Reserve Bank of India Occasional Papers
Vol. 27, No. 1 and 2, Summer and Monsoon 2006

State Finances and Effectiveness of Policy Measures: An Analysis of Indian States

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This paper provides a phase-wise analytical review of the fiscal situation of the Indian major States over the previous two and half decades and examines the effectiveness of the policy measures to strengthen the State finances. The analysis reveals that the States' fiscal position showed imbalances, *albeit* in a varied degree, since the mid-1980s which deepened in the second half of the 1990s. The effectiveness of policy measures has remained largely inadequate. Most of the Policy measures were exigency-driven rather than being structured. As the States face large resource gap, they require effective and time-bound policy measures to enhance revenues particularly non-taxes and shift in expenditure pattern towards economic infrastructure and social sectors to facilitate acceleration in growth.

JEL Classification : H71, H72, H74

Key Words : State Taxation, State Budget, State Borrowing

Introduction

In the Indian federal set up, the States play an important role in accelerating and sustaining growth. The Indian Constitution assigns important responsibilities to States in many sectors such as agricultural development, infrastructure, poverty alleviation, water supply and irrigation, public order, public health and sanitation. Furthermore, they have concurrent jurisdiction in several areas like education, electricity, economic and social planning and family planning. In view of the larger responsibilities

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assigned to the States, their expenditure accounts for a substantial portion of the Government sector expenditure (Centre *plus* States) in India. The comparative position across countries reveals that in India the share of aggregate States' expenditure in Government sector expenditure is higher than that in several other countries such as Australia, Denmark, Argentina, USA and Germany (World Bank, 2005). The composition of receipts and expenditure of the Government sector in India reveals that while the State Governments collect about one-third of the total Government sector receipts, they incur more than three-fourth of the total expenditure on social services and more than half of the total expenditure on economic services. The States' ability to undertake and perform the developmental functions adequately and effectively is critically determined by their fiscal position.

A State specific assessment of fiscal position assumes importance in view of the wide disparities that exist among the Indian States and their increasing role in the development. The policy measures and prescriptions which are suggested for aggregate State finances may not be appropriate and effective for drawing out strategies for an individual State. It is worth noting as stated in the Economic Survey, (2004-05), Government of India, "*Though the fiscal deterioration of States began much later than that of the Centre, the fiscal stress of some of the State Governments is more acute and an important constraint in their development.*" The analysis of State finances in historical perspective since the mid 1980s reveals: (i) steady deterioration in revenue receipts-GSDP ratio, (ii) stagnating social sector expenditure, (iii) inadequate investment for basic infrastructure sectors, (iv) pre-emption of high cost borrowed funds for financing current expenditure, (v) large and persistent resource gap, and (vi) accumulation of high debt stock and debt service payments.

Many States undertook various policy measures to strengthen their finances mainly in the late 1990s. Given the size of the problem, the effectiveness of such policy measures, however, remained largely inadequate. Most of the policy measures were *ad hoc* in nature and were guided by the exigency rather than being structured.

Against the above background, the paper provides an analytical review of fiscal situation at State level during the previous two and a half decades. The paper examines the policy measures undertaken and their effectiveness to improve the State finances. The entire period under review is divided into four phases based on the emerging fiscal developments. The structure of the remaining paper is as follows. Section I provides an analytical framework to study the public finance at State level. Section II presents an analytical review and assessment of fiscal situation at State level. Section III sets out the review of policy measures. The details of effectiveness of the policy measures are provided in Section IV. The concluding observations are outlined in Section V.

Section I

Analytical Framework

In a federal system, the sub-national governments are assigned certain sources of revenues and expenditure responsibilities. In the Indian context, the State Governments have their own independent sources of revenue as well as transfers from the Central Government. Accordingly, the level of resource flow at State level in India is determined by both (i) endogenous factors (*i.e.,* States' own efforts in generating resources) and (ii) exogenous factors (*i.e.,* the resource transfers from the Central Government). The details of various sources of revenues and expenditure responsibilities of State Governments are set out below.

Sources of Revenues

States' own Revenues

(i) *States' own tax revenues:* States' own taxes can be grouped into three parts, *viz.,* (i) taxes on commodities and services such as sales tax, State excise, taxes on vehicles and taxes on goods and passengers, (ii) taxes on property and capital transactions such as stamps and registrations and land revenue, and (iii) taxes on income such as profession, trade and agricultural income. Among the above, the principal

sources of States' tax revenue are sales tax, State excise and stamps and registration fees. Sales tax alone accounts for nearly two-thirds of the total States' own tax revenue. Realising the need for tax reforms, many States have switched over to a Value Added Tax (VAT) regime on the basis of the recommendations of the Empowered Committee of State Finance Ministers with effect from April 1, 2005. VAT may be defined as a tax on the value added at each stage of production and distribution of a commodity.

(ii) *States' own non-tax revenues*: These include (i) interest receipts, (ii) dividend and profits,(iii) user charges on account of social and economic services, and (iv) general services which mainly include State lotteries. The major part of revenues comes from interest receipts, State lotteries and user charges on account of economic services.

Current Transfers and Devolution from the Centre

The current transfers and devolution from the Centre include States' share in the Central taxes and grants. The provision for these transfers to States aims at addressing the vertical imbalance or fiscal gap that stems from asymmetric devolution of functions and tax powers among different Government levels. Furthermore, such transfers aim to secure fiscal equalisation among the States which is necessary and imperative in the interest of equity and efficiency.

Expenditure Responsibilities of States

State Governments incur considerable expenditure towards provision of various social and economic services in addition to expenditure requirements towards maintenance of various organs and general administration. The total expenditure comprises of revenue and capital components. Broadly the expenditure which does not result in creation of assets is treated as revenue expenditure. Capital expenditure mainly includes expenditure on acquisition of assets like land, building, machinery *etc.* and also loans and advances by States mainly to Public Sector Undertakings (PSUs). Under revenue expenditure, certain items of expenditure, *viz.*, interest payments, pensions outgo, wages and salaries and expenses towards administrative services have downward rigidity.

Financing Pattern of Gross Fiscal Deficit (GFD)

The analysis of the State Government finances during previous two and half decades reveals that invariably almost all the States incur more expenditure than the revenues they mobilise. Consequently, the States undertake borrowings from a number of sources to finance their resource gap/GFD. The financing pattern of resource gap indicates that, historically, loans from the Centre have been the most important source of borrowings for the States. However, with the changes in accounting system in respect of small savings since April 1, 1999 and operationalisation of Debt Swap Scheme (during 2002-03 to 2004-05), the share of this source in financing GFD has declined significantly. The small saving receipts [(*i.e.*, Special Securities issued to National Small Saving Fund (NSSF)] are emerging a major source to finance the resource gap – constituting over two third of GFD in the recent period (RBI, 2005). The other major sources of financing available to the States include: (i) market borrowings, (ii) loans from banks and financial institutions (FIs) and (iii) public account borrowings.

Scheme of Presentation of States' Fiscal Analysis

Taking into account the fiscal developments on both front, *viz.*, (i) endogenous factors (within States' control) and (ii) exogenous factors (States' dependence on Central transfers), the period under review has been divided into four phases.

(i) ***Revenue Account in Surplus Position***: This phase covers the period 1980-81 to 1985-86. The buoyant growth in States taxes particularly sales tax led to the higher growth in revenues than the expenditure - resulting in surplus in the Revenue Account.

(ii) ***Emergence of Fiscal Imbalances*****:** This phase deals with the period 1986-87 to 1997-98. The growth in revenues remained sluggish on account of low/negligible user charges and dividends and profits coupled with stagnation in States' share in Central taxes. The liberalisation of trade and investment policies providing various incentives and concessions to attract private investment impacted the States' finances.

(iii) ***Deepening and Persistent Fiscal Imbalances[1]*:** This phase pertains to the period 1998-99 to 2003-04. The major reasons behind the worsening of fiscal imbalances were the significant increase in revenue expenditure due to Fifth Pay Commission award and growing interest payments on the past high cost borrowed funds. The growth in revenues remained sluggish due to stagnation in States' tax-GSDP ratio and decline in States' own non-taxes and Central transfers, particularly, grants to States.

