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Structural Problems and Fiscal Management of States in India

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This paper attempts to analyse structural fiscal problems and fiscal management of the State Governments based on the long term behavior of major fiscal variables during the last five decades starting from 1960. Analysis confirms that structural problems such as vertical fiscal imbalance, variation across States in imposing certain taxes and lower own non-tax revenues still exist and need to be addressed more progressively. Fiscal management of the States worsened from the second half of 1980s to 2003-04. However, fiscal reforms undertaken since 2004-05 benefitted States in managing their finances. The macroeconomic slowdown and the impact of pay revision on account of sixth pay commission halted the fiscal correction during 2008-09 and 2009-10 before the State governments resumed fiscal consolidation in 2010-11. Even though revenue receipts increased significantly over the last five decades, it was largely contributed by current transfers rather than States' own revenues. Inspite of increasing total expenditure, the share of capital expenditure shows a declining trend raising issues for potential growth of States. Nonetheless, rising share of social sector expenditure in total expenditure, curtailment in committed expenditure, progress under rule based regime in terms of lower key deficits and debt could be seen as positive developments in fiscal management of States in the post FRBM period.

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I. Introduction

The subject of fiscal federalism has received increasing attention from academics, analysts and policy makers in the recent years. Federalism is a universally accepted and acknowledged type of governance which promotes efficiency at different levels of government. India became a Constitutional republic in January 1950. The Indian Constitution provides the federal basis for governance in India. The Constitution has clearly specified all the statutory provisions, initially for two layers of government which was later expanded to

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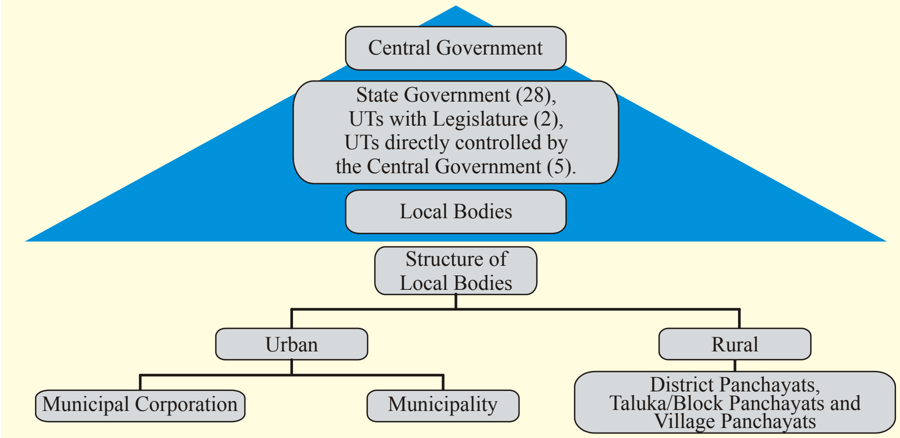
Chart 1: Structure of Electoral Governments at three layers



three. The Constitution also provides for the fiscal institutions and mechanisms for intergovernmental transfers to address the vertical and horizontal fiscal imbalances across different levels of governments.

The Constitution incorporated States as sub-national entities with specified political and fiscal authorities. India now consists of twenty-eight States, two "Union Territories (UTs) with legislature" and five UTs controlled by the Central Government (Chart 1).

The financial resources and functions of Centre and the States are specified in Seventh Schedule of the Indian Constitution. The schedule specifies the financial resources and functions of the Centre (the Union list) and the States (the State list). The powers under joint jurisdiction are included in the Concurrent list. However, Indian federal system is considered to be quasi-federal due to high concentration of powers with the Central government (Rao, 2004). This allocation of powers and functions between Centre and the States creates vertical imbalance. Even though concentration of power at the Central government level creates imbalance between the Centre and the States, it was supported by keen observers to maintain unity in the diversity of India. To quote Dr. Ambedkar, *"it is difficult to prevent the centre from becoming strong. Conditions in the modern world are such that the centralization of powers is inevitable. One has only to consider the growth of the Federal government in USA, which, notwithstanding the very limited powers given to it by the Constitution, has out grown its former self and has over shadowed and eclipsed the state governments. This is due to modern conditions. The same conditions are sure to operate on the Government of India and nothing that one can do will help to prevent it* *from being strong. On the other hand, we must resist the tendency to make it stronger. It cannot chew more than it can digest. Its strength must commensurate with its weight. It would be a folly to make it so strong that it may fall by its own weight"*[1]

Fiscal policy of States assumes importance in the macroeconomic policies of India as the States account for around 57 per cent of the total expenditure incurred by both levels of government in India (Centre and States). As the States have assigned major expenditure responsibility due to their proximity to the local issues, their contribution in developmental and social sector expenditure, particularly on social services increased significantly. With the adoption of planning and emphasis on the decentralisation of the fiscal activities, the role of States in providing better social and economic services has widened. The State governments are dependent on Centre for resources as the resource mobilisation powers assigned to them fall short of their expenditure responsibilities. Expenditure pattern of the States is dominated by committed expenditure such as interest payments, pension and administrative services. Consequently, fiscal management of the States to a large extent is shaped by devolution of resources from the Centre and expenditure commitments that arise from time to time.

In this study, the objective is to analyse structural problems, fiscal management and other issues relating to State finances. Accordingly, the study has been organised into seven sections. While this section set out an introduction to the fiscal federalism in India, a brief review of literature is provided in Section II. The structural problems relating to State finances are presented in Section III. Fiscal management based on long-term behavior of key deficit indicators with special emphasis on phases of improvement/deterioration in revenue account discussed in Section IV. Receipts and expenditure management, with emphasis on their composition, is analysed in Section V. Financing pattern of gross fiscal deficit (GFD), outstanding debt and its composition are covered in Section VI. Issues in State finances are provided in Section VII.

II. Review of Literature

There are many studies on various aspects of finances of the State governments. Bacgchi (2002), in an assessment of fiscal federalism observed that over-centralisation of economic policies, failure to ensure the development

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[1] Constituents Assembly Debates: Vol.VII, P.42, November 1948.

and smooth functioning of a common market, faulty design of intergovernmental transfers and inadequate Central oversight over States' borrowing resulting in the problem of subnational debt and deficit, as the weaknesses of fiscal federalism practised in India. Rao (2004) noted that even though the revenues of States grew faster than the Centre, States' fiscal dependence on Centre increased due to increase in expenditure at faster rate than revenue. Rao (1998) observed that inter-State differences in the ability to raise revenues and the coefficient of variation in per capita expenditure increased during 1990s. Bajpai and Jeffrey (1999) observed certain issues pertaining to stagnant tax-GDP ratio, rising share of non-developmental outlay in the total expenditure, large volumes implicit subsidies and increasing losses of State enterprises. Kurian (1999) noted that failure in containing wasteful expenditure and reluctance to raise additional resources resulted in deterioration of State finances. He also noted that States were unable to spend on investment in social and infrastructure sectors due to implementation of Fifth Pay Commission awards. Rajmal (2006) observed that State finances were under fiscal stress during the period 1986-87- 2003-04 due to growing interest burden, increasing wages and salaries, pension liabilities, losses incurred by State enterprises, inadequate user charges/cost recoveries and deceleration in the current transfers (States' share in Central taxes and grants-in-aid). He also noted a steady deterioration in revenue receipts-GSDP ratio, stagnating social sector expenditure, inadequate investment for basic infrastructure sectors, pre-emption of high cost borrowed funds for financing current expenditure and increasing debt stock and its servicing.

