Fiscal Reforms at State-Level : Review and Prospects *

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I must compliment the organisers of this conclave for choosing a subject of vital importance to our economy and society and, making excellent arrangements for a comprehensive but focussed discussion. This is a good opportunity to present the Reserve Bank of India's (RBI) perspectives on fiscal reforms at State level. The presentation is divided into five parts, *viz.,* role of the RBI in the State finances; review of fiscal reform effort; changing role of State Governments; impact of financial sector reform on State finances and prospects for and issues in fiscal improvement.

Role of the RBI in State Finances

The Reserve Bank has been the only authentic source of regular information and analysis of State finances on a consolidated and annual basis. These reports are published by the RBI and are widely circulated.

Since 1997, the Reserve Bank had convened seven conferences of State Finance Secretaries, which were also attended by senior officials of Central Government and Planning Commission. The Conferences have provided a forum for several initiatives by State Finance Secretaries for which the RBI provided professional inputs. A report on *State Level Guarantees* was generated which enabled several States to bring about legislation imposing a ceiling on State level guarantees while some other States are considering such a legislation. A *Core Group on Disclosure Norms for State Budgets* helped to improve the design and coverage of budget related documents in several States. Many States recently adopted economic and functional classification of budgets with the assistance of the RBI. A study on Public Account was sponsored by the RBI at the request of State Finance Secretaries which was discussed in the latest Conference. State Governments interactions with credit rating agencies and with Advisory Group on Fiscal Transparency were also facilitated by the RBI. In fact, several initiatives with State Governments were made possible with the RBI's role as banker, debt-manager and adviser.

Thus, as banker, the RBI has been assisting States in improved cash management to maximise returns on deployment of temporary surpluses. The Ways and Means Arrangement was reviewed and a new system was introduced in 1998 in consultation with States. Arrangements have been made for electronic exchange of information between Central Accounts Section, Nagpur and individual States on daily transactions.

As debt-manager, the Reserve Bank had devised a scheme for Consolidated Sinking Fund. Seven States have since set up such a Fund, while several others have expressed interest. Flexibility has been provided to State Governments since 1998-99 to directly access the market for borrowings between 5 to 35 per cent of their gross borrowing programme. Seven States have already raised funds through this route and these States appear to have obtained finer terms than otherwise.

As adviser on a variety of issues, the Reserve Bank has been active in matters impinging on fiscal matters relevant to States. Thus, the Reserve Bank participated in formulating a scheme for management of the *Calamity Relief Fund.* Help on technical issues was rendered on the proposed *Legislation on Fiscal Responsibility by Centre*. The Reserve Bank's analysis of State finances has been used extensively by the Eleventh Finance Commission, which has acknowledged the RBI's contribution. In fact, the Reserve Bank is represented in the Advisory Panel on Fiscal-Monetary Policies set up by the National

Commission to Review the Working of the Constitution.

Review of Efforts towards Fiscal Reform

A reading of State budgets and speeches of Finance Ministers for the year 2000-01 helps in understanding the broad directions of the reform effort, though the measures announced do vary from State to State.

The budgets of the States for 2000-01 contain proposals relating to new tax and non-tax measures aimed at strengthening the revenue base, and expenditure management measures to arrest the growth in current expenditures. The finances of States during 2000-01 are budgeted to record an improvement over the deterioration experienced during 1999-2000. The Gross Fiscal Deficit (GFD) of the 26 States as a ratio to GDP is budgeted at 4.1 per cent in 2000-01, as compared to 3.9 per cent budgeted in 1999-2000 and the revised estimates of 4.9 per cent. The States' own taxes are budgeted to record a buoyant rise of 18.9 per cent, with sales tax receipts expected to record a 19.6 per cent increase. Consequently, the States' own resources are expected to finance 54.1 per cent of the revenue expenditure, as compared with 49.8 per cent in 1999-2000.

Complementing the efforts of States to augment their own resources, the resource flow from the Centre in the form of devolution of taxes is anticipated to be of a higher order. The shareable taxes are estimated to show a rise of 4.3 per cent as compared with the growth of 12.8 per cent in the previous year.

The expenditure control measures initiated by the State Governments are reflected in the deceleration in both revenue and capital expenditures. However, the imbalance in the composition of expenditures would continue, with non-developmental components recording a growth of 13.9 per cent in 2000-01 on top of the growth of 27.4 per cent in 1999-2000. The rise in the non-developmental component is predominantly due to committed expenditures *viz.,* interest payments, administrative services, and pensions.