(iv) ***Recent Fiscal Developments and Challenges Ahead:*** This phase takes into account the period since 2004-05 onwards. Implementation of VAT with effect from April 1, 2005, recommendations of Twelfth Finance Commission (TFC) for the period 2005-10 and the States' continued emphasis on the on-going fiscal reforms with statutory backing such as fiscal responsibility legislations (FRLs) which got further boost on account of TFC's recommendations are the major recent developments. The fiscal position of States would be largely influenced in the medium term by these developments. This phase also highlights the major challenges for the States in the medium term.

The details of major fiscal indicators to examine the fiscal situation of States include: (i) trends in revenue receipts, States' own revenues and share in the Central taxes and grants, (ii) pattern and trends in major components of expenditure, (iii) available resources for financing resource gap, and (iv) movement in major deficits and debt stocks[2].

Section II

Finances of Major States: Analytical Review and Assessment[3]

An Overview

A quick overview of the fiscal position of major States reveals that they were generating surpluses in their revenue account in the first phase. The fiscal position of States, however, had started to show signs of stress in the second phase and fiscal imbalances deepened and persisted during the third phase. The factors responsible for the widening fiscal inbalances include: (i) growing interest burden, (ii) increasing wages and salaries (iii) pension liabilities, (iv) losses incurred by State Public Sector Undertakings, (v) inadequate user charges/cost recoveries and (vi) deceleration in the Central transfers (RBI, 2004). In the recent years, interest payments alone constitutes over one-fourth of the revenue expenditure and absorbs between 30-50 per cent of revenue receipts in many States (West Bengal, Orissa, Punjab, Rajasthan, Gujarat, Uttar Pradesh). Notably, during 2002-03 to 2003-04, interest payments and pensions outgo taken together absorbed as high as around 70 per cent of revenue receipts in case of West Bengal and nearly 50 per cent of revenue receipts in Kerala.

The fiscal stress experienced by the States has seriously constrained their ability to discharge major responsibility of developing social and economic infrastructure. The expenditure for developmental activities, which are directly related to growth, has suffered. On the other hand, expenditure on non-developmental purposes, largely committed in nature, has witnessed a steady rise. The problem was exacerbated by low productivity of capital expenditure. The proliferation of projects spread the resources thinly and inadequate financial allocations cause severe cost and time over runs (Rao, 2002).

The Planning Commission, while stressing the need for fiscal and other reforms at the State level, observed that "… *a joint effort by the Centre and States is needed to fulfill the Tenth Plan objectives. Along with the Centre, States need to reform more and much faster, and raise substantially higher levels of their own resources to mobilise the financial resources essential for the much needed productive investments*. .." *(*Mid Term Appraisal, Tenth Five Year Plan).

Phase-wise Analysis of State Finances: Major Features

The analytical framework developed in section I has been used to analyse the fiscal position of States. The major features of each phase are set out below.

Phase 1: ***Revenue Account in Surplus Position***

All the major States except West Bengal[4] were generating surplus in the Revenue Account. The major features of this phase include: (i) growth in revenue receipts was mainly led by States own taxes particularly, sales tax, (ii) the revenue expenditure of major States in terms of GSDP, on an average remained at 12.8 per cent, (iii) the revenue receipts of States were placed at 13.2 per cent of GSDP thus leaving surplus of 0.4 per cent of GSDP under revenue account, and (iv) GFD-GSDP ratios in case of all the States except Punjab and Orissa was below 4 per cent.

Phase 2: ***Emergence of Fiscal Imbalances***

The major highlights of this phase are: (i) Revenue Account of the States turned into deficit from surplus, (ii) the deceleration in the States' own non-tax revenues coupled with stagnation in States' share in Central taxes resulted in sluggish growth in the revenue receipts, (iii) revenue expenditure in terms of GSDP, on an average, increased by more than two percentage points, (iv) the revenue receipts-GSDP ratio increased less than one percentage point in this phase over the previous phase, (v) many States started utilising the high cost borrowed funds to finance the current expenditure, (vi) total expenditure-GSDP ratio increased marginally over the first phase - reflecting the impact of cutback of capital expenditure which declined to 3.8 per cent from 5.6 per cent of GSDP in the previous phase, (vii) the liberalisation of trade and investment policies in the economy impacted State finances as they provided various incentives and concessions to attract private investment, and (viii) the increasing share of the services in States' GSDP, which were not covered under the tax net, also affected adversely their fiscal health.

Phase 3: ***Deepening and Persistent Fiscal Imbalances***

The major features include: (i) the increasing fiscal imbalances in the previous phase had started deepening and persisted, (ii) revenue receipts-GSDP ratio decelerated by 0.8 per cent while revenue expenditure-GSDP ratio increased by around 2 percentage points over the previous phase, (iii) deceleration in revenue receipts was due to decline in States own non-tax revenues, which reflected low/negligible user charges, dividends and profits, and central grants, (v) revenue expenditure grew significantly mainly due to increase in salaries and wages bill on account of the Fifth Pay Commission recommendations coupled with high interest payments on past loans and pensions outgo, (vi) interest payments and pension outgo of major States absorbed as high as 37 per cent of revenue receipts (varying from 26 per cent in Madhya Pradesh to 58 per cent in West Bengal) as against 21 per cent in the previous phase (varying from 15 per cent in Maharashtra to 28 per cent in Kerala), (vii) total expenditure-GSDP ratio increased to around 21 per cent due to significant increase in revenue expenditure, (viii) a sharp increase in revenue expenditure accompanied by inadequate growth in revenues constrained the States ability for releasing adequate resources for capital expenditure which remained almost stagnated at the level of the previous phase (3.8 per cent of GSDP), (ix) the large and persistent resource gap resulted in a vicious cycle of deficit, debt and debt service payments.

Phase 4: ***Recent Fiscal Developments and Challenges Ahead***

The recent major fiscal development, *viz.,* implementation of VAT, TFCs recommendations and States' FRLs, are expected to largely impact the State finances in the medium term. There are some signs of improvement in the State finances as reflected in their recent budgets. However, given the past track record of weak fiscal marksmanship of State Governments, the high level of fiscal corrections appears to be difficult to achieve in a short span of time. For a durable fiscal discipline and realistic fiscal correction path, States would have to place continuous emphasis on timely and effective measures towards on both revenue enhancement and expenditure reprioritisation. In this regard, the fiscal correction path as spelt out by the TFC provides a new direction and motivatation to the States to undertake the appropriate policy measures.

TFC's Impact on State Finances

The TFC's recommendations for fiscal consolidation in the States will have far-reaching implications for the federal-state fiscal relationship. The States' fiscal imbalances are likely to ease on account of higher tax devolution, enhanced grants as well as the debt relief schemes by the TFC. The critical aspect of the recommendations of the TFC is the linking of certain resource transfers to enhance the fiscal prudence on the part of the States, in general, and the enactment of FRLs by the States, in particular. The increase in transfers recommended through tax devolution and grants are expected to facilitate the States to undertake fiscal correction even while undertaking social and infrastructure expenditure required to move on an accelerated growth path.

A New Borrowing Regime for States

Following the TFC's recommendations that the Centre should not act as an intermediary for future lending and allow the State Governments to approach the market directly, a new borrowing regime for the States was put in place[5]. Accordingly, in the Union Budget 2005-06, there was no provision made for Central loans for State Plan Schemes. The Union Budget indicated an amount of Rs.29,003 crore which was to be raised by the States and Union Territories with Legislature directly from the market. Furthermore, as per the TFC's recommendations (also accepted by the Government of India), external assistance would be transferred to the States on the same terms and conditions as attached to such conditions by external funding agencies (making Centre a financial intermediary - without any gain or loss). The States would get the same maturity, moratorium and amortisation schedule as the Centre gets from the external lender.

The past experience of some States reveals that the weaknesses in their finances invited adverse reaction from the financial markets as manifested in the widening spread on State Government securities and under-subscription to market loans. The under-subscription to the State market loans also brings to the fore various factors that impact State Governments liquidity. These factors include: (i) the fiscal health of the State Governments, (ii) the credibility of their prospective policy actions and, (iii) transparency of their budgets (RBI, 2004).

In view of the new borrowings regime, States would need to improve the market perception about their fiscal position by exhibiting adequate will and action for fiscal rectitude by actively considering the fiscal reforms measures. The better fiscal performing States would get the benefit relatively more than the fiscally weak States from the market.