III. Structural problems in fiscal management of States

Vertical fiscal imbalance between the Centre and the States

The constitutional allocation of taxation powers between Centre and the States is based on some economic and administrative considerations such as minimising/avoiding the problem of double taxation, tax rivalry among States, and duplication of tax administration. While determining expenditure responsibilities, subjects of regional concern, such as, law and public order, agriculture, irrigation, public health and sanitation, roads and bridges are assigned to States due to their proximity to the local issues. However, this allocation of taxation powers and expenditure responsibilities between Centre and the States creates an imbalance referred to as vertical fiscal imbalance. States have the responsibility of development in areas such as education, health, agricultural and industrial growth, construction of roads, bridges and irrigation schemes, *etc*. However, their revenue raising powers to meet these expenditure responsibilities are inadequate. This led to States' growing dependence on transfers from the Centre to finance their expenditure commitments. The expenditure policies of States are also influenced by the Centre under the objectives of planning (Centrally Sponsored Schemes).

Successive Finance Commissions have emphasized the need to reduce these imbalances by increasing the States' share in Central taxes. However, the imbalances did not show any marked reduction, as evident from the fact that the share of States' revenue receipts in combined revenue receipts of the Centre and the States declined from 63.7 per cent in 1980-81 to 62.8 per cent in 2010-11 (BE).

Horizontal imbalances due to differences in revenue generation capacities and expenditure commitments across States

The existence of region-specific disparities as well as diverse socio-economic structure across States causes variations in resource mobilisation and expenditure responsibilities across States. Populist fiscal measures such as non-levy of certain taxes, differences in tax rates, and State-specific expenditure schemes, also contribute to the differences in revenue generating capacity and expenditure commitments across States. These differences create fiscal imbalances, commonly referred to as horizontal fiscal imbalances. Table 1 shows that the extent of horizontal fiscal imbalance increased during 1990s, and in the first half of 2000s (the number of States in the fiscally imprudent category, *i.e.*, above 4.0 per cent gross fiscal deficit-GSDP ratio, increased gradually from 13 during 1980s to 15 during 1990s and further to 23 during 2000-01 to 2004-05) but declined during 2005-06 to 2010-11 (the number of States in the fiscally imprudent category, *i.e.*, above 4.0 per cent fiscal deficit declined to 11). Considering imbalance in the revenue account, horizontal fiscal imbalance increased during 1990s, and in the first half of 2000s (the number of States with revenue balance/surplus came down from 15 during 1980s to 8 during 1990s and further to 6 during the first half of 2000s) but declined during 2005-06 to 2010-11 (22 States recorded revenue surplus during 2005-06 to 2010-11). Measures such as specific purpose grants and incentives for rule based framework on the basis of the Twelfth Finance Commission’s recommendation helped the States to reduce the extent of fiscal imbalances as well as horizontal fiscal imbalances across States during 2005-06 to 2010-11.

Table 1. Horizontal Fiscal Imbalances during 1980-81 to 2010-11

(Number of States)

	Gross Fiscal Deficit as per cent to GSDP			Revenue surplus/deficit as per cent to GSDP		
	Average					
Period	0 to 3.0	3.0 to 4.0	above 4.0	0 or < 0	> 0 to 1.5	above 1.5
1980s	3	9	13	15	10	-
1990s	5	5	15	8	8	9
2000-01 to 2004-05	2	3	23	6	5	17
2005-06 to 2010-11(BE)	11	6	11	22	3	3

-: Nil BE: Budget Estimates

Source: State Finances: A Study of Budgets, RBI, various issues.

Lack of uniformity in tax rates and levying taxes across States

Though the States have undertaken measures towards rationalisation of taxes and simplification of tax procedures over the years, levy of taxes and tax rates have not been uniform across States. For example, rate of major taxes such as Sales tax/Value Added tax (VAT) varies across States. In addition, observations based on data reported in the budget documents of the State governments show variations in the imposition of certain taxes across States. For example Andhra Pradesh, Arunachal Pradesh, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Punjab and Uttarakhand do not levy Agricultural Income Tax as there was no receipt from this tax in any of the years during 1990-91 to 2010-11. Similarly, there was no receipt from taxes on profession, trades, callings and employments in Arunachal Pradesh, Goa, Himachal Pradesh, Kerala, Punjab and Tamil Nadu during the same period. Arunachal Pradesh, Bihar, Chhattisgarh, Goa, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Meghalaya, Mizoram, Nagaland, Orissa, Punjab, Sikkim and Uttarakhand did not record any receipts from urban immovable property tax during 1990-91 to 2010-11. It shows lack of uniform tax policies across States. Perhaps, introduction of Goods and Services Tax (GST) may have uniformity across the States in terms of tax and tax rates.

Lower own non-tax revenues due to lower return on investment and inadequate user charges

States' own non-tax revenues comprise receipts from interest on loans given by the State Governments, dividend and profits from State enterprises, State lotteries and non-tax revenues from various social and economic services. Losses of State enterprises particularly, state electricity boards contributed to lower non-tax revenues of the States. In addition, low recovery of economic services and lack of proper user charges on social services are major drawbacks in improving non-tax revenues of the States. In order to improve revenues from non-tax sources, States should initiate reforms to ensure better performance of State enterprises, proper user charges and increase in recovery from economic services.

Dominance of committed expenditure

The revenue expenditure of States is dominated by committed expenditures such as interest payments, administrative services and pension. Higher committed expenditure resulted in deficit on the revenue account of the States. Consequently, resources borrowed through market and other sources had been utilised to finance revenue deficits rather than financing infrastructure in the 1980s and 1990s which was reflected in lower capital outlay as a ratio to GDP.

