

IV

Issues and Perspectives

From a medium term perspective, enduring improvements in the quality of states' finances hinges around the revival of state level public enterprises (SLPEs) and improving the viability of Discoms, alongside the rationalisation of centrally sponsored schemes. Strengthening of state finance commissions would facilitate resource empowerment through greater devolution to local bodies. Issues with revenue implications for both the Centre and states have to be addressed for enabling a smooth roll-out of the goods and services tax (GST).

4.1 States play an equally important role as the Centre in securing overall fiscal consolidation, through efforts to optimise revenue while allocating expenditure in the most productive manner. In this regard, ensuring profitability of state level public enterprises (SLPEs) and improving the viability of debt-ridden state power distribution companies (Discoms) would go a long way in boosting non-tax revenue. Furthermore, in the context of the recommendations of the fourteenth finance commission (FC-XIV) on devolution of resources between the Centre and states, the issue of rationalisation and prioritisation of centrally sponsored schemes (CSS) assumes significance, especially on socio-economic considerations. Yet another facet of quality enhancing medium-term fiscal policy is the need for reinvigorating state finance commissions (SFCs) and aligning them with the central finance commission in order to ensure that the flow of resources permeate to the lowest level of government (local bodies) efficiently. Finally, given that states have limited manoeuvrability in raising tax revenues, the introduction of goods and services tax (GST) would have a lasting impact on revenues of states. This chapter addresses these five issues with a view to offering some perspectives on improving state finances going forward.

1. Performance of State Level Public Enterprises (SLPEs)

4.2 As envisaged in Article 246 of the Constitution of India, states started to set up public

enterprises as an instrument of public policy to fulfill various socio-economic objectives (Mishra *et al.*, 2014). A number of SLPEs were incorporated under various five year plans. There are 849 operating state level public enterprises (SLPEs) in India with about 18.0 lakh employees (GoI, 2012). Kerala occupies the premier position in terms of the number of working SLPEs in the country (Mishra *et al.*, 2014). Major sectors of operation of SLPEs are manufacturing, finance, power, infrastructure, agriculture and allied services.

4.3 SLPEs are expected to be financially viable and generate surpluses for providing dividend pay-outs to the state governments. Over the years, however, some of them have degenerated into loss making entities or at best, low profit earners. On an average, around 30 per cent of total SLPEs are estimated to be incurring losses. This has adverse fiscal consequences since loss-making SLPEs depend on budgetary support, adversely impacting state finances instead of bolstering them.

4.4 The lacklustre performance of SLPEs can be attributed to both internal (management, excess manpower, lack of planning) as well as external factors (market conditions and policy changes). These factors are compounded by inadequate infrastructural and logistical aspects such as vintage equipment, outdated technologies/products, recurring breakdowns due to weak

maintenance, lack of customer orientation and inadequate checks on quality control. Moreover, acute shortage of working capital, liquidity constraints and higher operational costs also impair their performance.

Initiatives for Improving Performance

4.5 Given significant differences among states in the levels of social and economic advancement, institutional structures, administrative capabilities, geographical attributes and the like, there are no standardised solutions that can be prescribed across states. Accordingly, public enterprise reform will have to be modulated as per state-specific requirements (Gol, 2002). Apart from budgetary support, state governments need to invest in research and development for enhancing product quality while consumer preferences need to be gauged through market surveys.

4.6 Alternatively, disinvestment or transfer of ownership to private entities may help in improving performance. In this regard, providing the company's workforce with an ownership interest in the company through an employee stock ownership plan (ESOP) is a viable option for SLPEs. The disinvestment process, if preceded by the restructuring of SLPEs, may help in higher price realisation on sale of equity. Yet another important issue for SLPEs is to create an ambience for functioning efficiently, based on commercial considerations and without any political interference. This requires granting autonomy to these enterprises. Furthermore, lack of adequate professional expertise in the accounting and finance departments of these PSUs hinders the maintenance of accounts with due diligence and on the basis of established norms of accounting (Gol, 2002).

4.7 Several states have already undertaken restructuring of SLPEs. Illustratively, the Government of Kerala has set up a Restructuring

and Internal Audit Board (RIAB), which is engaged mainly in performance monitoring, restructuring, revival package implementation and development of industry information systems for the public sector enterprises under its jurisdiction. The RIAB is also involved in planning, design and implementation of one-time interventions in ailing public sector enterprises with the intent of comprehensively restructuring sick enterprises on a case-by-case basis through capital upgradation, technology modernisation, reduction of debt burden, broad-basing the sources of finance and organisational changes. In Tamil Nadu, an objective review of SLPEs is undertaken periodically through which expansion/modernisation are prioritised, based on thrust areas and market conditions. Going forward, states need to rigorously examine the viability of loss-making SLPEs so as to decide whether to restructure these units or to go for sell-offs.