Challenges Ahead

In the process of fiscal correction in the medium term, the allocation of adequate resources towards productive sectors, which is essential to accelerate the growth and to increase the revenues particularly through non-taxes by increasing user charges, cost recovery, dividends and profits, *etc.*, would be major challenges for the States.

The large repayment of market borrowings (from Rs. 6,274 crore in 2005-06 to increase two-fold by 2007-08, three-fold by 2010-11 and nearly six times by 2014-15) would have a bearing on the fiscal health of the States (RBI, 2005).

Furthermore, the impact of the Sixth Pay Commission on fiscal health, if followed by the State Governments, also needs to be taken into account[6]. Although the Pay Commission, is meant to cover only the Central Government employees, its recommendations, as the past experience reveals, are generally adopted by the State Governments as well. The Commision is expected to submit the report within eighteen months from the date of its constitution.

A State-wise Analysis

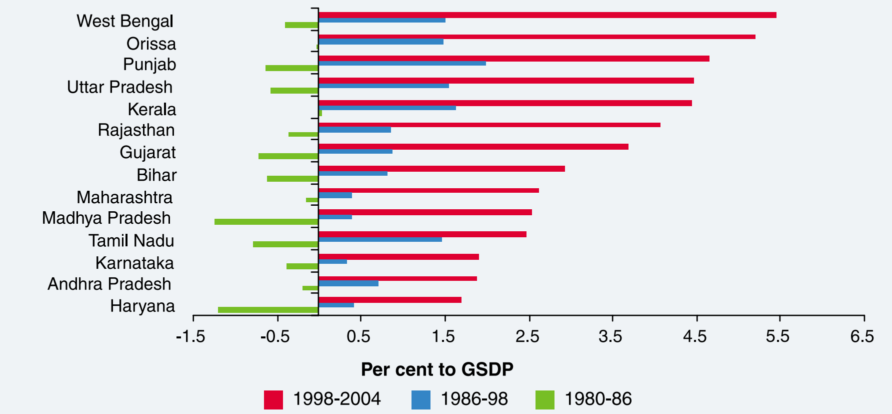
A State-wise analytical review of the fiscal position based on select fiscal indicators is set out below.

Trends in Major Deficits and Financing pattern

Revenue Deficit

The degree of deterioration in the revenue account varied significantly across the States (Chart 1 and Exhibit 1). States like Orissa and West Bengal showed substantial increase in their revenue deficit-GSDP ratio in the third phase as compared to the

Chart 1 : Phase-wise Surplus (-)/Deficit (+) in the Revenue Account



Note : During the first phase, West Bengal revenue account was in surplus only in 1985-86.

second phase. The deterioration in the revenue account led to significant increase in the overall resource gap.

Revenue Deficit Accounts for Sizeable Portion of GFD

The revenue deficit of State Governments such as West Bengal, Punjab, Kerala and Uttar Pradesh showed substantial increase and accounted for over 70 per cent of GFD in the third phase. The significant deterioration in Revenue Account of States led them to

Exhibit 1 : States' Revenue Surplus/Deficit-GSDP Ratio: A Comparative Position

Per cent	Phase 1 : 1980-86 (Revenue Surplus)
Above 1	Haryana, Madhya Pradesh
0.5 to 1	Uttar Pradesh, Bihar, Punjab, Gujarat, Tamil Nadu
Below 0.5	Kerala, Orissa, Maharashtra, Andhra Pradesh, Rajasthan, Karnataka, West Bengal *
* : During the first phase, West Bengal revenue account was in surplus only in 1985-86.	
	Phase 2: 1986-98 (Revenue Deficit)
Above 1.5	Punjab, Kerala, Uttar Pradesh, West Bengal
0.5 to 1.5	Orissa, Tamil Nadu, Gujarat, Rajasthan, Bihar, Andhra Pradesh
below 0.5	Haryana, Maharashtra, Madhya Pradesh, Karnataka
	Phase 3 : 1998-2004 (Revenue Deficit)
Above 4	West Bengal, Orissa, Punjab, Uttar Pradesh, Kerala, Rajasthan
2.5 to 4.0	Gujarat, Bihar, Maharashtra, Madhya Pradesh, Tamil Nadu
Below 2.5	Karnataka, Andhra Pradesh, Haryana

Exhibit 2 : States' Revenue Surplus/Deficit-GFD Ratio: A Comparative Position

Per cent	**Phase 1 : Revenue Surplus/ GFD Ratio**
Above 40	Madhya Pradesh, Haryana
20 to 35	Tamil Nadu, Karnataka, Gujarat, Bihar, Uttar Pradesh, Punjab, West Bengal *
Below 20	Kerala, Andhra Pradesh, Maharashtra, Rajasthan, Orissa
*** :** During the first phase, West Bengal revenue account was in surplus only in 1985-86.	
	Phase 2 : Revenue Deficit/GFD Ratio
Above 40	Kerala, West Bengal, Tamil Nadu
20-40	Andhra Pradesh, Orissa, Uttar Pradesh, Punjab
below 20	Karnataka, Haryana, Maharashtra, Madhya Pradesh, Rajasthan, Gujarat, Bihar
	Phase 3 : Revenue Deficit/GFD Ratio
Above 70	Kerala, Punjab, West Bengal, Uttar Pradesh
60 to 70	Gujarat, Tamil Nadu, Orissa, Rajasthan, Maharashtra
Below 60	Madhya Pradesh, Bihar, Karnataka, Haryana, Andhra Pradesh

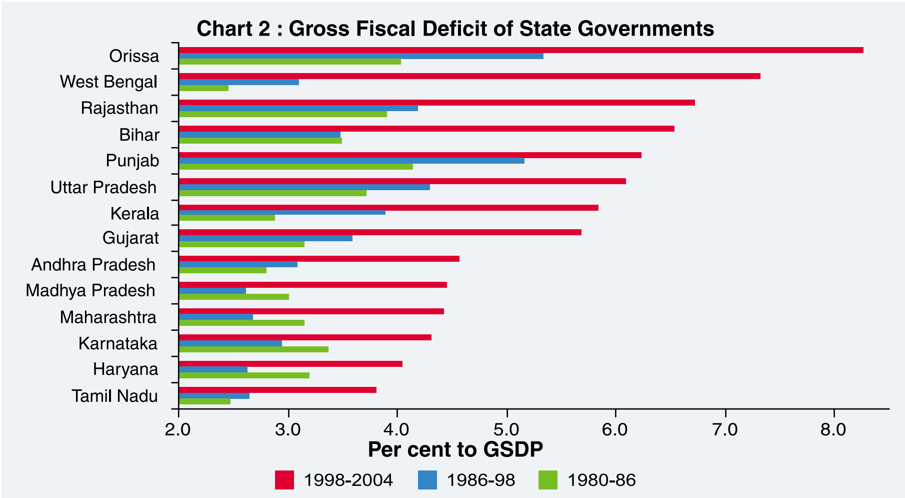
use a substantial portion of the borrowed funds to finance their current expenditure in the third phase (Exhibit 2).

GFD of State Governments

The substantial increase in GFD was evident in case of many States such as Orissa, West Bengal, Rajasthan, Bihar, Punjab, Uttar Pradesh (Chart 2 and Exhibit 3).

Financing Pattern of GFD

State Governments access funds from a number of sources to finance their resource gap *viz.*, (i) loans from the Centre, (ii) market borrowings, (iii) loans from banks and financial institutions (FIs) (such as SBI and other banks, NABARD, LIC, GIC) and (iv) Public Account Borrowings (PAB) (such as State provident funds, reserve funds and deposits and advances). To meet the temporary mismatches in receipts and expenditure, the States also avail ways and means advances from the Reserve Bank of India. A quick analysis of the



borrowed funds by the States reveals that during the 1990s loans from the Centre was a dominant source of financing States' deficit followed by State Provident Funds and other PAB, market loans and banks and FIs.