The important policy initiatives towards reform as culled out from the Budget Speeches of the State Government Budgets for 2000-01 may be classified broadly into fiscal consolidation, institutional, and sectoral reforms.

Fiscal consolidation measures proposed in the State budgets explore ways of moderation of expenditure and revenue augmentation. Some States have proposed the setting up of Expenditure Reforms Committees. A few States have identified performance indicators to assess the quality of expenditure restructuring. States have also initiated measures for reduction in non-merit subsidies, better targeting of subsidies and reduction of non-productive expenditures as part of expenditure management. Fiscal restructuring measures through downsizing the Government, have also been proposed. With regard to revenue augmentation, the budget proposals include enhancement and restructuring of sales tax, land revenue rates, vehicle tax, betting tax, introduction of professional tax, etc. The State Governments have through a landmark agreement, decided to implement a harmonised floor rate of sales tax, as a prelude to the introduction of a uniform Value Added Tax (VAT).

The institutional reforms proposed in the State budgets also support the fiscal consolidation process. Many States have announced ways of reducing the cost of administration by proposing a freeze on fresh recruitment as well as reviewing manpower requirements. Some States have adopted decentralisation as the main policy plank through which expenditure moderation is sought, while a few are attempting contract-employment. In order to strengthen the administrative machinery, States have also

proposed the computerisation of their records/departments.

The financial health and management of State level public sector undertakings have been a cause for concern in the last few years. To address this issue, proposals for financial and managerial restructuring include setting up of Board and a comprehensive review of the functioning of the State Public Sector Undertakings, which includes closing down of non-viable undertakings, after providing suitable safety nets to the employees and offering voluntary retirement schemes (VRS). Some of the States propose to set up Infrastructure Development/Investment Funds.

Sectoral reforms are varied and include commissioning Software Technology Parks or setting up Hi-Tech City, or Expor t Promotion Industrial Parks. In the agricultural sector, initiatives include strengthening horticulture, floriculture, animal husbandry, farm mechanisation, expanding irrigation and wasteland development. Industry status is proposed for agriculture. Environmental protection is another important agenda for action proposed by the State Budgets consisting of "Green Goa Fund" and a 'plastic containment fund' through a cess on industries using plastic packing material and plastic mineral water bottles.

Power sector reforms receive a major thrust in the reform agenda of the State Budgets. Some States have outlined initiatives aimed at restructuring of the power sector through measures relating to private sector entry into power generation; reorganization of power monoliths into separate corporations for generation, transmission and distribution; privatization of assets; and most importantly, statutory steps for establishment of regulatory/tariff authorities.

To sum up, there is a widespread realisation about the need for fiscal stabilisation and reform. Each State has devised its own measures but most of these have a common thread of reform of public enterprises, reduction in subsidies, expenditure containment and revenue augmentation. There are, however, severe limitations in regard to the adjustment effort in view of the large magnitudes of committed expenditures *viz.,* salaries, pensions and interest charges.

Changing Role of State Governments

The changing role of State Governments on account of the reform may be analysed in terms of the vertical balance between Centre and States, horizontal interState imbalances and balance within State Governments.

As the reforms progress, it appears that the relative balance between Centre and States tends to tilt in favour of States for a number of reasons.

First, the most important areas for the Central Government's responsibilities are in international trade, financial sector, telecommunications, aviation, and especially banking and corporate law/practices. In most of these areas, factors such as multilateral agreements (say, WTO), globalisation, and recommended best practices of the world, tend to circumscribe, over a period, the discretionary power available in normal times to Central Government.

Second, the capacity of the Centre to reach tax levels as well as tax regimes, very different from international practices (customs, excise, corporate or income tax) also tends to get constrained, over a period, since the free and rapid flow of commodities, skills and finances among the countries would require us to be not too much out of alignment.

Third, major thrust-areas needing expansion of Government are in physical infrastructure

such as road, waterworks, power, and social infrastructure, such as, schools and hospitals. Whether it is direct or indirect intervention, the regime that governs funding and provision in these areas is to be determined by State Governments. Thus, relative to the Centre, States are currently in the expansionary module in the State-market optimal mix. State Governments currently have more freedom to access resources for financing economic growth from the market both from domestic and in some ways, global sources. Hence, the proportion of net official flows from Centre to States as a proportion of total capital flows to States tend to get reduced.