2.State Power Utilities

4.8 The power sector consisting of generation, transmission and distribution is a key infrastructural input for harnessing a state's development potential. Empirically, a positive correlation between GDP growth and increase in power generation capacity of a country has been observed (Ferguson, 2000). In the power sector in India, there have been impressive developments in capacity generation, private sector participation, expansion of electricity markets and restructuring of state electricity boards (SEBs). Distribution and retail supply, however, remain the weakest link in the entire value chain.

Financial Performance

4.9 The growth in total capital employed by the power utilities peaked during 2013-14, with power utilities relying on market resources rather than on state governments (Table IV.1). During 2012 to 2014, the aggregate revenue from sale of power

Table IV.1: Financial Parameters of Power Utilities (end-March)

Sl. No.	Parameters	2012	2013	2014
1	2	3	4	5
1	Capital Employed (Rs. Billion)	4,634.80	5,034.28	5,632.91
2	Share of Banks/FIs/Market (%)	85	92	97
3	Aggregate Revenue (Rs. Billion)	2,412.17	2,886.41	3,292.78
4	Aggregate Technical and Commercial (AT&C) losses (%)	26.63	25.45	22.70
5.	Collection Efficiency (%)	93.19	94.36	97.35
6.	Average Cost of Supply (without subsidy) Rs./Kwh	4.55	5.04	5.15
7.	Average Revenue Realised (without subsidy) Rs./Kwh	3.30	3.76	4.00
8.	Gap on Subsidy Received (Rs./Kwh)	0.94	0.85	0.73

Source: Report on the performance of State Power Utilities for the year 2011-12 to 2013-14, Power Finance Corporation Limited.

increased at an average rate of 18.3 per cent. The overall aggregate technical and commercial (AT&C) losses progressively declined during this period, reflecting efficiency gains alongside buoyancy in overall collection in response to improvements in commercial operations. Both average cost of supply (ACS) as well as average revenue realised (ARR) increased, while the gap on subsidy received declined.

Reforms in Power Utilities

4.10 State Electricity Boards (SEBs) are the dominant players in the power sector, being responsible for generation, transmission and distribution. Deteriorating financial health and mounting losses and debt necessitated reforms in the power sector. The enactment of the

Electricity Act, 2003 mandated unbundling of the SEBs into separate and independent generation, transmission and distribution companies (Discoms). Reform initiatives were extended through the Accelerated Power Development and Reforms Programme (APDRP) in 2002-03 and Restructured-APDRP in 2008.

4.11 In October, 2012 the Central government promulgated a financial restructuring plan (FRP) for all participating state-owned Discoms which had accumulated heavy losses and faced difficulty in financing operational losses. Under the FRP, state governments are committed to ensuring that Discoms eliminate the chronic gap between ACS and ARR within the moratorium period. Eight states *viz.* Uttar Pradesh, Tamil Nadu, Rajasthan, Haryana, Bihar, Jharkhand, Telengana and Andhra Pradesh signed the FRP but were unable to curb losses and reduce the outstanding debt of their power utilities. The inability of state governments to implement tariff hikes resulted in growth of ACS outpacing that of ARR, imposing a severe constraint on the debt servicing ability of Discoms. Thus, FRP's objective of gap elimination proved difficult to achieve. In a bid to intensify the reform process, the Central government has approved amendment in the Electricity Act, 2003 in December, 2014 as contained in the Electricity (Amendment) Bill, 2014, which has been referred to the Parliamentary Standing Committee on Energy.

Higher Aggregate Technical and Commercial (AT&C) losses

4.12 AT&C losses, consisting of technical and commercial losses, is a measure of the overall efficiency of the distribution business. Technical losses are caused by power theft, overloading of existing lines due to higher demand for power, non-upgradation of equipment, improper relocation

of distribution substations and provisioning for additional distribution transformers in the pipeline. Commercial losses arise due to low metering/billing/collection efficiency, causing persistent gaps between ACS and ARR. Furthermore, faulty meters, billing on average consumption basis, delays in revenue collections and unauthorised usage of power by agricultural and rural consumers also contribute to heavy commercial losses. As a result, AT&C losses are the most important vexing issue for Discoms, impairing the performance of the distribution sector.