The States dependence on the Centre to finance their deficit, however, showed significant decline due to introduction of NSSF

Exhibit 3 : States' GFD-GSDP Ratio: A Comparative Position

Per cent	**Phase 1 : 1980-86**
Above 3.5	Punjab, Orissa, Rajasthan, Uttar Pradesh, Bihar
3.0-3.5	Karnataka, Haryana, Maharashtra, Gujarat, Madhya Pradesh
Below 3.0	Kerala, Andhra Pradesh, Tamil Nadu, West Bengal
	Phase 2: 1986-98
Above 4	Orissa, Punjab, Uttar Pradesh, Rajasthan
3.5- 4.0	Kerala, Gujarat, Bihar
Below 3.5	West Bengal, Andhra Pradesh, Karnataka, Maharashtra, Tamil Nadu, Haryana, Madhya Pradesh
	Phase 3 : 1998-2004
Above 6	Orissa, West Bengal, Rajasthan, Bihar, Punjab, Uttar Pradesh
4.5 to 6.0	Kerala, Gujarat, Andhra Pradesh, Madhya Pradesh
Below 4.5	Maharashtra, Karnataka, Haryana, Tamil Nadu

Exhibit 4 : Financing Pattern of GFD of States: A Comparative Position

(Per cent to GFD)

State	Phase 2 : 1986-1998			Phase 3 : 1998-2004			
	CL	MB	OT *	CL	MB	NSSF #	OT *
Andhra Pradesh	51	23	26	24	31	26	19
Bihar	65	34	1	24	19	41	16
Gujarat	57	10	33	16	24	61	-1
Haryana	50	15	35	10	21	51	18
Karnataka	46	16	38	21	27	34	18
Kerala	33	23	44	8	21	18	53
Madhya Pradesh	40	17	43	18	25	34	23
Maharashtra	52	8	40	9	14	42	35
Orissa	38	25	37	23	28	18	31
Punjab	76	7	17	1	18	54	27
Rajasthan	39	19	42	12	26	48	14
Tamil Nadu	49	21	30	9	24	35	32
Uttar Pradesh	50	17	33	10	24	40	26
West Bengal	60	18	22	17	16	56	11

CL : Central Loans, MB: Market Borrowings, OT : Others, NSSF : Loans from National Small Saving Fund.
* : Includes negotiated loans from Banks and FIs and public account borrowings.
# : Came into existence on April 1, 1999.

since April 1, 1999. During 2002-05, States have made substantial repayment of Central Loans under Debt Swap Scheme. Consequently, the share of Central loans in financing the States' GFD has declined significantly while the share of market loans, small savings and other loans has increased. In the recent years, a number of States have financed over 50 per cent of their GFD through loans from NSSF (Exhibit 4).

Revenue Performance of States

Revenue receipts showed sluggish growth in case of many States in the third phases. Inadequate growth in revenue receipts was due to near stagnation in States' tax-GSDP ratio with no perceptible change in the contribution of States' non-tax revenue to GSDP and deceleration in resource transfers from the Centre to the States. Revenue receipts-GSDP ratio was above 15 per cent in case of five States during the second phase, however, in the third phase only two States could manage their revenue-GSDP ratio at this level (Exhibit 5).

Exhibit 5 : States' Revenue Receipts-GSDP Ratio: A Comparative Position

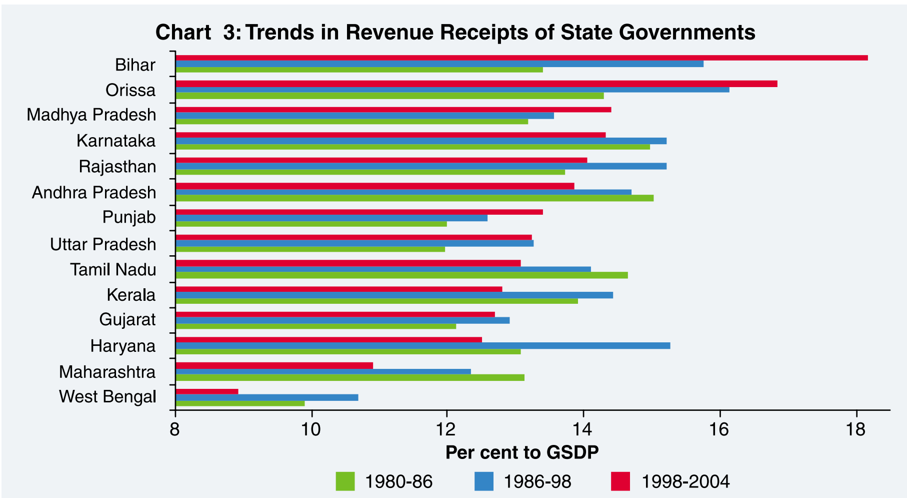
Per cent	Phase 1 : 1980-86
Above 14	Andhra Pradesh, Karnataka, Tamil Nadu, Orissa
13 to 14	Kerala, Rajasthan, Bihar, Madhya Pradesh, Maharashtra, Haryana
Below 13	Gujarat, Punjab, Uttar Pradesh, West Bengal
	Phase 2: 1986-98
Above 15	Orissa, Bihar, Haryana, Karnataka, Rajasthan
14 to 15	Andhra Pradesh, Kerala, Tamil Nadu
Below 14	Madhya Pradesh, Uttar Pradesh, Gujarat, Punjab, Maharashtra, West Bengal
	Phase 3 : 1998-2004
Above 15	Bihar, Orissa
13 to 15	Madhya Pradesh, Karnataka, Rajasthan, Andhra Pradesh, Punjab, Uttar Pradesh, Tamil Nadu
Below 13	Kerala, Gujarat, Haryana, Maharashtra, West Bengal

Many State Governments showed deterioration in their revenue receipts-GSDP ratio in the third phase (Chart 3). The component-wise performance of revenue receipts of State Governments is set out below.

Trends in States' Own Revenue

States' own taxes

States' own taxes remained almost stagnant at 7 per cent of GSDP during the second and third phase. Under State taxes, the poor performance has been mainly marked in the case of taxes on sales tax, state excise and



stamps and registrations. The major reasons behind the inadequate growth in States taxes over the years are (i) narrow tax base, (ii) greater dependence on indirect taxes mainly the sales tax, (iii) lack of harmonised inter-state tax structure which allowed distortions and rigidities to creep in, (iv) competitive tax reductions by the States to attract trade and industry. The competitive reduction in taxes led to a mere redistribution of existing capital among the States at the cost of significant revenue foregone, (v) States inabilty to levy taxes on services and agricultural income, and (vi) tax evasion and slackness in the recovery of arrears.

States' own non-tax revenue

The States' own non-tax revenue in terms of GSDP showed deterioration in the second and third phases. A major reason underlying the sluggish growth in non-tax revenue is the levy of inadequate user charges/cost recoveries. The cost recovery in the case of education and health services has hovered around 1 per cent and 5 per cent, respectively, in the recent period (RBI, 2005). Apart from inappropriate user charges, low or negative returns from investment have adversely affected the growth of States' own non-tax revenues over the years.

The trends in States' own revenue receipts (comprising State' own taxes and own non-taxes) indicate that the many States such as West Bengal, Karnataka, Haryana, Gujarat and Maharashtra showed deterioration in the third phase as against the second phase (Chart 4).

Chart 4 : Trends in States own Revenue Receipts

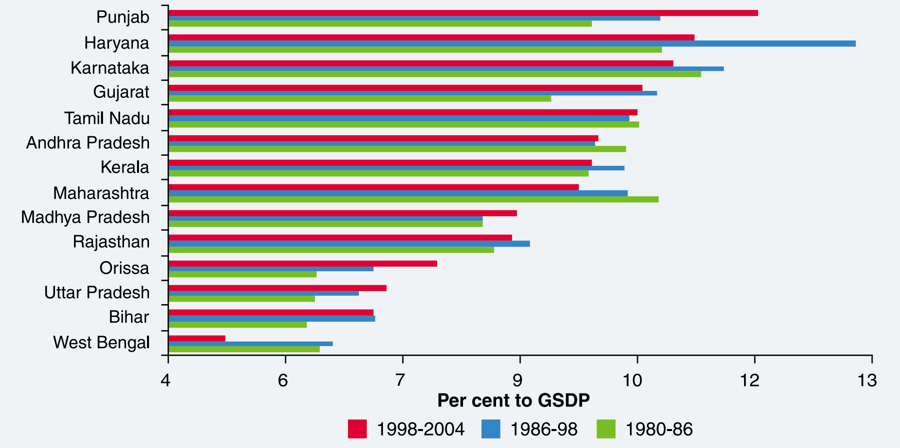


Exhibit 6 : States' Own Revenue-GSDP Ratio: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 10	Karnataka, Haryana, Maharashtra, Tamil Nadu
8 to 10	Andhra Pradesh, Punjab, Kerala, Gujarat, Rajasthan, Madhya Pradesh
Below 8	West Bengal, Orissa, Uttar Pradesh, Bihar
	Phase 2: 1986-98
Above 10	Haryana, Karnataka, Punjab, Gujarat
8 to 10	Tamil Nadu, Maharashtra, Kerala , Andhra Pradesh, Rajasthan, Madhya Pradesh
Below 8	Bihar , Orissa, Uttar Pradesh, West Bengal
	Phase 3 : 1998-2004
Above 10	Punjab, Haryana, Karnataka, Gujarat, Tamil Nadu
8 to 10	Andhra Pradesh, Kerala, Maharsahtra, Madhya Pradesh, Rajasthan
Below 8	Orissa, Uttar Pradesh, Bihar, West Bengal

