items which are proposed to be exempted or outside the purview of GST include crude petroleum, high speed diesel, natural gas, motor spirit (petrol), aviation turbine fuel and alcoholic liquor for human consumption. States will have the authority to levy tax on these items.

regressive subsidies. The Commission also recognises the need to improve transparency and accountability by putting in place stricter audit procedures in general and operational audit, in particular, for proper assessment of the 'efficiency and effectiveness' of various items of expenditure. It has also suggested that 'institutional deepening' through the creation of local body ombudspersons, fiscal councils and independent evaluation organisations would help in better expenditure management. States could encourage the use of innovative measures that can reduce cost and also improve the quality of public services. The efficient allocation of public expenditure is crucial not only for setting the pace of fiscal consolidation at the State level but also for raising their economic potential over the medium term.

6. Surplus Cash Balances

2.14 State governments have been parking their large cash surplus balances in market instruments like 14-day intermediate treasury bills (ITBs) since 2004-05. Although States' average investment in 14-day ITBs showed a sharp decline in 2008-09 and 2009-10 due to fiscal stress, States tended to accumulate large surplus cash balances towards the last quarter of these years. As on March 18, 2011, States' investment in 14-day ITBs stood at ₹1,20,318 crore as compared with ₹93,776 crore as at end-March 2010. Apart from the improved macroeconomic situation which had positive implications for State finances, the accumulation of large surplus cash balances indicates that some States tended to borrow more than their fiscal deficit. Taking note of this situation, the Thirteenth FC has highlighted that while States require some cushion for smoothening expenditure at the implementation level, the accumulation of cash beyond a level reflects inefficiency, leading to an avoidable interest burden.

2.15 Given the fact that States still have ample surplus cash balances and the GFD-GSDP ratio is envisaged to be lower in the coming years, it is essential that States adopt a need-based approach to their market borrowings. The Thirteenth FC has also suggested that there should be a directed effort

by States with large balances towards utilising their existing cash balances before resorting to fresh borrowings. States may consider using their surplus cash balances for bullet repayments of market borrowings raised for debt swaps during the period 2002-2005, which are likely to become due during the next few years. Further, State governments need to have an effective forecasting and monitoring mechanism for their cash inflows and outflows. Effective cash management is possible only if State governments develop the skills and capacity to record, monitor, and project short-term inflows and outflows. States should encourage co-ordination among State entities that collect revenue and expend funds. Better timing of decisions involving major expenditures and rationalising the number of bank accounts may also help them use cash surpluses more efficiently.

7. Disclosure and Dissemination in State Budgets

2.16 With the enactment of Fiscal Responsibility Legislations (FRLs), there has been some improvement in the fiscal transparency at the States' level. However, there are still issues with regard to lack of availability of information, inconsistency in the available information and lack of uniformity in data reporting by the State governments. There are considerable discrepancies in the methodology in some State budgets. To make an objective assessment, it is important that the budget documents provide accurate information in a transparent manner. For instance, many of the State governments do not publish data on outstanding liabilities, contingent liabilities and off-budget borrowings in their budget documents, despite the recommendations of various committees. The data on wages and salaries and 'operations and maintenance' are spread over a number of heads in the State budgets, such as administrative services, economic services and social services. Thus, from the State budgets, it is difficult to make out the extent of funds spent on wages and salaries and operations and maintenance expenditure.

2.17 There are several inconsistencies in the budget documents of State governments. For

instance, GSDP data which is used to calculate key fiscal indicator ratios are at times inconsistent with the GSDP estimates given in the budget documents of some States. Similarly, the formats in which the State governments disclose information on key items are not uniform. Therefore, States which lack disclosure and transparency standards need to gradually improve them, keeping in view the best benchmarks set by some other States.

8. Strengthening the State Finance Commissions

2.18 With an increasing emphasis on decentralisation through greater devolution of powers, functions and authority to local bodies, it becomes important to strengthen the State Finance Commissions (SFCs). The SFCs can play an important role in ensuring allocative efficiency of resources transferred from the States to local bodies in the form of compensations and transfers. It is also essential to strengthen the SFCs to make their functioning more predictable while ensuring transparency in the process of implementing their recommendations. The Thirteenth FC has suggested that the Central Finance Commission and the SFCs could be constituted simultaneously.

2.19 Under Article 243-I of the Constitution, the SFCs are supposed to be appointed at the end of every fifth year. This is to ensure that all State government transfers to local bodies are governed by the mandate of the current SFC. However, considerable delays have been observed in submission of reports by the SFCs in some States. State governments also take their own time to finalise 'Action Taken Reports'. In some States, the lag between submission and the Action Taken Report is unduly long. In some States, the SFCs

have not even been constituted while other States are exempted under Article 243M from setting up an SFC. While setting up an SFC, the State Government should emphasise that the report of the Commission should be adequately analytical. One of the major challenges that the SFCs face is the lack of credible data that is comparable across local bodies. This limits their effective use by SFCs to work out a sound distribution framework across the local entities of the State. Thus, local bodies should gradually move towards sound budgetary, accounting and auditing practices so that their resource requirements are assessed in a better manner by the SFCs.

9. Conclusion

2.20 To conclude, a major issue at the present juncture is to make credible progress towards fiscal consolidation at the States' level. Even though the States' fiscal performance to a large extent depends on macroeconomic conditions, they need to explore sources of non-tax revenues and review their policies towards user charges in certain highly subsidised sectors. In the current phase of fiscal correction, the focus has to be on expenditure-related reforms to improve the productivity of public expenditure which can contribute to the sustained fiscal position of State governments. Going forward, the implementation of GST would assume significance in determining the revenue position of States. States should prepare and put in place adequate infrastructure to effectively capture the tax base once GST is implemented. States also need to strengthen the SFCs by asking them to use an analytical approach to issues pertaining to local bodies. Timely submission of reports by the SFCs and finalisation of action taken by the State Government should be ensured so that the recommendations made in the Report do not become outdated and irrelevant with time.