4.13 The overall AT&C losses moderated from 26.4 per cent in 2010-11 to 22.7 per cent in 2013-14, but they are still at an elevated level. In this context, Discom-wise AT&C loss reduction trajectories have been finalised in consultation with all state governments in June 2015.

Rise in Subsidy Dependence

4.14 One of the key reasons for the deteriorating finances of distribution entities is delay and non-payment of subsidies by state governments. These subsidies are meant to be paid to the Discoms to compensate for cheaper power supplies to certain segments promised by the state governments. In particular, the subsidy burden for distribution companies is estimated to have increased due to higher costs and cheaper tariff for the farm sector.

Under pricing and Reporting Lags

4.15 Power distribution companies suffer from the fundamental problem of underpricing, with their selling price set significantly lower than the procurement price for electricity. Historically, their pricing decisions have been strongly influenced by the political agenda of state governments. Furthermore, Discoms release their financial results with a considerable lag, which complicates the assessment of their financial viability by potential lenders.

Power in Concurrent List

4.16 Electricity is a concurrent subject under the purview of states; as a result, oversight of Discoms is the domain of state governments. Consequently, it is difficult for the Central Government to reform Discoms directly. Nevertheless, key reforms undertaken over the years have largely been at the initiative of the Central Government through policy guidance as well as providing suitable environment for enabling regulations in consultations with state governments. The situation has reached an impasse, largely due to the inability of state governments to implement commercial decisions.

Reduction in Power Purchase Agreements (PPAs)

4.17 Despite increase in power generation capacities, the lower demand for energy by Discoms due to their fragile financial health is affecting Power Purchase Agreements (PPAs) with power generating entities. The lower energy requirement of Discoms has resulted in fewer PPAs. Going forward, signing of new PPAs will depend on the ability of Discoms to enter into long-term commitments. This implies that in the short-term market, electricity generating companies will continue to remain exposed to volatile prices.

Impact on Banks/ Financial Institutions (FIs)

4.18 The major source of capital employed in power utilities is borrowing from banks, FIs, and the market. The total capital employed by commercial banks in the power sector has progressively increased over the years despite the weak financial position of Discoms, which is partly attributed to the low levels of transparency about their financial viability. As a result, banks are unable to properly evaluate the underlying credit risk of their investments in Discoms, which has resulted in a steady deterioration in their asset quality.

**Box IV.1:
UDAY Scheme - Salient Features**

Adoption of UDAY is optional for states. Those states who adopt UDAY and perform as per operational milestones will be given additional / priority funding through Deendayal Upadhyaya Gram Jyoti Yojana (DDUGJY), Integrated Power Development Scheme (IPDS), Power Sector Development Fund (PSDF) or other such schemes of Ministry of Power and Ministry of New and Renewable Energy. States not meeting operational milestones, however, will be liable to forfeiture of their claim on IPDS and DDUGJY grants.

States shall take over 75 per cent of DISCOM debt as on September 30, 2015 over two years – 50 per cent in 2015-16 and 25 per cent in 2016-17.

The part of DISCOM debt not taken over by the states shall be converted by banks / FIs into loans or bonds with an interest rate not more than the bank's base rate *plus* 0.1 per cent. Alternately, this debt may be fully or partly issued by the DISCOM as state guaranteed DISCOM bonds at the prevailing market rates which shall be equal to or less than the bank base rate *plus* 0.1 per cent.

The Government of India will not include the debt taken over by the states in the calculation of their fiscal deficits in the financial years 2015-16 and 2016-17.

States will issue non-SLR state development loan (SDL) bonds in the market or directly to the respective banks / FIs holding the Discom debt to the appropriate extent. States shall take over the future losses of Discoms in a graded manner and shall fund them.

State Discoms will comply with the Renewable Purchase Obligation (RPO) outstanding since 1st April, 2012, within a period to be decided in consultation with Ministry of Power. Such states shall also be supported with additional coal at notified prices and, in case of availability through higher capacity utilisation, low cost power from NTPC and other Central Public Sector Undertakings (CPSUs).

A tripartite agreement between the Union power ministry, state governments and the Discoms will be signed as part of the bailout plan.