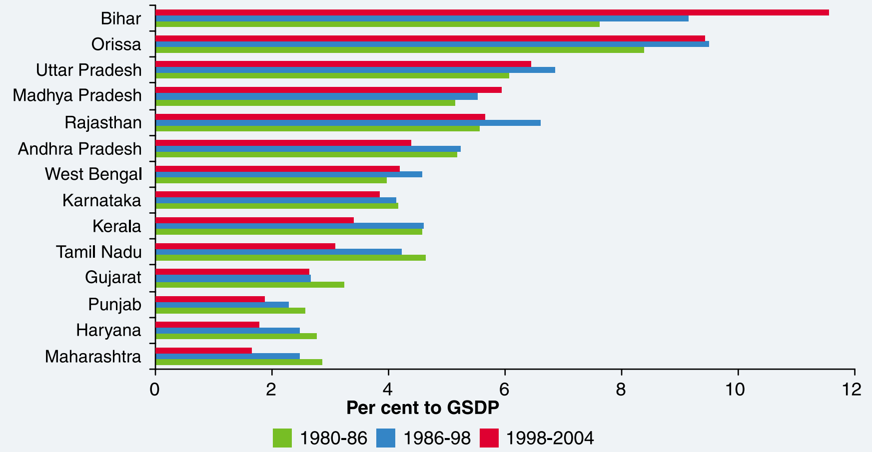
The near stagnation in States taxes and deterioration in States' own non taxes resulted in decline in States' own revenue from 8.9 per cent of GSDP in second phase to 8.6 per cent of GSDP in the third phase. The degree of variation, however, varied across the States (Exhibit 6).

It is worth noting that many States could finance less than 50 per cent of their total expenditure from own revenue receipts (Exhibit 7).

Exhibit 7 : Financing of Total Expenditure through States' Own Revenues: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 55	Maharashtra, Haryana
50-55	Karnataka, Gujarat, Andhra Pradesh, Tamil Nadu, Punjab
Below 50	Kerala, Madhya Pradesh, West Bengal, Rajasthan, Uttar Pradesh, Bihar, Orissa
	Phase 2: 1986-98
Above 55	Haryana, Maharashtra, Gujarat, Karnataka
50-55	Tamil Nadu, Punjab, Kerala
Below 50	Andhra Pradesh, Madhya Pradesh, West Bengal, Rajasthan, Uttar Pradesh, Bihar, Orissa
	Phase 3 : 1998-2004
Above 55	Haryana, Maharashtra, Tamil Nadu
50-55	Karnataka, Punjab
Below 50	Gujarat, Kerala, Andhra Pradesh, Madhya Pradesh, Rajasthan, Uttar Pradesh, West Bengal, Orissa, Bihar

Chart 5 : Current Transfers from the Centre to States



Trends in current transfers and devolution from the Centre

The trends in central transfers indicate stagnation in terms of GSDP in the second phase and decline in the third phase due to lower central grants. Bihar, Orissa, Uttar Pradesh and Rajasthan continued to receive the highest level of current transfers while Punjab, Haryana and Maharashtra occupied the lowest positions (Chart 5).

Pattern and Trends in Total Expenditure

The pattern of expenditure reveals that revenue expenditure accounted for a significant proportion (about three-fourth) of the total expenditure of the States over the years. Total expenditure showed a significant increase in many States such as Orissa, Bihar, Uttar Pradesh, Rajasthan and Punjab (Exhibit 8).

Trends in Revenue Expenditure

Interest payments, expenses towards administrative services, wages and salaries, pensions and subsidies given by the States led the revenue expenditure to grow significantly. Interest payments alone constitute more than one-fifth of the total revenue expenditure. The major components of revenue expenditure, *viz.*, interest payments and pensions absorbed as high as over 45 per cent, on an average, of revenue receipts in the third phase as against 25 per

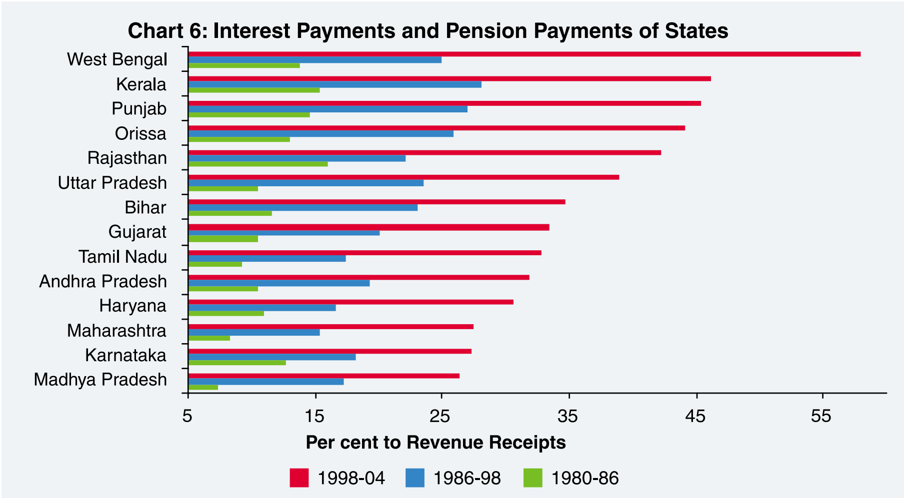
Exhibit 8 : Total Expenditure-GSDP Ratio of States: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 20	Karnataka, Orissa, Rajasthan
18 to 20	Bihar, Tamil Nadu, Andhra Pradesh, Punjab, Kerala, Haryana
Below 18	Madhya Pradesh, Maharashtra, Uttar Pradesh, Gujarat, West Bengal
	Phase 2: 1986-98
Above 20	Orissa, Rajasthan, Bihar
18 to 20	Kerala, Karnataka, Haryana, Andhra Pradesh, Punjab, Uttar Pradesh, Tamil Nadu
Below 18	Gujarat, Madhya Pradesh, Madhya Pradesh, Maharashtra, West Bengal
	Phase 3 : 1998-2004
Above 20	Orissa, Bihar, Rajasthan, Uttar Pradesh, Punjab, Gujarat, Andhra Pradesh
18 to 20	Karnataka, Kerala, Tamil Nadu, Madhya Pradesh
Below 18	Haryana, West Bengal, Maharashtra

cent in the second phase (Exhibit 9 and Chart 6). In fact, in some years (during 2002-03 and 2003-04) these two components of expenditure absorbed around 70 per cent of revenue receipts in case of West Bengal and nearly 50 per cent of revenue receipts in case of Kerala.

Exhibit 9 : Interest Payments and Pensions as per cent to Revenue Receipts: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 14	Rajasthan, Kerala
12 to 14	Punjab, West Bengal, Orissa, Karnataka
Below 12	Bihar, Haryana, Gujarat, Andhra Pradesh, Uttar Pradesh, Tamil Nadu, Maharashtra, Madhya Pradesh
	Phase 2: 1986-98
Above 25	Kerala, Orissa, Punjab
22 to 25	West Bengal, Uttar Pradesh, Bihar, Rajasthan
Below 22	Gujarat, Andhra Pradesh, Karnataka, Tamil Nadu, Madhya Pradesh, Haryana, Maharashtra
	Phase 3 : 1998-2004
Above 45	West Bengal, Kerala, Punjab
35 to 45	Orissa, Rajasthan, Uttar Pradesh, Bihar
Below 35	Gujarat, Tamil Nadu, Andhra Pradesh, Haryana, Maharashtra, Karnataka, Madhya Pradesh



The significant increase in revenue expenditure was observed in States such as Orissa, Bihar, Punjab, Madhya Pradesh, Gujarat, Kerala and Rajasthan in the third phase over the second phase (Chart 7 and Exhibit 10).