Fourth, States could also seek advice on growth strategies not only from Planning Commission as in the past, but also from institutions like Asian Development Bank or the World Bank.

The balance, especially, economic balance among States is also likely to be affected to the extent the overall Government's role in allocation of resources tilts in favour of markets. Thus, first, States will be competing more intensely than before, in market place for resources in future and, they may find it somewhat difficult to place a significant responsibility on the Centre for their relative performance.

Second, with growth in communications, especially on economic and financial issues, people will tend to benchmark economic performance of States. There may be a slow beginning but the momentum could pick up, as evidenced by varying capacities (both in terms of amounts and interest rates) to raise financial resources for State level public enterprises, on the basis of their guarantees.

Third, there are a variety of options for managing change, which are adopted by different States. For example, a single Electricity Board for each State was an earlier model for all States, while now each State is looking at its own model of combination of institutional arrangements as well as transition path. There are plenty of opportunities to learn from each other's experiences and make modifications. Thus, inter-State interaction tends to be more intensive, by themselves or through institutional consultants, who may be interacting with several States.

Fourth, there is in this decentralised scenario, a potential for increasing the divergence in levels of income among States or even intra-State. To this extent, there may be pressure from less developed States on the Centre to play a more active role in countering market's possible neglect of less developed States.

Fifth, there could be competition among States to benchmark, perform and excel but, the new balance will have to ensure healthy competition.

The balance between the Ministries representing the combination of political executive and Government bureaucracies *vis-à-vis* exercise of ownership functions as well as regulatory functions may also change somewhat adverse to Ministries. The process of privatisation, diversified ownership and autonomy of public enterprises may erode the discretionary element of the Ministries. Once separate regulatory bodies on statutory basis are established and strengthened, they are meant to be semi-autonomous. Often, their membership need not coincide with political cycles and thus may impart greater stability to regulatory regime. Increasing role of semi-autonomous regulatory bodies tilt the balance away from the Ministries and in favour of more stable policies.

Furthermore, experience at State level in some areas has shown that the preferred route to enlarging the role of, and efficiency in functioning of Government is decentralisation in Government. For example, in primary schools or water management, the approach in

some State seems to be through decentralisation or localised water management users' committees or village panchayats. This may also involve emerging new balances between Ministries or departments at State headquarters and local bodies, in favour of the latter.

While regulatory framework would be critical for development of physical infrastructure, social infrastructure would require significant Government funding. No doubt, the traditional water-tight division between Government or public and private sector each combining within itself funding and provision may get blurred and larger scope realised for intermingling of the two. Such intermingling may involve non Governmental organisation as well as local initiatives. These are in a nascent stage but evolution of new balances between public and private sectors is on the horizon. Funding and provision of social infrastructure will, however, remain the primary responsibility of States for a long time.

In brief, the major focus of economic reform in India has to be States. Second, the inter-State issue will have to be the major concern of Governments. Third, the focus of economic-management may shift from Ministries to regulatory bodies. Fourth, the major thrust of reform is to expand what may be called social infrastructure especially drinking water, health and sanitation, elementary schools, roads, etc. all of which require large public funding and scope for private funding is extremely limited in the short run – especially among poorer regions. Fifth, the objectives of reform can be attained by fiscal reorientation towards larger responsibilities for States to provide public goods and social services, including anti-poverty programmes, with concomitant rollback of fiscal activism in commercial activities.

Impact of Financial Sector Reform

The financial sector reforms encompassing the RBI's funding of fiscal deficit, deregulation of interest rates, regulation of banks and credit delivery through banks have a bearing on the fiscal management at the State level.

(i) The introduction in 1997 of Ways and Means Advance system in respect of the Government of India also implies that the Reserve Bank now considers the extent of monetisation at its discretion, taking into account internal debt management policy objectives. In a sense this imposes limitations, if not a precise limit, on expansionary fiscal policy to fund expenditures.

(ii) Combined with automatic monetisation of budget deficits, the Reserve Bank's contributions to financial institutions also caused significant increases in primary or reserve money. This practice has been gradually discontinued in recent years on the ground that in a liberalised environment, financial institutions should expand the avenues of raising resources from the market and to the extent certain activities require cross-subsidisation, it should rightfully be the primary responsibility of the Government of India. Thus, while discontinuing the RBI's support to financial institutions, net transfer of profits of the RBI as dividend has increased.