References

- (i) Press Trust of India, Press Release, November 05, 2015 available at <<http://pit.nic.in/newsiste/mainpage.aspx>.
- (ii) CRISIL, Press Release, November 6, 2015 available at <www.crisil.com>
- (iii) Ministry of Power, Government of India, available at <<http://powermin.nic.in>>

Recent Initiatives

4.19 The central government announced Ujwal Discom Assurance Yojana (UDAY) on November 05, 2015 in order to effect a turnaround in the financial viability of state-owned Discoms and improve operational efficiency (Box IV.1). This initiative is expected to carry forward the mission of 100 per cent rural electrification, uninterrupted power supply and sustain national priorities such as “Make in India” and “Digital India”. It is considered markedly different from earlier restructuring schemes – by 2017-18, it is intended to downsize the Discom losses of eight states that participated in the FRP by fifty per cent. It empowers Discoms with the opportunity to break even in the next 2-3 years through four initiatives *viz.* (i) improving operational efficiencies; (ii) reduction in cost of power; (iii) reduction in interest burden; and (iv)

enforcing financial discipline through alignment with state finances.

4.20 Outstanding debt of Discoms has increased from about Rs. 2.4 lakh crore in 2011-12 to about ₹4.3 lakh crore in 2014-15, with interest rates in the range of 14-15 per cent. If states take over 75 per cent of Discom's debt under UDAY, it may reduce the latter's interest burden to around 8-9 per cent, thus improving overall efficiency.

4.21 In the past, FRPs had improved the liquidity of Discoms by providing a moratorium on debt repayments so that losses could be reduced during the moratorium period. This could not deliver desired results, however, as there were no deterrents to non-compliance with loss-reduction targets. In this context, UDAY is expected to focus on both liquidity improvement and a sharp

reduction in losses by lowering the interest burden which will provide Discoms an opportunity to start afresh. By making the states formally accountable, UDAY is likely to address the issue of efficiency improvement and cost-reflective tariff hikes, which is perceived to be a more comprehensive solution than FRPs.

4.22 Within 2 months of the announcement of UDAY, a total of 15 out of 29 states /UTs have voluntarily joined UDAY, covering 90 per cent of the total debt of Discoms. These fifteen states are Uttar Pradesh, Bihar, Odisha, Maharashtra, Andhra Pradesh, Himachal Pradesh, Madhya Pradesh, Uttarakhand, Chhattisgarh, Jammu and Kashmir, Jharkhand, Gujarat, Punjab, Haryana and Rajasthan.

4.23 There are, however, some areas of concern regarding the impact of UDAY on state finances over the medium term. Although the effect may not be instantaneous, state finances may come under stress in the coming years on account of burgeoning liabilities due to takeover of 75 per cent of the existing debt of Discoms. This would considerably reduce the fiscal space of states which might lead to curtailment of capital expenditure with an adverse impact on growth. Furthermore, the interest burden of states would inflate with immediate effect, destabilizing fiscal outcomes and resulting in a deviation from the fiscal consolidation path as well as the targets set by the FC-XIV. With UDAY coming into operation, “it is unlikely that states will be able to shrink their deficits, which puts pressure on the Centre to adjust more” (Rajan, 2016).

4.24 As of September 2015, banks’ exposure to Discoms was in the range Rs 1.6-1.8 trillion, which comprise about 30 per cent of banks’ exposure to the power sector (ICRA, 2015). In this regard, UDAY holds the potential to reduce the vulnerability of banks by strengthening their

balance sheet through an improvement in asset quality. With improvement in the financial health of state Discoms, counter party risk for banks may also come down. It would, however, lead to a shrinkage in banks credit book by 1-7 per cent (depending on the share of state Discoms loans in total credit book) over the financial year 2016 and 2017 (ICRA, 2015).

3. Centrally Sponsored Schemes

4.25 With a view to engendering inclusive growth and sustainable human development, the central government provides centrally sponsored schemes (CSS) to states. Such schemes have been implemented by states for more than five decades, with special purpose grants intended to encourage and motivate state governments to attain national goals and objectives. States have, however, been raising concerns about lack of flexibility/portability in these schemes. Accordingly, the Planning Commission constituted a Sub-Committee in March 2011 (Chairman: Shri B.K. Chaturvedi) to suggest restructuring of CSS to enhance its flexibility and efficiency. The main recommendations of the Sub-Committee are (i) restructuring of the existing CSS into three categories; (ii) distribution of CSS funds on transparent, notified guidelines; (iii) focusing only on major interventions required by national development needs, (iv) flexible and untied resources to states to meet their special needs; and (v) evaluation of the CSS by a third party.

4.26 Pursuant to the recommendations of the fourteenth finance commission (FC-XIV), central assistance to states has now been subsumed in major CSS in view of the larger devolution of the divisible pool of tax revenue (42 per cent) to states. According to the Union Budget of 2015-16, there are 31 CSS that are fully sponsored by the

central government while 24 CSS will henceforth be run with the “changed sharing pattern”. Though many CSS on state subjects are to be delinked from central support, those representing national priorities, especially poverty alleviation, will continue. Besides, the schemes mandated by legal obligations and those backed by cess collection will be fully supported.