Trends in Capital Expenditure

The impact of resource crunch and the need for fiscal correction has more often been in form of a compromise in the capital expenditure. Amidst the fiscal consolidation process in the 1990s,

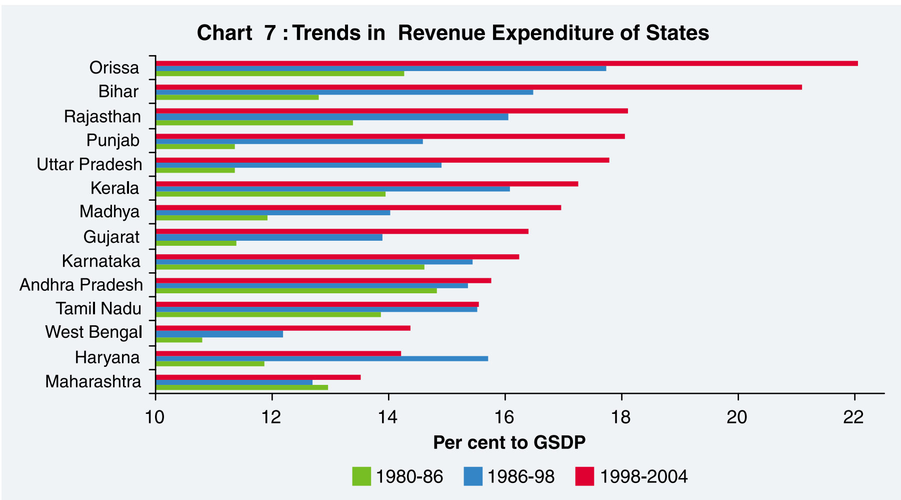


Exhibit 10 : States' Revenue Expenditure-GSDP Ratio: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 14	Andhra Pradesh, Karnataka, Orissa, Kerala
12 to 14	Tamil Nadu, Rajasthan, Maharashtra, Bihar
Below 12	Madhya Pradesh, Haryana, Gujarat, Uttar Pradesh, Punjab, West Bengal
	Phase 2: 1986-98
Above 16	Orissa, Bihar, Kerala, Rajasthan
14 to 16	Haryana, Tamil Nadu, Karnataka, Andhra Pradesh, Uttar Pradesh, Punjab, Madhya Pradesh
Below 14	Gujarat , Maharashtra, West Bengal
	Phase 3 : 1998-2004
Above 18	Orissa, Bihar
16 to 18	Rajasthan, Punjab, Uttar Pradesh, Kerala, Madhya Pradesh, Gujarat
Below 16	Andhra Pradesh, Tamil Nadu, West Bengal, Haryana, Maharashtra, Karnataka

the capital expenditure of many States started to show declining trend (Chart 8 and Exhibit 11).

Debt Stocks of Major States

Persistenee of large deficits of State Governments has resulted in accumulation of large debt stocks. The growth in debt stocks varied across States. Debt-GSDP ratio was higher by 19 per cent in case of Orissa, 15 per cent for West Bengal, 14 per cent for Rajasthan and 12

Chart 8 : Trends in Capital Expenditure of State Governments

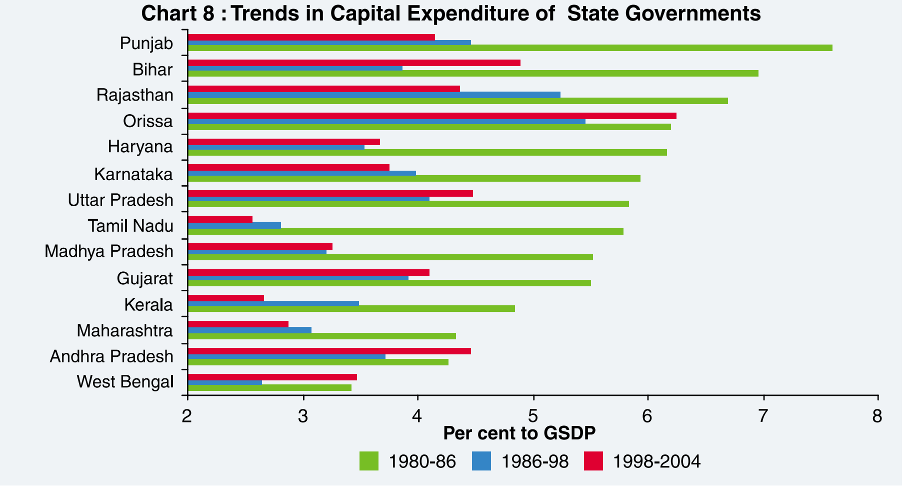


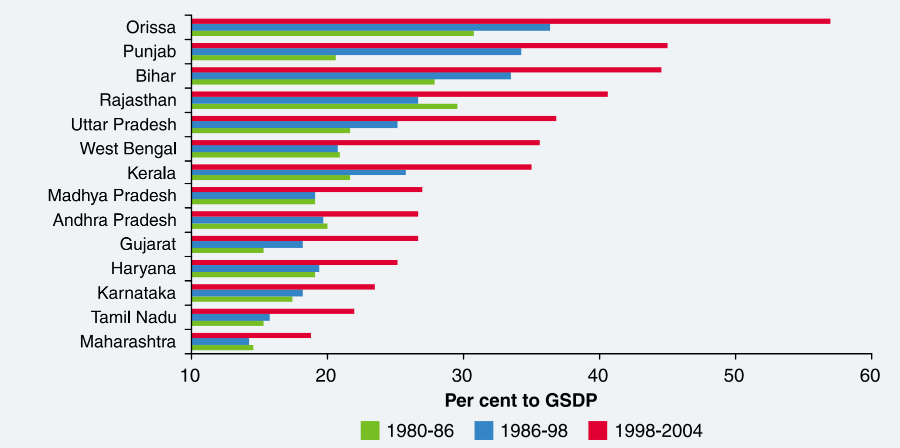
Exhibit 11 : States' Capital Expenditure-GSDP Ratio: A Comparative Position

Per cent	Phase 1 : 1980-86
Above 6.0	Haryana, Orissa, Rajasthan, Bihar, Punjab
5.5 to 6.0	Gujarat, Madhya Pradesh, Tamil Nadu, Uttar Pradesh, Karnataka
Below 5.5	West Bengal, Andhra Pradesh, Maharashtra, Kerala
	Phase 2: 1986-98
Above 4.0	Orissa, Rajasthan, Punjab, Uttar Pradesh
3.5 to 4.0	Karnataka, Gujarat, Bihar, Andhra Pradesh, Haryana, Kerala
Below 3.5	Madhya Pradesh, Maharashtra, Tamil Nadu, West Bengal
	Phase 3 : 1998-2004
Above 6.0	Orissa
4.0 to 6.0	Bihar, Uttar Pradesh, Andhra Pradesh, Rajasthan, Punjab, Gujarat
Below 4.0	Karnataka, Haryana, West Bengal, Madhya Pradesh, Maharashtra, Kerala, Tamil Nadu

per cent for Uttar Pradesh in the third phase over the second phase (Chart 9).

In addition to budgetary debt, states have also increasingly resorted to off-budget borrowings through guarantees. With States increasingly accessing the market for resources, those with poor fiscal position may find financial markets unwilling to absorb their securities. Recognising the magnitude of the problem, the Comptroller and Auditor General of India (CAG) and the Finance Commissions

Chart 9 : Debt Stocks of State Governments



in their various reports have sounded warnings about the unsustainability of finances of State Governments. During 2003-04, the outstanding State Government' Guarantees in terms of GSDP were above 15 per cent in a number of States such as Maharashtra, Kerala, Punjab and Rajasthan.