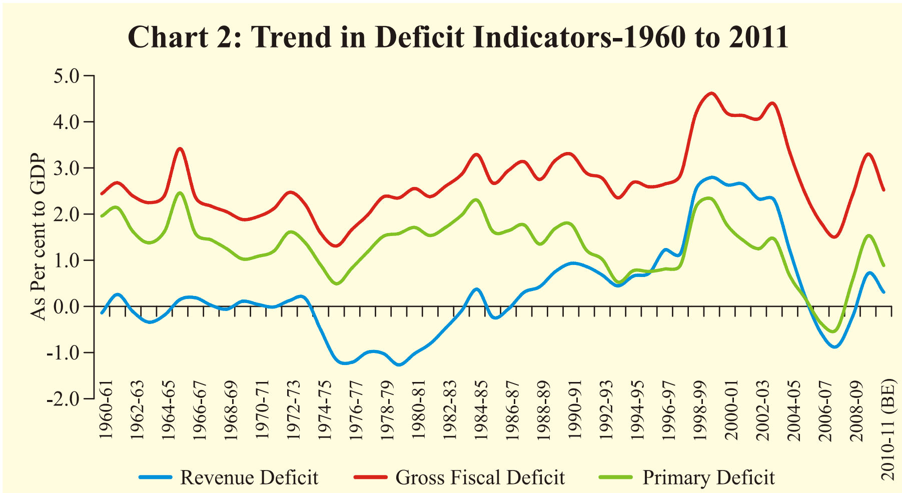
Multiple channels of transfers and inappropriate distribution criteria

There is an imbalance between revenue assignments relative to the expenditure responsibilities of States. Transfers from the Central government to the States seek to corrective such imbalances. However, these transfers are determined/recommended by multiple agencies such as Finance Commission, Planning Commission and Central Ministries. Increasing dependence of States for current transfers from the Centre leads to weakening of their fiscal discipline. Formula for inter se distribution of taxes does not take into account important parameters such as poverty and unemployment levels in the State. The equalisation transfers should serve the objective of reducing inequality among States.

IV. Fiscal Management -An Overview

Fiscal position of States was not a concern till 1985-86 as revenue account was either in surplus or marginally in deficit while fiscal deficit of all States at the consolidated level was less than 3 per cent of GDP. In fact, remarkable improvement in terms of maintaining surplus in revenue account and reduction in fiscal deficit was observed between 1974-75 to 1986-87 (longest period of persistent revenue surplus) due to larger devolution of resources from the Centre and substantial debt relief on lines of the recommendations of the Sixth Finance Commission. However, deterioration in the finances of States started in 1987-88 in the wake of increased expenditure on salary and pension due to the pay revisions in some States which was supplemented by higher expenditure on relief and rehabilitation on account of floods in a number of States. Deterioration became sharper in the late 1990s due to the Fifth Pay Commission awards to the State government employees. States witnessed sharp increases in their revenue and fiscal deficit in the subsequent years till 2003-04 on account of decline in States' own non-tax revenues due to losses of State enterprises and decline in transfers from the Centre due to low economic growth. Higher revenue and fiscal deficits resulted in accumulation of debt which, in turn, increased the interest burden of the States during this period. In view of considerable fiscal stress and the need to finance the requirement of investment in infrastructure, States extended guarantees to State enterprises. Consequently, outstanding guarantees as a ratio to GDP also increased substantially from 6.1 per cent in 1991-92 to 8.0 per cent in 2000-01.

Since 2002-03, the Central government and the States Governments, on their own as well as on the basis of the recommendation of the Twelfth Finance Commission, introduced systematic reforms in the areas of revenues, expenditure and fiscal discipline. First, realising the growing interest burden of the States, the Central government introduced the debt swap scheme under which high cost Central loans of the States having interest rate of above 13 per cent were swapped through fresh issuances of low cost market borrowings and securities issued to National Small Savings Fund (NSSF). Second, the Twelfth Finance Commission (TwFC) recommended Debt Consolidation and Relief Facility (DCRF) by linking it to the enactment of Fiscal Responsibility and Budget Management (FRBM) Act by the States. These measures resulted in significant decline in interest payments of the States in subsequent years and also brought about fiscal discipline for States which enacted their FRBM Acts. Third, State governments implemented Value Added Tax (VAT) to replace State sales tax which improved their revenue performance. Fourth, many States implemented New Pension Scheme (NPS) for their employees which enabled them to control their pension liabilities in the recent years (Box 1). Consequently, there was a remarkable improvement in the fiscal position through decline in revenue expenditure and increase in revenue receipts between 2005-06 and 2007-08. The revenue account of States at the consolidated level turned surplus in 2006-07 after the gap of 19 years and remained so during 2007-08 and 2008-09. States also recorded progressive reduction in GFD-GDP ratio and debt-GDP ratio during these years. However, the impact of the Sixth Pay Commission on the revenue expenditure and lower receipts due to macroeconomic slowdown halted the process of fiscal correction in 2008-09 and 2009-10. With the revival in economic growth during 2010-11, States, however, resumed fiscal correction path by reducing key deficit ratios (Chart 2).



An inter-temporal analysis of the revenue account[2] clearly shows five different phases. The contribution of receipts and expenditure in the correction/ deterioration of revenue account has undergone changes from time to time in accordance with the emerging situation.

Phase I: Improvement in revenue account entirely through higher receipts (1960-61 to 1976-77)

In the first phase, revenue account was either in surplus or in a marginal deficit. Revenue surplus increased from 0.1 per cent of GDP at the start of the phase to 1.2 per cent by the end of the phase (1976-77). Thus, revenue account recorded an improvement of 1.1 percentage point of GDP during this phase which was due to higher revenue receipts, particularly from States' own revenues. In fact, the increase in revenue receipts not only contributed to the revenue account correction but also compensated for increase in expenditure over the same period (Table 2).

Phase II: Deterioration in revenue account entirely through revenue expenditure (1977-78 to 1986-87)

The revenue account of the States was in surplus in all the years (except 1984-85) during this phase. However, a decline in surplus by 0.9 percentage

[2] Revenue account is composed of revenue receipts and revenue expenditure. Revenue receipts of the States includes tax revenues (States own taxes and share in Central taxes) and non-tax revenues (States own non-tax revenue and Grant-in-aid from the Central government). Most of the committed items of expenditure such as interest payments, expenditure on wages and salaries and pension comes in the category of revenue expenditure. Excess of revenue expenditure over the revenue receipts leads to a deficit in the revenue account.