4.27 Consolidated state level data reveal that grants in aid have reduced by 0.8 per cent of GDP from 2014-15¹. Although higher devolution will lead to an increased share in central taxes by 0.5 per cent of GDP in 2015-16, the net impact of the changed pattern of funding is a decline of 0.3 per cent in central transfer to states from the previous year, with adverse implication for states’ spending on social infrastructure (see Chart III.1 & Chart III.2 in Chapter III).

Downsizing of CSS

4.28 Several factors are responsible for the rationalisation of CSS. These *inter alia* are (i) inability of the central ministries to control these schemes while attaining the stated objectives in a cost effective manner and within the given time frame; (ii) inability of central ministries to ensure accuracy of state governments’ claims on physical and financial performance; (iii) narrow focus of the central ministries on expenditure rather than on attainment of objectives while state governments emphasize release of assistance by the ministry rather than ensuring the quality of expenditure; (iv) misuse of funds provided for vulnerable sectors and sections of the society and little accountability for shortfall in performance, poor delivery of output and misappropriation of funds; (v) legislative and procedural delays in release of funds by states leading to uncertainty about the availability of funds at the field level; and (vi)

sharp jump in the ratio of unconditional transfers to states which the latter have been using at their own discretion.

4.29 A Sub-Group of Chief Ministers on Rationalisation of Centrally Sponsored Schemes (Chairman: Shivraj Singh Chauhan) submitted its report to NITI Ayog in October 2015 recommending the reduction of the number of CSS from 72 to 27. The Centre would fully fund ten of the reduced number of CSS and provide 60 per cent funding for the rest. The funding pattern will be 60:40 between the Centre and states for schemes which are part of the national development agenda while it would be 90:10 for north-eastern and the three Himalayan states. Accordingly, scheme guidelines are required to be modified to suit requirements of states and give them greater flexibility to spend.

Way ahead

4.30 Implementation of CSS needs to be improved through a multi-faceted approach relying on professionalisation of public service delivery, quality management and innovative use of IT. Moreover, there are several sectors such as education and health in which states are responsible but lack adequate resources. Apart from the Gadgil-Mukherjee formula (1991), devolution of funds may be considered in a manner in which states should be given greater autonomy in opting for strategies that achieve socio-economic priorities. Finally, the amount of funds in each CSS which states can spend on their discretion within the overall parameters of the main scheme (flexi-funds) will provide them greater leeway in allocation of funds. Thus, effective implementation of CSSs requires fine tuning of scheme guidelines to local situations and requirements and involves close coordination with related departments and agencies.

¹ This is an outcome of reduction in central assistance to state plan scheme.

4. State Finance Commissions

4.31 Articles 243(I) and 243(Y) of the Constitution of India provide for the creation of state finance commissions (SFCs) on the lines of the central finance commission (CFC) every five years for the devolution of resources from the state to local governments, viz., panchayati raj institutions (PRIs) and urban local bodies (ULBs). The basic function of the SFCs is to examine the principles of distribution of resources between the states and local bodies, determine the taxes, duties, tolls and fees which are assigned or appropriated by the local bodies as also the grants-in-aid to the PRIs and ULBs from the consolidated fund of the state. Furthermore, SFCs also make recommendations on the measures required to improve the financial position of the local governments.

Formation of SFCs

4.32 SFCs were first constituted as early as 1994 (GoI, FC-XII). The range of recommendations of the SFCs varies from finance to technology so that local bodies can undertake schemes for development and social justice as also improve living standards. Apart from resource mobilisation, SFCs have stressed on the need for delivery of basic services by the local bodies to their residents. All the SFCs follow certain criteria such as total population/ those below poverty line (BPL), area, literacy gap, etc. on making their recommendations. Almost all SFCs emphasize generation of own resources for local bodies rather than grants within an appropriate legal and administrative framework. SFCs have also suggested an incentive-compatible scheme for revenue mobilisation by providing performance grants, matching grants and cash awards to local bodies. Some SFCs have even included incentives for own revenue generation in the devolution formula. SFCs also recommended that since the recovery rate of taxes in the LBs

is very low, a periodic review is essential. In this regard, databases of taxes should be IT-enabled, providing seamless access to the public.

Concerns

4.33 SFCs were mandated to address the mismatch between the allocation of financial powers and responsibilities between the state governments and local bodies. After two decades of formation, this objective remain unfulfilled.