(iii) Interest rates have been deregulated to a significant degree not only to facilitate more effective monetary policy, but also because the administered interest rate regime proved to be inefficient and costly, without necessarily ensuring flow of credit to the deprived. The RBI's recommended approach, however, does not preclude subsidisation by the Government but, it disfavours in-principle excessive use of banking system to cross subsidise especially as credit seepages are not controllable. The Reserve Bank favours a

financial system that provides incentives to encourage flow of credit and at the same time ensuring servicing of interest and principal, *i.e.,* bankability of schemes. Thus, the Reserve Bank has introduced modified interest rate prescriptions, providing concessionality in the case of small borrowers to size of credit limits, rather than to specified sectors or groups of borrowers.

(iv) There are two issues relating to credit delivery on which the RBI's initiative is sought, namely, regional dimension and rural-urban divide. The regional variations or inter-State disparities in credit-deposit ratio existed in the past and continue to persist in the post-reform period also. The variations may be less pronounced in some cases if ratio of credit plus investments to deposits is taken into consideration. The Reserve Bank has been sensitising banks to ensure flow of credit to all States, while at the same time, urging State Governments to create enabling environment for flow of credit. Progressively, the instruments available with the RBI to 'direct' credit are less in a deregulated environment, especially since financial intermediation through non-banks including mutual funds and NBFCs, is justifiably expanding. In fact, unequal distribution of burden of social obligations between banks and non-banks could undermine the health of the banking system, which is vital to our economy.

Similarly, on the rural-urban divide in flow of bank resources, there are some constraints, as mentioned above, on the policy instruments available. The Reserve Bank, therefore, encourages local level financial intermediaries to address this issue. These include expanding the network of urban co-operative banks which are also local, revitalising the Regional Rural Banks (whose banking business in recent years is growing faster than scheduled commercial banking activity), promoting local area banks, apart from efforts to improving the cooperative credit system as a whole.

(v) As part of reform in the financial sector, there have been significant reductions in statutory preemptions, under the Statutory Liquidity Ratio in respect of banks. The share of market of non-public sector banks in the banking system is increasing. There has been diversification of ownership of several large banks. Insurance companies are also coming under competitive pressure, and hence there are limits to what may be termed as involuntary subscriptions to public debt. Under these circumstances, full subscriptions to borrowing programme approved by Government of India in respect of some of the States may not be possible if the banks and other market participants do not volunteer to subscribe. At the same time, some States which are favourably perceived by financial markets do get subscriptions at more favourable rates when they exercise the limited option of approaching the market directly.

(vi) Monetary and credit policy in India thus focusses increasingly on what Dreaze and Sen call "growth mediated security" while "support-led security", often consisting of direct anti-poverty interventions are to be addressed mainly by fiscal and other governmental activities.

In brief, as a result of financial sector reform, there are more stringent overall limits to fiscal expansion, impinging on both Central and State finances. Second, the non-bankable components of developmental activities are required to be increasingly met by fiscal policies. Third, the commercial components or bankable components of development could be squarely shifted by State Government to financial sector provided they are made commercially viable. Fourth, the administrative, social and economic infrastructure and overall perception of governance influences flow of credit due to

diversification of means of financial intermediation, deregulation and competition. Fifth, the perceptions of financial markets including credit rating agencies is relevant in ensuring full subscription to approved market borrowing programme incorporated in the State Budgets. In sum, State budgets may have to differentiate between bankable and non-bankable segments, enable, expand and hive off the former while focussing on efficient use of resources for non-bankable components such as anti-poverty programmes, and social services.

Prospects and Issues

The Reserve Bank has been in close interactive mode with State Governments in regard to fiscal matters in the recent past and has been of mutual benefit. There is a clear recognition among all concerned that focus of further reform would increasingly be at the State level. The reforms in financial sector have implications for fiscal management at State level and this has been fully appreciated by State Governments. The State Governments are making valiant efforts to meet the fiscal challenges before them.

The overall strategy for fiscal improvement consistent with the reform agenda in general and financial sector reform in particular is three-fold.

First, commercial activities such as power, transport, water for irrigation will have to be fully funded and operated commercially to reduce fiscal burden and also to attract financial resources from financial sector especially banks. To the extent *cross subsidisation* is deemed necessary, it should be self balancing with no burden on either the fisc or banks. This is a valid strategy irrespective of public or mixed or private ownership of the concerned commercial and financial entities. This approach would also be a precondition to adopt other more compelling strategies.