Table 2: Contribution in the correction/deteriration in Revenue Account

	Phase I 1960-61 to 1976-77		Phase II 1977-78 to 1986-87		Phase III 1987-88 to 2001-02		Phase IV 2002-03 to 2007-08		Phase V 2008-09 to 2010-11 (BE)	
	Variation*	Contribution#	Variation*	Contribution#	Variation*	Contribution#	Variation*	Contribution#	Variation*	Contribution#
I. Revenue Deficit (III-II)	**-1.1**		**0.9**		**2.3**		**-3.2**		**0.5**	
II. Revenue Receipts (1+2)	**4.1**	**388.1**	**2.5**	**264.6**	**-1.4**	**-57.6**	**1.4**	**42.6**	**-0.9**	**-159.1**
1. Own Revenue Receipts	**2.3**	**215.6**	**1.1**	**122.0**	**-0.5**	**-21.3**	**0.3**	**9.2**	**-0.5**	**-95.5**
1.1 Own Tax Revenue	1.8	170.7	1.1	114.9	0.0	0.3	0.2	5.4	-0.4	-65.4
1.2. Own-non Tax Revenue	0.5	44.9	0.1	7.2	-0.5	-21.6	0.1	3.8	-0.2	-30.2
2. Transfers from Centre	**1.8**	**172.5**	**1.3**	**142.6**	**-0.9**	**-36.3**	**1.1**	**33.4**	**-0.3**	**-63.6**
2.1 Share in Central Taxes	0.9	82.6	0.9	96.6	-0.4	-17.4	0.7	22.8	-0.3	-63.4
2.2 Grants	1.0	89.9	0.4	45.9	-0.4	-18.9	0.3	10.6	0.0	-0.1
III. Revenue Expenditure	**3.1**	**-288.1**	**3.4**	**-364.6**	**1.0**	**-42.4**	**-1.8**	**57.4**	**-0.3**	**59.1**

* Variation in percentage points of GDP. # Contribution in Variation (per cent).

Note: Minus (-) sign in variation in deficit shows improvement.

Source: State Finances: A Study of Budgets, RBI, various issues and authors calculations.

point of GDP was observed over the period of this phase. Deterioration in revenue account was due to substantial increase in expenditure by 3.4 percentage points of GDP, even though it was compensated by increase in revenue receipts (2.5 percentage points of GDP). Improvement in revenue receipts was mainly through current transfers (States share in Central taxes and grant-in-aid from the Centre).

Phase III: Persistent and widening revenue deficit caused by lower receipts and higher expenditure (1987-88 to 2001-02)

State governments witnessed persistent revenue account deficit during this phase. Over the period of this phase, revenue deficit increased by 2.3 percentage points of GDP to 2.7 per cent of GDP in 2001-02. The deterioration was on account of both lower receipts and higher expenditure. The share of revenue receipts and revenue expenditure in deterioration accounted for 57.6 per cent and 42.4 per cent, respectively. Within revenue receipts, the share of decline in current transfers in revenue account deterioration (36.3 per cent) was larger than that of States' own revenues (21.3 per cent).

Phase IV: Remarkable improvement aided by buoyant receipts and lower expenditure (2002-03 to 2007-08)

This period can be described as a combination of systematic reforms and a rule based fiscal framework. State governments initiated a process of fiscal reforms which helped in improving their revenue account. These reforms/ initiatives include, successful implementation of VAT to replace sales tax by all the States, rule based fiscal framework enacting Fiscal Responsibility and Budget Management Act and New Pension Scheme. Apart from these, 'Debt Consolidation and Relief Facility' recommended by the TwFC and 'Debt Swap Scheme' introduced by Central government benefited States in turning their revenue account into surplus (Chart 2 and Box 1). The revenue deficit of 2.3

Box 1: Institutional Reforms Initiated at State level

1) **Fiscal Responsibility and Budget Management (FRBM) Acts at State Level:** All States (except Sikkim and West Bengal) enacted between September 2002 (Karnataka) and May 2007 (Jharkhand). West Bengal and Sikkim enacted FRBM in 2010.
2) **Value Added Tax (VAT):** VAT introduced by all the States to replace States sales tax.
3) **Debt Swap scheme**: The Debt Swap Scheme (DSS) which was formulated by Government of India to enable the States to prepay Central loans, which had an interest rate of over 13 per cent, by raising lower cost debt from the market or through small savings schemes. DSS was operational from 2002-03 to 2004-05. During this period, outstanding Central loans amounting to Rs. 1.02 lakh crore were prepaid by the States.
4) **Debt Consolidation and Relief Facility (DCRF):** Under the Debt Consolidation and Relief Facility recommended by the Twelfth Finance Commission (TwFC), Central loans to the States contracted till March, 31, 2004 and outstanding on March 31, 2005 were consolidated at an interest of 7.5 per cent and rescheduled for a term of 20 years (with repayment in 20 equal annual installments). These benefits were made available to the State Governments from the year in which they enacted Fiscal Responsibility and Budget Management Acts in line with the recommendations made by the Twelfth Finance Commission.
5) **Consolidated Sinking Fund (CSF):** To cushion repayments of open market loans, 20 States (excluding Bihar, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Rajasthan and Uttar Pradesh) constituted CSF.
6) **Guarantees Redemption Fund (GRF):** To provide a cushion to the servicing of contingent liabilities arising from the invocation of guarantees issued by the State governments, 15 States (Andhra Pradesh, Goa, Gujarat, Haryana, Jammu and Kashmir, Madhya Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Rajasthan, Sikkim, Tamil Nadu and Uttarakhand) constituted GRF.
7) **New Pension Scheme (NPS)**: 20 States (excluding Arunachal Pradesh, Jammu and Kashmir, Meghalaya, Mizoram, Nagaland, Punjab, Tripura and West Bengal) introduced new pension scheme.

Source: State Finances: A Study of Budgets, RBI, various issues.

per cent of GDP in the initial year of the phase changed into a surplus of 0.9 per cent of GDP. Thus, over the period of this phase, revenue account witnessed an improvement of 3.2 percentage points of GDP. Both receipts and expenditure contributed in correcting revenue account during this phase. However, the contribution of expenditure was higher (57.4 per cent) than receipts (42.6 per cent). Within revenue receipts, the contribution of current transfers (33.4 per cent) was significantly higher than the States' own revenues (per cent 9.2).

Phase V: Turnaround from surplus to deficit entirely due to lower receipts [2008-09 to 2010-11 (BE)]

Impact of the Sixth Pay Commission awards on the revenue expenditure and macroeconomic slowdown on the revenues led to deterioration in revenue account during 2009-10. While revenue receipts continued to decline, significant reduction in revenue expenditure facilitated correction in revenue account during 2010-11. Thus, despite correction in 2010-11, revenue account witnessed deterioration of 0.5 percentage points during this phase (2010-11 over 2008-09). Within revenue receipts, States own revenues accounted for 95.5 per cent of the deterioration in revenue account during this phase.

Fiscal and institutional reforms helped in improving gross fiscal deficit and its quality

Gross fiscal deficit of the States is the excess of total expenditure (excluding debt repayments) of the State government over its revenue receipts and non-debt capital receipts. Thus, it reflects the borrowing requirement of the States to finance the expenditure to be incurred during a particular financial year. In order to analyse quality of fiscal deficit its decomposition into revenue deficit, capital outlay and net lending shows the utilisation of borrowed resources. Higher GFD utilised for capital outlay improves growth prospect of the economy while its use for meeting revenue deficit can put pressure on interest and debt levels of the government.