4.34 First of all, the constitution of the SFC is a time-consuming process due to its formation by the state government in different stages. Considerable time is also taken in providing logistic support, including staff, before the SFC becomes fully functional. Every state is expected to set up the SFC within one year from the commencement of the Act and continue to do so at the expiry of every fifth year. While the constitution of the fourth SFC was due in 2009-10, only eleven states have done so with only two states having constituted the fifth SFC. Furthermore, while six states have set up the third SFC, six have set up the second and one is yet to form its SFC (GoI, FC-XIV). However, there were certain changes in the status of the SFC numbers during the subsequent period (Table IV.3) .

4.35 Secondly, there has been wide divergence in submission of both SFC reports and “action taken” reports across states, rendering them bereft of meaningful inputs for the CFC. The recommended criteria for distribution vary across reports from simple and straight forward to complex and detailed formula-based approaches. Due to these reasons, CFCs could not base their recommendations on the SFC reports and hence suggested *ad hoc* grants for local bodies.

4.36 Previous CFCs have pointed out that follow-up actions on the SFC reports are either in terms of legislative measures by several states or the recommendations are marked as “under

consideration” while sometimes, state governments have rejected SFC reports without any reason. In some states, while the recommendations were accepted, no timeframe for implementation was specified while presenting to the legislature. Only a few states have honoured their commitments for the release of additional funds, based on the recommendations of SFCs.

4.37 Most of the SFCs suffer from lack of transparency. Neither the data provided by the state governments nor the reports of SFCs provide enough support for quantification of supplementary resources to be distributed uniformly across the states. As of now, there is no provision for verifying the data in respect of fiscal performance of local governments by the CFC, unlike state government finances which are cross-checked by the CFC.

4.38 All the SFC members are drawn only from one discipline, *viz.*, law, whereas other important disciplines like economics, public administration, public finance have been ignored (Mohanty *et. al.*, 2007). This undermines the status and authority of the SFC, adversely affects its functioning and erodes the quality of its report.

4.39 Some chairpersons of SFCs have highlighted that “financial recommendations get acted upon while those dealing with systemic improvements are seldom addressed” (GoI, FC-XIV). Moreover, implementation of recommendations of SFC gets adversely affected because of lack of proper coordination between the finance department and the departments dealing with urban and rural affairs. Finally, SFCs often complain that their work is adversely affected due to lack of reliable data on receipts and expenditure at the local body level. Although this issue was raised by previous CFCs, not much action has been taken.

Strengthening SFCs

4.40 Some major states have accepted the recommendations of their respective SFCs’ and have implemented the awards and released funds as per the recommendations (Table IV.2). Illustratively, the share of local bodies in taxes has been provisioned for with a separate demand in the budget. Although these steps are in the right direction, much more needs to be done in order to make the SFCs a robust mechanism for devolution of funds and powers from the states to the local bodies.

4.41 In order to synchronize the formation of SFCs with the CFC, there is a need to appoint the SFC at the expiration of every fifth year. It is also necessary to ensure that action taken reports are placed by state governments in the state legislature in a time-bound manner.

4.42 In order to discharge their duties, SFCs have raised certain issues before FC-XIV for its consideration. These are classified under two broad heads: (a) discharge of SFCs’ functions and (b) recommendations of measures for supplementing local body resources. The issues under the first category include (i) setting up of an independent national agency for support of a common platform for exchange of information between SFCs; (ii) designing simpler accounts and data formats; (iii) studies on governance issues with respect to local bodies; and (iv) supporting studies on standards of essential civic services to help future SFCs to assess the performance of local bodies in their core functions. In the second category, the 2011 Census data was to be used for allocating grants for knowledge transfer and capacity enhancement. There is also a request by the SFC for taking steps to sensitize the local bodies on the purpose of Finance Commission grants.

Table IV.2: State Finance Commission Reports - Status

(Amount in Rs. crore)