Section III

A Review of Policy Measures

The growing fiscal imbalances of the States called for structured policy initiatives to address the problem. These initiatives had to be operationalised by the States when the Eleventh Finance Commission set binding preconditions for undertaking reforms to get the fiscal assistance. The policy initiatives include preparation of Medium-Term Fiscal Reform Programmes (MTFRPs). Adjustment programme had also been undertaken in some of the States which were linked to borrowings from multilateral agencies. Major landmark in co-ordinated tax reforms were simplification and rationlisation of the sales tax system since the beginning of the current decade and the introduction of VAT from April 1, 2005, in place of the existing cascading type sales (Rao, *et al.*, 2005). Incentive based fiscal reforms recommended by the TFC are also an important policy step towards bringing fisal discipline at State level.

Supplementing the States efforts, the Central Government introduced measures to encourage and facilitate fiscal reforms at the State level. These mainly include: (i) introduction of Fiscal Reforms Facility, (ii) one time settlement of State Electricity Boards, (iii) introduction of Debt Swap Scheme and debt relief measures. The Reserve Bank of India, as debt manager and banker to the State Governments has also initiated measures towards strengthening their fiscal position. The major initiatives include: (i) constitution of various Group/Committees on State finances, (ii) managing Market Borrowings Programme of States, (iii) organising conferences on State Finances, (iv) policy initiatives towards cash management, (v) policy initiatives towards off-budget borrowings[7].

The policy measures initiated by the States may be grouped under three categories, *viz.*, (i) Policy measures towards State taxes and non-taxes, (ii) Expenditure Management, and (iii) Institutional Reforms. The detatils of these policy measures are set out below.

Policy Measures towards States' taxes and non-taxes

States' taxes

The general approach of the States has been to rationalise and simplify the tax structure, broaden the tax base and impose moderate rates of taxation. States have initiated policy measures towards fiscal empowerment mainly through States own taxes and showed intention to increase the magnitude and efficiency of tax revenue mobilisation over the years. The initiated measures by States include enhancement/ restructuring of various taxes such as land revenue, vehicle tax, entertainment tax, sales tax, electricity duty, tax on trades, professional tax and luxury tax. The major policy initiatives are as under:

(i) *Expert Committees/Commissions:* A number of States have appointed committee/commission to review the structure of their tax and non-tax revenues (Exhibit 12). The efforts were also initiated towards computerisation of tax/budget departments, treasuries and check-posts in view of the VAT as implementated by the States.

Exhibit 12 : Policy Initiatives by Major States

Policy Measures	**Name of the State**
1. Expert Committee/Commissions	Andhra Pradesh (*Revenue Reforms Committee*), Karnataka (*Tax and Revenue Reforms Commission, Fiscal Policy and Analysis Cell*), Tamil Nadu (*Taxation Reforms and Revenue Augmentation Commission, Staff and Expenditure Reforms Commission, Disinvestment Commission),* Haryana *(Committee to Mobilise Additional Resources),* Maharashtra *(Consultative Committee of Trade and Industry),* Uttar Pradesh *(Resource and Expenditure Commission)*
2. Introduction of VAT	All the States have introduced VAT except Tamil Nadu and Uttar Pradesh. Haryana was the first State to introduce the VAT in April 2003.
3. One-time settlement/amnesty schemes for recovery of tax arrears.	A number of States including those of Maharashtra, Karnataka and Kerala

(ii) *Introduction of VAT:* Realising the need for tax reforms, most of the States have switched over to a VAT regime on the basis of recommendations of the Empowered Committee of State Finance Ministers with effect from April 1, 2005. VAT may be defined as a tax on the value added at each stage of production and distribution of a commodity. VAT is inherently efficient than the sales tax or excise duty or any turnover tax. Operationally, application of VAT at a particular stage implies payment of tax by the producer or distributor on the value of his output but with a rebate (or credit) on the taxes paid by him on the inputs.

States' non-tax revenues

The policy measures towards non-taxes include reviewing/ rationalising the royalties, including those on major and minor minerals, forestry and wildlife, revision of tuition fees, medical fees, irrigation water rates and tariffs on urban water supply. The States have prepared MTFRPs and have emphasised on the cost effectiveness and raising user charges of services rendered by them.

Expenditure Management

The major policy initiatives on expenditure front include containing unproductive expenditures and reorienting spending towards developmental purpose, restrictions on fresh recruitment/ creation of new posts, review of manpower requirements, cut in establishment expenses and reduction in non-merit subsidies through better targeting. In their recent budgets, some State Governments, such as Punjab, have called for restructuring of the staff position in each government department and have indicated that future employment in the government would be project-specific and need-based.

Tamil Nadu took initiatives to constitute an *Expenditure Review Committee* to review, on an on-going basis, the expenditure in respect of each department. States, like Punjab, have initiated measures towards disinvestment on a select basis in respect of loss-making Public Sector Undertakings. Many States including those of Andhra Pradesh, Gujarat, Rajasthan, Tamil Nadu, Uttar Pradesh and Madhya Pradesh have introduced the new pension scheme based on the defined contribution system.

Institutional Reforms

The institutional reforms facilitating the fiscal consolidation process are set out below:

Rule based fiscal policy measures: Recognising the need for providing statutory backing to the fiscal reforms, many States have initiated measures to enact the FRLs targeting to eliminate revenue deficit and reduce GFD (Exhibit 13).

Other Institutional Reforms: These include setting up of the Guarantee Redemption Fund, Consolidated Sinking Fund and Ceiling on Guarantees (Exhibit13).

State Public Sector Undertakings Reforms

Several States have shown interest in undertaking a comprehensive review of the functioning of the State Public Sector Undertakings (SPSUs), including the possibility of closing down of non-viable units after providing for suitable safety-nets to the employees including voluntary retirement scheme (VRS). States such as Tamil Nadu, Kerala, Haryana, Karnataka and Orissa have encouraged private sector participation in the transport and power generation sectors. Karnataka's initiatives towards Policy Paper on restructuring of SPSUs and Maharashtra's initiatives towards setting up a Board for Restructuring of the SPSUs are noteworthy.

A notable development has been the initiation of power sector reforms which include the constitution of State Electricity Regulatory Commissions (SERCs) for determining the tariff structure,

Exhibit 13 : Initiatives towards Institutional Reforms by Major States

Institutional Reforms	**Name of the State**
1. Fiscal Responsibility Legislation	All the major States (except Bihar and West Bengal) have enacted FRLs.
2. Guarantee Redemption Fund	Andhra Pradesh, Gujarat, Haryana, Karnataka, Orissa, Rajasthan
3. Ceiling on Guarantees	Gujarat, Karnataka, Kerala, Punjab, Rajasthan, Tamil Nadu, West Bengal
4. Consolidated Sinking Fund	Andhra Pradesh, Gujarat, Haryana, Maharashtra, Orissa, West Bengal

unbundling of electricity boards into separate entities for power generation, transmission and distribution, increasing power tariffs and measures for reducing transmission and distribution losses.

Section IV

Effectiveness of Policy Measures

The effectiveness of policy measures to strengthen the State finances remained largely inadequate keeping in view of the size of the problem. Most of the policy measures were *ad hoc* in nature and were guided by the exigency rather than being structured and well planned to put the State finances on the right path. The component-wise details of various policy measures and their effectiveness to strengthen the State finances are set out below.

Effectiveness of Revenue Mobilisation Measures

The policy initiatives towards revenue mobilisation remained inadequate to keep pace with the growing expenditure requirements. These are discussed below.

States' Tax Revenues

Taking into account the past trends of State finances and the literature available on State finances, it seems that there was not much progress on restructuring of State finances. Many State Governments continued to carry their business as usual. There has been some progress in reforming the tax system, although the leakages in tax base through exemptions continue to pose problems (RBI, 2005). States took initiatives towards setting up Committees/ Groups and prepared MTFRPs to suggest the ways to enhance revenues. However, the implementation part of these measures remained weak as evident with the near stagnation in States taxes-GSDP ratios in the 1990s.

Despite the States' efforts towards enhancing revenues, the factors, such as, narrow States' tax base, greater dependence on indirect taxes and lack of control on populist measures (such as free electricity) taken by States continued to persist. Furthermore, the increased competition among the States to attract the investment by providing tax concessions and other fiscal incentives has only resulted in a race to the bottom (Rastogi, 2004). Competitive reduction in taxes led to a mere redistribution of existing capital among the States at the cost of significant revenue foregone, while taxes could not be levied on services and agricultural income (Rao, 2002).