Table 3: Phase-wise Averages of Key Deficit Indicators

(As a ratio to GDP)

	Phase I 1960-61 to 1976-77	Phase II 1977-78 to 1986-87	Phase III 1987-88 to 2001-02	Phase IV 2002-03 to 2007-08	Phase V 2008-09 to 2010-11 (BE)
	Average				
Revenue Deficit	-0.2	-0.6	1.3	0.8	0.3
Gross Fiscal Deficit	2.2	2.6	3.2	2.9	2.7
Primary Deficit	1.4	1.7	1.4	0.4	1.0

Note: Minus (-) sign indicates surplus.

Source: State Finances: A Study of Budgets, RBI, various issues.

Gross fiscal deficit at the consolidated level was below the mark of 3.0 per cent of GDP in phase I and II (Table 3). GFD in the first two phases was used either for capital outlay or lending as revenue account in these phases was in surplus. Capital outlay and net lending together accounted for above 100 per cent of GFD during these phases (Table 4). However, GFD-GDP ratio crossed 3.0 per cent mark in 1987-88 and peaked at 4.6 per cent in 1999-2000 (highest during 1960-61 to 2010-11). On average, GFD-GDP ratio was 3.2 per cent during the third phase (Table 3). Causative factors for higher GFD during this phase were increase in expenditure on salaries and pension of State government employees in pursuance of the recommendations of the fifth pay commission, compensating losses of State public enterprises viz., State electricity distribution companies on account of populist measures such as free/subsidised power to farmers, reimbursement of losses incurred by State Transport companies for carrying certain categories of passengers such as students, physically challenged, freedom fighters, *etc.*, at lower fares (Gupta, 2007). The worrisome feature of the GFD during this phase was substantially higher proportion of revenue deficit (35.9 per cent of GFD) indicating that borrowed resources were being used to meet current expenditures (Table 4). While capital outlay was accounted for 74.0 per cent (average) of GFD, substantial decline in net lending was observed during this phase.

The fiscal reforms at the State level started from 2002-03 contributed to the foundation of fiscal consolidation of the State governments. Reforms such as implementation of VAT, enactment of FRBMs, debt consolidation and relief facility and robust growth in the economy benefited States in improving their finances during the fourth phase. Though GFD-GDP ratio during this phase averaged 2.9 per cent, it declined to 1.5 per cent in 2007-08. States governments during this period had not only taken initiatives for reducing fiscal imbalance but also had undertaken comprehensive reforms such as constitution of Consolidated Sinking Fund and Guarantee Redemption Fund (Box 1). Considering the growing emphasis on social and physical infrastructure, the decomposition of GFD of the States had also undergone changes with the passage of time. Consequently, capital outlay accounted for 84.1 per cent (average) of the GFD during this phase.

The process of fiscal consolidation experienced by the States in the fourth phase was paused during the fifth phase due to combined impact of Sixth Pay Commission awards and the macroeconomic slowdown. In order to boost aggregate demand in the economy, Central government allowed States to borrow additional 0.5 per cent of their GSDP by relaxing fiscal deficit target under

Table 4 : Decomposition of GFD[3]

(As a ratio to GDP)

	Phase I 1960-61 to 1976-77	Phase II 1977-78 to 1986-87	Phase III 1987-88 to 2001-02	Phase IV 2002-03 to 2007-08	Phase V 2008-09 to 2010-11 (BE)
	Average				
Revenue Deficit	-10.9	-24.1	35.9	10.8	8.2
Capital Outlay	71.3	78.7	48.8	84.1	88.1
Net Lending	39.6	45.4	15.4	7.0	4.4

Note: Minus (-) sign indicates surplus.
Source: State Finances: A Study of Budgets, RBI, various issues.

FRBM to 3.5 per cent in 2008-09 and further to 4.0 per cent in 2009-10. Consequently, GFD-GDP ratio increased to 3.3 per cent of GDP in 2009-10 (RE) before declining to 2.5 per cent in 2010-11 (BE). Thus, on average, GFD-GDP ratio remained at 2.7 per cent during the fifth phase [2008-09 to 2010-11 (BE)]. It may be noted that while the proportion of capital outlay to GFD averaged higher at 88.1 per cent, net lending as a ratio to GFD continued to decline and reached at lowest level of 4.4 per cent during this phase (Table 4).

Improvement in primary deficit reflects trend in GFD

States at the consolidated level incurred primary deficit[4] during all the years of last five decades (except 2006-07 and 2007-08). Broadly, primary deficit followed similar trend to that of GFD in the first and second phase. However, during the phase of extreme deterioration, *i.e.*, third phase, PD-GDP ratio was lower even though GFD was higher, thereby reflecting the dominance of interest burden in the expenditure of States. In the fourth phase, *i.e.*, the phase of consolidation, significant improvement was witnessed in PD-GDP ratio. In fact, primary deficit turned into surplus in 2006-07 and 2007-08. However, with the upward movement in GFD, PD-GDP ratio worsened again during the fifth phase (Table 3).

V. Receipts and Expenditure Management

Improvement in total revenue receipts aided by current transfers and States' own tax revenues

Phase-wise average of revenue receipts as per cent to GDP shows that revenue receipts of the States witnessed gradual and significant increase during

[3] For the purpose of analysing the quality of expenditure, GFD is decomposed into revenue deficit, capital outlay and net lending which may not add-up to total as it excludes non-debt capital receipts.

[4] Primary deficit is fiscal deficit less interest payments and thus its shows the excess of non-interest expenditure of the States over its revenue receipts and non-debt capital receipts.

Table 5:Phase-wise Performance of Revenue Receipts

(As a ratio to GDP)

	Phase I 1960-61 to 1976-77	Phase II 1977-78 to 1986-87	Phase III 1987-88 to 2001-02	Phase IV 2002-03 to 2007-08	Phase V 2008-09 to 2010-11 (BE)
	Average				
A. Revenue Receipts (1+2)	**7.3**	**11.0**	**11.4**	**11.7**	**12.1**
1. Own Revenue (a+b)	**4.7**	**6.7**	**7.0**	**7.1**	**7.0**
a. Own Tax Revenue	3.2	4.8	5.3	5.7	5.6
b. Own Non-tax Revenue	1.4	1.9	1.7	1.4	1.4
2. Current Transfers (c+d)	**2.7**	**4.3**	**4.4**	**4.6**	**5.1**
c. Share in Central Taxes	1.4	2.4	2.5	2.6	2.7
d. Grants from the Centre	1.3	1.9	1.9	2.0	2.5

Source: State Finances: A Study of Budgets, RBI, various issues.

the last five decades. Both own revenues of the States and current transfers from the Centre contributed to increase in revenue receipts by 4.8 percentage points of GDP in the fifth phase as compared to the first phase. However, the contribution of current transfers which increased gradually over the period, was more than the own revenues of the States. While increase in the current transfers was contributed by States' share in Central taxes and grant-in-aid, increase in own revenues during the same period was entirely on account of own tax revenues of the States. However, improvement in States' own non-tax revenues witnessed during the second phase could not sustain over the period and declined during the third and fourth phase. Thus, own non-tax revenues of the States remained stagnant over the period (Table 5).