Region/State	No. of Commissions constituted so far	Date of submission of latest report	Amount of funds allocated as per the SFC Report	Date of submission of ATR
Andhra Pradesh	4	January 2008 (3 rd)	-	-
Arunachal Pradesh	2	June 2014	-	-
Assam	5	September 2014	1065.44	-
Bihar	5	January 2016	-	-
Chhattisgarh	2	July 2011	2504.85 ⁺	July 2013
Goa	-	-	-	-
Gujarat	3	March 20, 2015	-	-
Haryana [#]	-	30 th June 2014	560.12	13 th March 2015
Himachal Pradesh	4	20 th January, 2014	-	-
Jammu and Kashmir	2	November 2010	-	-
Jharkhand	-	-	-	-
Karnataka	3	December 2008	33125.00	-
Kerala	5	March 2016	4958.95 [#]	March 2012
Madhya Pradesh	4	January 2012	5099.86 ⁺	-
Maharashtra	4	Jun-2006	-	-
Manipur	3	December 2014	-	December 17, 2015
Meghalaya		Exempted under Article 243 M		
Mizoram	1	December 2014	-	-
Nagaland	2	October 2014	-	-
NCT Delhi	4	2 nd , December, 2015	-	-
Odisha	4	September 2014	2310.34 [#]	-
Punjab	5	May 2011 (4 th)	-	October 2013
Rajasthan	5	Interim Report for 2015-16 15 September 2015	-	22 September, 2015
Sikkim	4	May 2013	-	-
Tamil Nadu	5	September, 2011	9348.40 [§]	May, 2013
Tripura	4	-	-	-
Uttar Pradesh	4	December 2014	-	November 2015
Uttarakhand	3	June 2011	-	-
West Bengal	4	February 2016	-	-

^{‘-’}: Not Available; [§] 10 per cent of Net State's Own Tax revenue; ⁺ Data pertain to 2014-15 (BE).

[#] Allocated in the Budget 2016-17.

Note: Data on amount of funds allocated pertain to 2015-16 (BE), unless otherwise specified.

Source: Various state governments.

4.43 FC-XIV has opined that there is a need to have a reliable database on local body finances for making informed decisions. For this, compilation and auditing of accounts is important. FC-XIV has also recommended performance grants to address (i) availability of reliable data on local

bodies' receipt and expenditure through audited accounts; and (ii) improvement in own resources. It also suggested that urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of the award

period of FC-XIV, *i.e.*, 2016-17 onwards in order to give sufficient time to state governments and also the local bodies to put in place a scheme and mechanism for implementation. Therefore, introduction of performance grants by the FC-XIV will not only increase the accountability of the local bodies but also ensure the timely availability of reliable data to stakeholders for decision making.

4.44 It was suggested by the thirteenth finance commission (GoI, FC-XIII) that in order to bring uniformity in reports to assess the needs and also to prepare the reports in a systemic way, SFCs could use a uniform template prepared by FC-XIII.

4.45 It is observed by the FC-XIV that there is wide variation in the assignment of functions, funds and functionaries to local bodies across states for which it is difficult for the CFCs to assess the needs of LBs in each states. In view of this, it is suggested that the needs of local bodies should be assessed by the SFCs in detail as envisaged by the Constitution. Thus, in order to address the issue of mismatch of financial power and responsibilities between the states and LBs, a concerted and sincere effort from the State governments is necessary to make SFCs a meaningful body.

5. GST Implementation

4.46 At present, the Constitution empowers the central government to levy excise duty on manufacturing and service tax on the supply of services. Further, it empowers state governments to levy sales tax or value added tax (VAT) on the sale of goods. In addition, central sales tax (CST) is levied on intra-state sale of goods by the central government, but collected and retained by the exporting states. Furthermore, many states levy an entry tax on the entry of goods in local areas. Cumulatively, this has resulted in a complex

indirect tax structure with hidden costs for trade and industry in the country. Despite several reform measures, goods and services continue to be bogged down with several indirect taxes at different stages of the value chain with significant tax cascading. Therefore, a need to introduce a consumption-based destination-centric goods and services tax (GST) has been strongly felt. Incidentally, the proposal for the introduction of GST was first mooted in the Union Budget 2006-07 (GoI, 2015).

4.47 The proposed dual GST envisages taxation of supply of goods and services simultaneously by the Centre and the states. GST is expected to simplify and harmonise the complex indirect tax regime in the country and reduce the cost of production, thereby making industry more competitive. By unifying the tax structure across states, the new tax regime would pave the way for a common national market for goods and services. Furthermore, GST will broaden the tax base and result in better tax compliance, enabled by a robust IT infrastructure developed for the purpose. Due to the seamless transfer of input tax credits from one stage to another in the value chain, there is an in-built mechanism that would incentivize tax compliance by traders. In short, GST is the next step forward towards wide-ranging indirect tax reform in the country after the introduction of Value Added Tax (VAT).