States' Non-Tax Revenues

The effectiveness of various non-tax reforms to improve cost recovery for major social and economic services provided by States has remained below the expectations. This is reflected in very low user charges/cost recovery from various services and low/negative returns from investment in PSEs. User charges remained inadequate because of the perception of availing government services as free. Furthermore, with the inferior quality of services, the public is loath to pay higher charges for public services. Cost recovery in the case of a number of social services, such as education and health, have hovered around 1 per cent and 5 per cent, respectively, in the recent period. The cost recovery in respect of economic services such as irrigation, roads and power is found to be higher than that of social services but still remains quite low (RBI, 2005). It seems that there is no link between capacity to borrow and the return on services provided by the Government. Since there is not enough incentive for the government to undertake appropriate levy of user charges, states are encouraged to become fiscally irresponsible and to subject user charges to populist considerations (Mohan, 2000; Acharya, 2002).

Over the years, States have initiated a number of measures to improve the functioning of State public sector enterprises (PSEs). There has, however, not been adequate generation of revenues in the form of dividends and profits received from the PSEs. There is a need to take a relook of the functioning of PSEs in order to ensure the viability of running State level PSEs in long run. Around one-fourth of the total State public sector enterprises are profit making while the rest are the largest drain on the system. Most State PSEs are unlikely to yield significant resources from privatisation proceeds, but privatisation could at least help avoid recurring losses which are otherwise a burden on the budgets. The power sector remains the worst affected by the populist measures announced by a number of States. The average tariff rate for electricity provided to agriculture remained 25 paisa per kwh for all States (even some States have actually made it free) while average cost of supplying power remained Rs.2.81 per unit. Irrigation charges cover only around one fifth of the maintenance costs of the system, to say nothing of capital charges (Ahluwalia, 2001).

The reforms initiated in the power sector in recent years at State level are encouraging. However, keeping in view of the past record of populist measures such as free electricity, for certain sectors requires a close monitoring on the effectiveness of these reforms. In view of the large investment made by States in the public sector enterprises, state level fiscal strategy should be designed in a manner which ensures that these returns in the form of user charges and profits from commercial activities be adequate and augment fiscal discipline.

Effectiveness of Expenditure Management Measures

The effectiveness of policy measures towards expenditure management could be seen in the light of the fact the non-developmental expenditure (comprising, *inter alia*, interest payments, pensions and administrative services) has shown noticeable increase and stood at around 7 per cent of GSDP in the third phase higher by over 3 per cent and 2 per cent than the first phase and second phase, respectively. A sizeable reduction in non-developmental expenditure may not be feasible in the short-term, given the committed nature of many of its constituent items.

Notwithstanding the downward rigidity, the Debt Swap Scheme has brought about definite savings on interest costs as far as interest payments are concerned. Here again the question arises what about the higher interest cost in case of those loans negotiated from banks and FIs. Furthermore, the high interest cost on small saving receipts used by States to finance the resource gap also assume importance.

The States initiatives towards containing the subsidies were also not much effective and the subsidies given to various sectors including those of power sector and State road transport corporations continued to increase. Over the years, the inability to contain consumption expenditure due to explicit and implicit subsidies, which are mostly cornered by the influential segments of the society, and the reluctance to raise additional resources on the part of the States have been the main causes for the deterioration of fiscal situation in States (Kurian, 1999). Direct and indirect subsidies provided by State Governments, most of which are not well targeted, have become unsustainable (Ahluwalia, 2001). The power subsidies have increased manifold over the years and even after subventions (financial support) from State Governments and cross-subsidisation, the magnitude of the 'uncovered' subsidy leaves little scope for the State Electricity Boards (SEBs), but to default on payments (RBI, 2004).

The States efforts to enhance desired allocations towards developmental expenditure could not materalise with the fact that in terms of GSDP this component of expenditure in the third phase showed decline around one percentage point from the earlier phases. The share of developmental expenditure in total expenditure also continued to show deterioration in the second and third phase.

To sum up, it is worth noting as stated in the Draft on "*Towards Faster and More Inclusive Growth: An Approach to the Eleventh Five Year Plan*", Planning Commission, Government of India, "….*Fiscal discipline also requires control in non-Plan expenditure by both the Centre and the States. Some of what is non-Plan expenditure is essential for effective delivery of public services. Another part is pre committed such as interest payments and pensions. Effective control must be exercised in the rest of non-Plan expenditure if ambitious plan targets are to be met. In practice this means control of subsidies and also levy of rational user charges to keep the demands on budgetary expenditure within limits*".

Section V

Concluding Observations

The fiscal imbalances at State level appeared in the second phase had deepened and continued to persist in the third phase. The States took policy measures which helped to some extent to avoid further worsening of their fiscal position; however, these have not been significant. The recent fiscal developments at State level put emphasis on the on-going fiscal and institutional reforms and seem to follow the path of reforms as suggested by the TFC. As the States face large resource gap, they would have to explore new avenues apart from utilising the traditional resources effectively and efficiently. States need to set priorities in their expenditures to reap the benefits and operate their economy in its full capacity.

Notwithstanding some moderation in fiscal imbalances in recent years, the low and stagnant revenues particularly non taxes and large component of non developmental expenditure requires the States to take corrective measures. Interest payments account a major portion of the revenue expenditure and absorb a sizeable portion of revenue receipts in case of many States. The increasing liabilities from the NSSF need to be addressed as they involve high interest cost. Furthermore, the loans contracted from banks and financial institutions in the past also carry high interest rate. The upturn in interest rate cycle, currenly underway, is likely to put further pressure on interest burden of the States

In view of the large and persistent resource gap, the cornerstone of the fiscal strategy pursued at State level needs to be examined as per the changing requirements. As rightly stated in the Mid Term Appraisal of the Tenth Five Year Plan 2002-07, Government of India, *"Improving resources of States on a sustainable basis, providing incentives for developmental performance, fiscal prudence and accountability and putting in place successful and flexible mechanisms for intergovernmental transfer are key issues, not only in the remaining period of the Tenth Plan but even more for the Eleventh Plan"*.

To sum up, the fiscal policy pursued at State level needs to be mainly focussed on (i) to broaden tax base including those of agriculture income and to reduce exemptions/concessions, (ii) administrative and legislative reforms in taxation, (iii) increase in cost recovery/user charges and returns from public investment, (iv) public sector undertakings restructuring, (v) rationalisation and containment of both explicit and implicit subsidies, (vi) expenditure reprioritisation towards social and productive sectors and, more importantly, (vii) institutional reforms. These initiatives would go a long way to bring fiscal discipline and sustainability in the public finance at State level.

Notes

[1] Major deficits of States revealed marginal improvement during 2000-03; however, States' fiscal health again deteriorated in 2003-04. Notwithstanding some moderation in major deficits, the low and stagnant revenues particularly non tax and large component of non developmental expenditure remained cause of concern.

[2] The data have been sourced from the State finances articles, various issues published by the RBI and the Budget Documents of the State Governments. The GSDP data have been sourced from the Central Statistical Organisation website.

[3] The analytical review is based on the fiscal position of 14 major States of India. These States account for about 90 per cent of aggregate budget of all States. Uttar Pradesh, Madhya Pradesh, and Bihar are taken as undivided States for purpose of comparison. North Eastern and other special category States have been excluded from the analysis because of special features and also gaps in the data for some of these States. The small States of Goa and Delhi have also been excluded, the latter having the additional feature of being the capital.

[4] West Bengal's Revenue Account was in surplus (0.4 per cent of GSDP) only in 1985-86 and the rest of the period State's Revenue Account was in deficit (on an average at 1.2 per cent of GSDP).

[5] The TFC also recommended, if, however, some fiscally weak States are unable to raise funds from the market, the Centre could resort to lending, but the interest rate should remain aligned to the marginal cost of borrowings for the Centre.

[6] The constitution of the Sixth Pay Commission has been approved by the Union Cabinet on July 20, 2006.

[7] For further details of these policy measures, please see RBI's publication : *State Finances: A Study of Budgets*", various issues, published by the RBI annually.

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