Higher own revenues in the post reform period reflecting better performance of own taxes

Own tax revenue has remained major source of States' own revenues and witnessed gradual increase during the first four phases. It has increased substantially by 2.4 percentage points to 5.7 per cent in the fourth phase as compared to the first phase (3.2 per cent of GDP). Tax reforms such as rationalisation of taxes and simplification of procedures by States in 1991 mandated States to rationalise their taxes which helped them in generating more revenues. Implementation of VAT replacing State sales tax also improved tax collections of States. However, anti-recessionary measures of reducing/

Table 6. Trend in Revenue from Major Own Tax and Non-Tax Sources

(As per cent to GDP)

	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2004-05	2005-06 to 2009-10	2005-06	2006-07	2007-08	2008-09	2009-10 (RE)	2010-11 (BE)
	Average									
Major Own Tax Sources										
Stamps and Registration fees	0.41	0.45	0.52	0.68	0.67	0.76	0.75	0.65	0.60	0.58
State Sales Tax/VAT	2.41	2.35	2.61	3.01	2.84	3.00	3.07	3.20	2.92	2.85
State Excise	0.81	0.69	0.71	0.70	0.68	0.68	0.68	0.73	0.73	0.70
Major Own Non-Tax sources										
Interest Receipts	0.57	0.49	0.36	0.27	0.25	0.28	0.25	0.29	0.26	0.21
Dividends and Profits	0.01	0.01	0.01	0.01	0.02	0.01	0.01	0.01	0.01	0.01
General Services	0.38	0.41	0.33	0.43	0.32	0.43	0.53	0.40	0.46	0.35
Social Services	0.11	0.10	0.11	0.14	0.12	0.16	0.16	0.14	0.13	0.14
Economic Services	0.78	0.60	0.60	0.60	0.59	0.59	0.60	0.62	0.61	0.59

Source: State Finances: A Study of Budgets, RBI, various issues.

exempting taxes in the wake of macroeconomic slowdown resulted to marginal decline in own tax revenue to 5.6 per cent of GDP in fifth phase (Table 5).

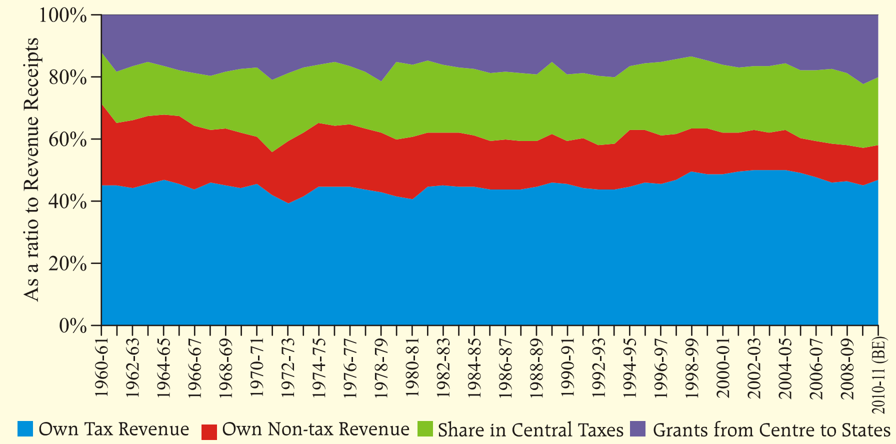
Table 6 shows that 'State sales tax/VAT' is the major source of States' own tax revenue followed by 'State Excise' and 'Stamps and Registration fees'. The trend in revenues from these taxes indicates that while VAT and State excise improved marginally, the revenues from Stamps and Registration fees declined during 2006-07 to 2008-09. On the States' own non-tax front, revenue from economic services constitutes major source of non-tax revenue, followed by interest receipts and general services (Table 6).

Revenues from major sources of own non-tax revenue has remained either stagnant or declined since 2006-07 (Table 6). Own non-tax revenues have remained subdued as the State enterprises such as State Electricity Boards have been incurring huge losses while the non-tax revenues from various social and economic services also remained poor due to lack of proper user charges and cost recovery. Both these factors resulted in decline in States' own non-tax revenue as a ratio to GDP.

Share of States' own revenues in total revenue receipts declined over the last five decades

Composition of revenue receipts shows that the share of States own revenue has declined while the share of current transfers have increased over the last five decades. Within States' own revenue the share of own tax revenue recorded

Chart 3: Composition of Revenue Receipts-1960-61 to 2010-11 (BE)



marginal increase while own non-tax revenue witnessed decline over the same period. Within the current transfers, the States' share in Central taxes has registered marginal rise while the grant-in-aid witnessed decline in its share in total revenue receipts over the period (Chart 3).

Substantial increase in total expenditure entirely due to revenue expenditure

As per the Indian Constitution, expenditure responsibilities of the social sector and economic infrastructure are assigned largely to the State governments. In order to improve the social well being, the States need to step up their expenditure on social services such as education and health. However, expenditure of the States has been dominated by committed component. Given the budgetary constraint facing States, these expenditure commitments have been largely financed by borrowings. To improve the quality of expenditure, rationlisation measures aiming reduction in non-development expenditure and increasing development expenditure were adopted by the States over the period.

An evolution of the expenditure pattern of the States reveals that the average total expenditure as a ratio to GDP increased gradually from 11.1 per cent in the first phase to 16.3 per cent in the fourth phase before declining to 15.7 per cent in the fifth phase. The major issue in the composition of States expenditure is declining capital expenditure. In other words, given the composition of expenditure, increase in total expenditure is entirely on account of revenue expenditure which is considered to be less productive than the capital expenditure. In view of the limitation to enhance expenditure and dominance of committed expenditure, the expenditure reforms remained priority area of the State budgets during the recent years.

Decline in capital expenditure and widening gap between revenue and capital expenditure

Quality of expenditure by State governments can be gauged from the fact that the average share of revenue expenditure in total expenditure increased from 65 per cent in the first phase to 79 per cent in fifth phase. Accordingly, the average share of capital expenditure in total expenditure declined sharply from 35 per cent in the first phase to merely 21 per cent in the fifth phase (Table 7).