Second, State Governments will have to concentrate their efforts on institutional infrastructure especially relating to law and order and provision or delivery of essential services such as drinking water, sanitation, primary schools and dispensaries, etc. not only to serve the needs of the poor and the underprivileged but also to attract resources from the financial sector for investments in physical infrastructure and also productive activities. Improving the delivery of services should be the priority. Again, this approach is feasible in the current fiscal situation if and only if the cost recovery for commercial activities is total, with self-balancing cross-subsidisation. A word of caution is, however, necessary. To avoid seepage and misuse of concessions, the extent of cross-subsidisation should be limited.

Third, in the light of the above, public investments will have to be enhanced in agriculture to accelerate gainful employment generation and poverty reduction.

There is a broad consensus on the overall strategy but, in terms of managing the fiscal adjustment, the State Finance Secretaries have articulated several issues. The main consensus expressed in the latest (Seventh) Conference can be summarised. The main fiscal problem is structural and, solutions attempted are incremental and consequently their major pre-occupation is how to pay the each day's bills. They argued, that whenever fiscal adjustment is attempted, there is a cut, in non-committed expenditure but not in non-essential one. A predominant part of the budget is committed expenditure, especially interest, pensions, and salaries, which has no flexibility. As a consequence, there is often an atrophy of delivery of services in as much as there may be hospitals manned by doctors and nurses but no medicines, electricity or water supply. Grants to several institutions performing vital services are often postponed or reduced on account of fiscal

adjustment. They apprehend that cuts in output tend to be highly disproportional to cuts in expenditure making expenditure cuts of non-committed items highly unproductive, thus undermining the reform process. Some of the Secretaries also questioned the efficacy of increasing social expenditures on the ground that opening of new schools often meant only appointment of new teachers who do not turn up in schools in any case. A few felt that efficacy of social expenditures can be improved by decentralisation while a few others advocated contract employment of teachers instead of life-time employment. There was virtual unanimity among the State Finance Secretaries that the structural problems underlying fiscal situation in the States cannot be solved unless the issue of high committed expenditures is resolved. There was also a consensus that the fiscal problem is not State specific but an all-India phenomenon, often a result of policies of the Central Government such as in pay hikes and, solutions would warrant initiatives by and setting an example by the Union Government.

From the Reserve Bank's point of view, there are a few issues that are being addressed in the context of fiscal reforms at State level.

First, the Ways and Means Arrangements and Overdraft Scheme is being reviewed by a group of State Finance Secretaries in the light of settled recommendations of the Vithal Committee and those which are yet to be implemented. The Group will finalise its report by the end of December 2000. No doubt, the review will address only temporary mismatches between receipts and expenditures in State budgets, but not structural issues.

Second, recognising the need to ensure full subscription to approved borrowing programme of all States, it has been decided that the RBI would prepare a technical paper on the subject, taking into account the needs of special category States. The role of Primary Dealers in Government Securities would also be addressed in the paper. The paper could also consider some institutional arrangement in the form of a State Funding Corporation as suggested in the RBI Annual Report of 1993-94, which could assist the States that happen to be reluctant, under certain circumstances, to approach the markets individually and directly.

Third, there are a few States whose cash and budgetary positions have some linkage with consortium arrangements for food credit. Such State Finance Securities are being associated with the Committee being constituted for such as review, as announced in Governor Jalan's Mid-Term Review of Monetary and Credit Policy for the year 2000-2001.

Let me conclude with an appropriate quote from the latest book from Mr. A. Premchand *Control of Public Money* (Oxford University Press) :

"Experience shows conclusively that a policy deficit, together with a vigilance deficit, has contributed, over the years to a situation, where the fiscal machinery has not been successful in addressing the concerns of the public. Despite repeated efforts at improving the machinery, the institutional recidivism has become quite common. This, in turn, was partly due to the fact that the reforms did not fully address the major concerns, and partly because they were not fully implemented. Moreover, the solutions of one era became the problems of another era. Measures sought to be implemented within the executive wing of the governments were not always matched by corresponding efforts in the external agencies, such as the audit and the legislature. There is a continuing need for a balanced approach towards improvement in the operations of the executive, audit, and the legislature. This is the task of future managers."

*** Address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at India States' Reform Forum organised by the World Bank, at New Delhi, on November 24, 2000.**