Status

4.48 After the Bill is passed in both houses of Parliament, the Constitutional Amendment Bill will be sent to State Legislatures for ratification, which will require approval from at least 50 per cent of the state legislatures before the proposed amendments are brought into effect. For the levy of central goods and services tax (CGST), state

**Box IV.2:
Report on the Revenue Neutral Rate and Structure of Rates for the
Goods and Services Tax - Major Recommendations**

The revenue neutral rate (RNR) is proposed to be in a range of 15-15.5 per cent (Centre and states combined) but with a preference for the lower end of that range as (i) identifying the exact RNR is premised on a number of assumptions; and (ii) the prerogative of deciding the precise numbers will be that of the future GST Council. For the same reason, not one but a few conditional rate structures are proposed that depend on policy choices made on exemptions and taxation of certain commodities such as precious metals.

While India should strive toward a one-rate structure as the medium-term goal, a two-rate structure for the present is advised. In order to ensure that the standard rate is kept close to the RNR, the maximum possible tax base should be taxed at the standard rate. Accordingly, the lower rates would be kept around 12 per cent (Centre *plus* states) with standard rates varying between 17 and 18 per cent.

The sin/demerit rate is fixed at about 40 per cent (Centre *plus* states) which would apply to luxury cars, aerated beverages, paan masala, and tobacco and tobacco products (for the states). In this regard the decision of the GST Council regarding exemptions/low taxation (for example, on gold and precious metals, and area-based exemptions) will be critical as more the exemptions that are retained, the higher will be the standard rate.

The GST Council will determine the combined GST rates that are allocated between the Centre and states which will reflect their revenue requirements. For example, a standard rate of 17 per cent would entail a rate of 8 and 9 per cent for the Centre and states, respectively.

All taxes on inter-state trade (including the one per cent additional duty) may be eliminated and replaced by one GST. Complexity and lags in GST implementation require that any evaluation of the GST and any consequential decisions should not be undertaken over short horizons but over longer periods, say 1–2 years.

All commodities would be brought under the purview of GST. In this regard, bringing alcohol and real estate within the scope of GST would further the government's objectives of improving governance and reducing black money generation without compromising on states' fiscal autonomy. Similarly, bringing electricity and petroleum within the scope of the GST could make Indian manufacturing more competitive and eliminating the exemptions on health and education would make tax policy more consistent with social policy objectives.

Reference

Government of India (2015): Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax (GST), December 4.

goods and services tax (SGST) and integrated goods and services tax (IGST), a set of three laws would need to be enacted. While CGST and IGST laws would need to be enacted by Parliament, the SGST law would have to be enacted by each of the state legislatures. Key aspects of GST like the tax rate, tax base, exemption limits, place of supply rules for services, appropriate IGST model *etc.*, will be finalised on passage of the Bill (GoI, 2015). In this regard, the empowered committee (EC) of state finance ministers and the department of revenue, Government of India, have constituted

several working groups and committees for drafting GST Rules and processes.

4.49 The Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax (Chairman - Dr. Arvind Subramanian) was submitted on December 4, 2015 (Box IV.2). The Committee noted that implementing a new tax encompassing both goods and services by the Centre, 29 States and 2 Union Territories in a large and complex federal system is perhaps unprecedented in modern global tax history.

Concerns and Challenges

4.50 From an implementation perspective, the key pending issues on GST pertain to the provision of one per cent tax on inter-state commerce to help manufacturing states, the exclusion of alcohol from GST and the absence of a dispute-resolution authority. Also, the GST rules and rate will have to be fixed. In this regard, the government has created a company called GST Network (GSTN) to provide the technological inputs for facilitating the introduction of GST and connect the databases of the Centre and states.

6. Conclusion

4.51 Given the fiscal constraints and limited maneuverability of states in augmenting tax revenue, institutional reforms/restructuring will play a pivotal role in fiscal consolidation over the medium-term by both enhancing non-tax revenue and pruning unproductive expenditure. In this regard, reforms in SLPEs and Discoms would ensure financial viability and generate

surpluses so that they are no longer a drag on the state budget. While SLPEs need to improve their product quality through technological upgradation, Discoms would have to simultaneously aim at narrowing the persistent gap between ACS and ARR based on commercial considerations and reduce their AT&C losses. Moreover, the rationalisation of CSS would motivate states to prioritize and raise the productivity of their expenditure. Furthermore, reinvigorating SFCs would lead to greater synchronisation between state governments and local bodies in devolution and utilisation of resources in the best traditions of fiscal federalism. Finally, the implementation of GST would make industry more competitive through dismantling of the complex indirect tax structure and would boost the tax revenue of states as a lasting solution. Cumulatively, these measures are likely to propel states on the path of fiscal consolidation without compromising on expenditure quality.