Table 7: Phase-wise Expenditure Pattern

(As a ratio to GDP)

	Phase I 1960-61 to 1976-77	Phase II 1977-78 to 1986-87	Phase III 1987-88 to 2001-02	Phase IV 2002-03 to 2007-08	Phase V 2008-09 to 2010-11
	Average				
Total Expenditure	11.1	15.0	15.6	16.3	15.7
Revenue Expenditure	7.2	10.5	12.7	12.5	12.4
Capital Expenditure	3.9	4.6	3.0	3.9	3.4
					(As per cent to total expenditure)
Revenue Expenditure	64.4	69.4	81.0	76.3	78.7
Capital Expenditure	35.6	30.6	19.0	23.7	21.3

Source: State Finances: A Study of Budgets, RBI, various issues.

Uptrend in revenue expenditure and downtrend in capital expenditure reflect concerns with regard to expenditure quality (Table 7 and Chart 4).

Chart 4: Revenue and Capital Expenditure-1960 to 2011

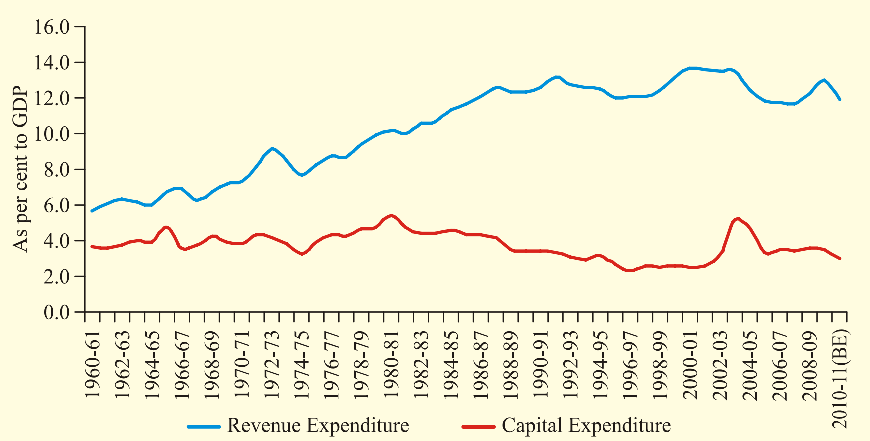
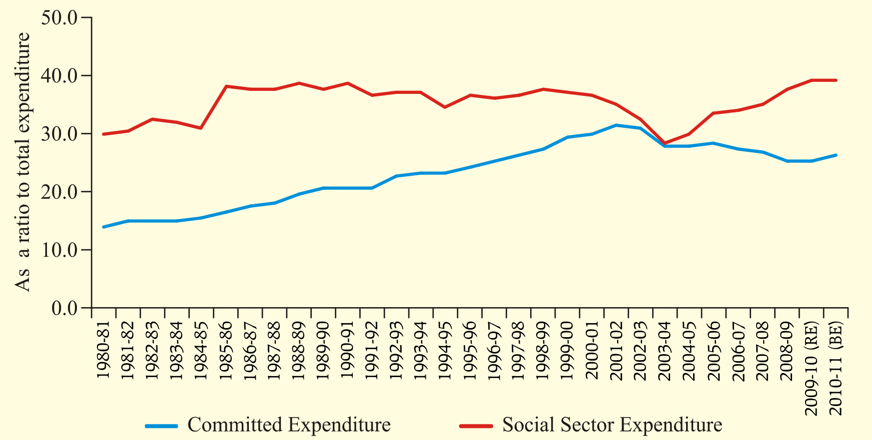


Chart 5: Social sector and committed expenditure



Reduction in committed expenditure facilitated higher social sector expenditure in recent years

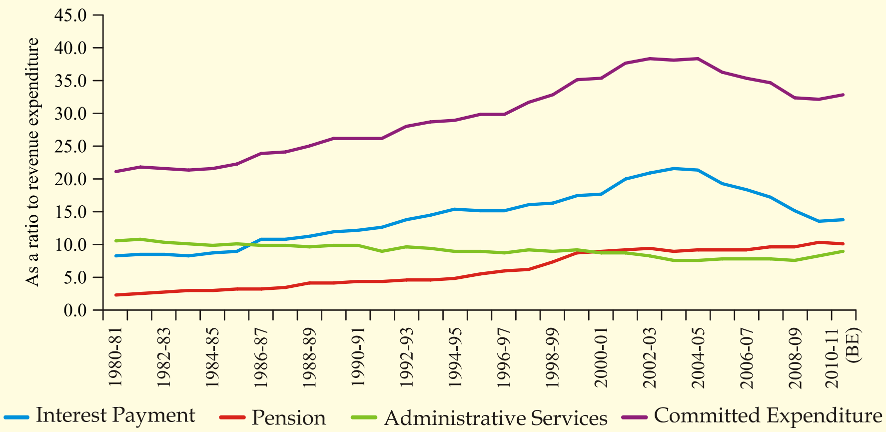
Apart from analysing revenue and capital composition of States expenditure, social sector expenditure (SSE) which comprises expenditure on social services, rural development and food storage and warehousing assumes importance as these are the areas which fall in the domain of States. On average, SSE accounts for around one-third (average) of States total expenditure. The share of SSE in total expenditure has been rising in recent years. The share of committed expenditure in total expenditure has almost doubled during the past three decades even though some moderation was observed since 2003-04 due to reduction in interest burden (Chart 5).

Committed expenditure is dominated by interest payments and pension

Chart 6 shows that since 1985-86 committed expenditure (comprising interest payments, pension and administrative services) recorded substantial increase up to 2002-03. The share of committed expenditure in revenue expenditure increased from 21.1 per cent in 1980-81 to 38.4 per cent in 2002-03. However, it started declining since 2003-04 and recorded at 32.7 per cent in 2010-11 (BE). The share of interest payments and pension in revenue expenditure has increased while the same of administrative services has declined over this period (Chart 6).

During the first half of 1980s, the share of expenditure on administrative services in revenue expenditure was higher than interest payments and pension.

Chart 6: Composition of committed expenditure



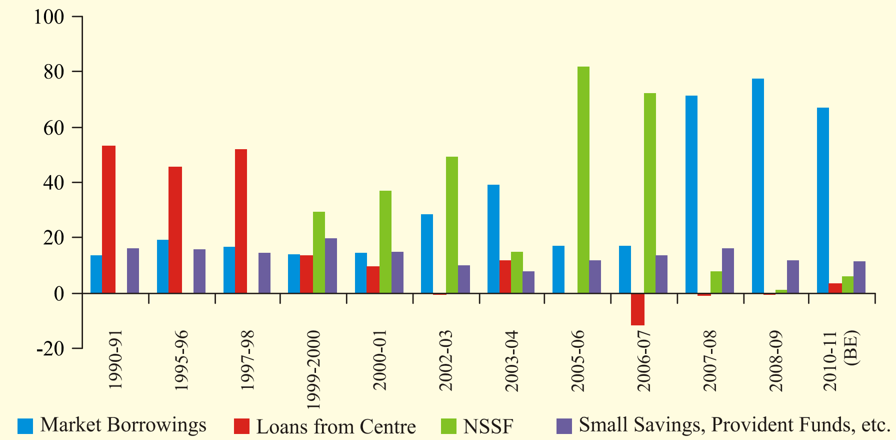
However, since 1985-86, interest payments have become highest component followed by administrative services till 1999-00. In 2000s, rising debt levels led to the dominance of interest payments in the revenue expenditure. However, the share of interest payments in revenue expenditure declined since 2004-05 due to decline in interest burden of States which was facilitated by debt swap scheme, Debt Consolidation and Relief Facility and decline in debt-GSDP ratio across States. Pension emerged as second highest component of revenue expenditure due to implementation of the fifth pay commission at the State level in the late 1990s which remained rigid in the subsequent years even though many State governments have taken initiatives towards new pension scheme in the second half of 2000s. However, expenditure on administrative services as a ratio to revenue expenditure declined marginally during 2000s.

VI. Financing pattern of gross fiscal deficit (GFD), Outstanding debt and its composition

Emergence of market borrowings as a major source of financing GFD

Financing pattern of gross fiscal deficit was dominated by Central loans to the States during 1980s and 1990s. However, the share of Central loans has recorded decline since the second half of 1990s. This was attributable to the setting up of National Small Savings Fund and phasing out 'Central loans to States' as recommended by the Twelfth Finance Commission. Recognising stable characteristic of NSSF loans, the securities issued to NSSF emerged as the dominant component, financing around 82 per cent of GFD in 2005-06.

Chart 7: Financing Pattern of GFD



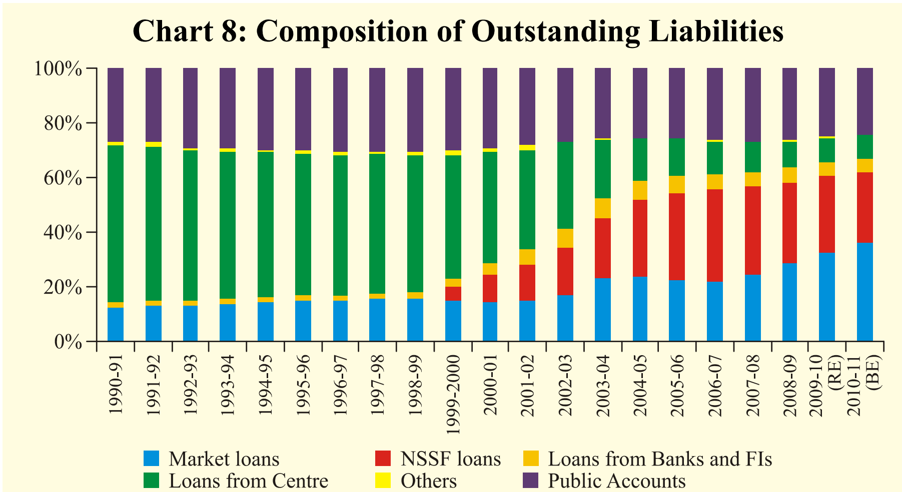
However, with the development in government securities market and increasing cost differentials between small savings and the market borrowings, States began to prefer market borrowings as a source of financing their GFD.

As evident from chart 7, financing pattern of States' GFD shows three distinct phases. In the first phase, during 1990-91 to 1998-99 (till the introduction of NSSF) loans from Centre to States financed around 50 per cent of GFD. Second phase started with the introduction of NSSF and securities issued to NSSF was major source financing GFD till 2006-07. However, in the third phase, *i.e.*, since 2007-08, market borrowings have clearly emerged as major source of financing States' GFD (Chart 7).

Decline in debt burden and shift in its composition

The structural weaknesses in the fiscal position of States during the latter half of 1980s resulted in widening revenue and fiscal deficits, which consequently translated into substantial rise in the size of outstanding debt of the States. Increased borrowings to finance deficits also led to increased burden of interest payments and hence revenue expenditure. As a result States fell into vicious cycle of debt trap.

The outstanding stock of debt in absolute as well as in terms of GDP continued to deteriorate during 1990s and early 2000s. States' outstanding debt as a ratio to GDP was 22.5 per cent as at end-March 1991 which increased to 32.8 per cent as at end March 2004. Consequently, the expenditure on discharge of debt by way of loan repayments and interest outgo also increased significantly during the late 1990s and early 2000s. However, improvement in State finances



and DCRF helped States in bringing down debt to 23.1 per cent of GDP as at end-March 2011.

Composition of outstanding liabilities of the States shows that outstanding Central loan being a major source of financing GFD in 1990s, was the major component of States liabilities. However, in line with the trend observed in financing GFD, the share of outstanding Central loans in liabilities declined significantly since 1999-2000 due to setting up of NSSF. The Twelfth Finance Commission's recommendation of phasing out Central loans to States also resulted in lowering its share since 2004-05. Being a stable source of financing the GFD, the share of special securities issued to NSSF in States liabilities has increased steadily up to 2006-07. However, owing to the decline in the collections under NSSF, market loans emerged as the most important source of financing the GFD as well as major component of outstanding liabilities of State governments in recent years. Further, high cost loans swapped by additional market borrowing under debt swap scheme contributed to higher share of market loans in liabilities of the States (Chart 8).

VII. Issues in State finances

Despite the efforts of the successive Finance Commissions, increasing share of the Centre in combined revenue receipts suggests that the issue of vertical fiscal imbalance continues to exist. Even though horizontal fiscal imbalances across States are still evident, efforts have been taken to reduce them through special purpose grants by the Finance Commissions (11th and 12th) which, to some extent, helped in balancing revenue account across States.

Structural problems such as, variation in imposing certain taxes, lower non-tax revenues and influence of the Centre through centrally sponsered schemes, need to be addressed in order to achieve the aim of greater fiscal decentralisation and reduction in horizontal fiscal imbalance.

The analysis of fiscal management of States over the last five decades brings forth a number of features. First, the revenue account management of States was guided by current transfers and committed expenditure. States need to focus on generating their own revenues and towards this end the introduction of GST is likely to be a good beginning.

Second, fiscal deficit and its composition were relatively favourable till the second half of 1980s. However, its magnitude and composition posed challenge for State finances in the subsequent years till 2003-04. Even though the fiscal deficit emanated from the higher capital outlays across States during 2002-03 to 2007-08, emphasis on revenue balance should continue to be a part of amended FRBM Acts of the States.

Third, the expenditure management of the States has been poor. It has been observed that during the phase of implementation of Pay Commission and macroeconomic slowdown in the Indian economy, capital outlay has often been compromised. States need to prepare for such adverse macroeconomic conditions by adopting sound fiscal strategies.

Going forward, the need is to put in place amended FRBM Acts so as to sustain the process of fiscal correction which ensures not only high growth potential but also provides fiscal room when counter-cyclical policies are required.

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