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STATE FINANCES IN INDIA : A CRITICAL REVIEW

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M. Govinda Rao

Abstract

There has been a sharp decline in the fiscal fortunes of the States during the last decade. Low buoyancy of central transfers and spill over of central pay revisions have had the most adverse impact on State finances. What is more worrisome, the States' own fiscal performance has also seen sharp deterioration. The paper brings out the trend in State finances, highlights the factors contributing to the decline and identifies areas of reform.

Introduction

Need for Subnational Fiscal Reforms

Launching Indian economy to the higher growth trajectory during the Tenth Plan crucially depends on the State-level fiscal reforms. The Constitution assigns a pre-eminent role to States in agricultural development, poverty alleviation and human development, as well as a co-equal position in the provision of physical infrastructure. These roles in allocation and redistribution make the States' fiscal operations crucial for macroeconomic stabilisation as well. Although the Constitution places limitations on the States' borrowing powers, in actual practice they are able to run large deficits, making fiscal reforms at the State level critical for achieving overall fiscal consolidation in the country. Thus, fiscal reform at the State level is important from the viewpoint of both macroeconomic stability and microeconomic allocative efficiency.

Much of the discussion on fiscal restructuring in the Indian context has remained at the Central level in spite of the fact that the States incur almost 55 per cent of total expenditures and raise 37 per cent of total revenues. Ironically, even at the Central level, even after a decade of fiscal restructuring, fiscal consolidation has remained elusive. Analysis shows that, on a comparable basis, there has hardly been any reduction in the Centre's fiscal deficit.[1] On the contrary, there has been a steady increase in the revenue deficits and sharp reduction in the share of capital expenditures, indicating significant deterioration in the quality of fiscal imbalance (Rao and Amar Nath, 2000). International comparison too shows that of the 74 countries with more than 10 million population, only 7 countries, including India, [which stood in third position after Turkey and Zimbabwe (Acharya, 2001)] recorded a government deficit higher than 7 per cent. The unsatisfactory nature of finances constrains the ability of the Central government to transfer adequate resources to the States.

State-Level Fiscal Problems in India

Fiscal health at the State level has seriously deteriorated in the last few years. Both revenue and fiscal deficits have increased sharply, particularly after 1997-98. Increasing deficits on the one hand have increased the States' indebtedness and on the other, severely compressed infrastructure spending. The States have also found a number of ways to soften their budget constraints. It is also seen that fiscal deterioration in poorer states has been more acute than in richer states. In this context, two important issues are noteworthy:

- lending by multilateral banks to states could, in the long run, aggravate fiscal instability. It softens budget constraints in the short-run.
- as the Central transfer system will become performance based in future, it is important to clearly identify performance indicators.

Therefore, reforming the transfer system is equally important.

Fiscal deterioration has occurred despite the attempts to contain expenditures by the States. Declining buoyancy of both tax and non-tax revenues in the 1990s is a matter of concern. In this, the most important factor is the sharply deteriorating performance of State Electricity Boards (SEBs). On the expenditure side, the principal factor causing fiscal imbalances was the revision of salaries and pensions. The remedial measures will have to focus on not only phasing out fiscal imbalances, but also imparting efficiency in the tax policy to enhance revenue productivity and impart efficiency.

Achieving the growth rates envisaged in the Approach Paper to the Tenth Plan (India, 2001) calls for immediate fiscal correctives. This paper analyses the problem of State finances in India with a view to identifying the policy and institutional reforms to achieve fiscal rectitude. First, it examines trends in fiscal imbalances at the State level and its contribution to overall fiscal imbalances in the country. Next, it analyses the sources and causes of fiscal imbalances on the revenue and expenditure sides, which helps to identify the policy measures required to restore fiscal balance. This is followed by the analysis of revenue and expenditure policies to identify the sources of allocative inefficiency in the States' fiscal operations. Finally, it brings out major challenges faced by the States to achieve fiscal consolidation.

Trends in State Finances: Macroeconomic Implications

Trends in Fiscal Imbalances

The trend in fiscal imbalances since the 1980s is presented in Figure 1. It is seen that revenue as well as primary deficit of the States have shown a sharp deterioration, particularly since 1998-99. Interestingly, the deteriorating trend in revenue deficit started right from the mid-1980s. In fact, in the initial years of the 1980s, the states generated a revenue surplus of one per cent of GDP. By 1987-88, however, the surplus had vanished. The fiscal adjustment during the early 1990s helped reduce the deficit from about 1 per cent in 1990-91 to 0.4 per cent in 1993-94. In the subsequent years until 1997-98, there was a gradual increase in the deficit, but thereafter, it increased sharply to 2.5 per cent in 1998-99, following the impact of the pay revision. It is expected to be close to 3 per cent in 2000-01.

The States' manoeuvrability over the fiscal deficit, however, is lower than the revenue deficit as the overall borrowing is determined by the Central government. Analysis shows that until 1995-96, the fiscal adjustment programme succeeded in reducing deficits. However, in the subsequent years, the imbalance worsened, coinciding with pay revisions of the State government employees in 1998-99. Thus, the proportion of fiscal deficit which fluctuated between 2.5 to 3 per cent until 1997-98, increased sharply to 4.2 per cent in 1998-99 and further to 4.6 per cent in 1999-2000. The impact of the pay revision, particularly on autonomous bodies assisted by the government, will continue into 2000-01.

Thus, both fiscal and primary and revenue deficits have deteriorated sharply since 1997-98, coinciding with pay revisions in the States. Further, the share of revenue deficit in fiscal deficit too has shown sharp increases over the years. Until 1986-87, the States collectively generated revenue surpluses. By 1990-91, a little over a quarter of borrowed funds was used to finance current expenditures. Even in 1997-98, the proportion of revenue deficit in fiscal deficit was just about 38 per cent. However, the proportion of borrowed funds used to finance current expenditures increased sharply to 60 per cent in 2000-01 reflecting the effect of pay revisions. Similarly, the proportion of primary deficit to fiscal deficit has shown a steady increase from about 30 per cent in 1995-96 to over 50 per cent in 1999-2000. This shows that the fiscal deficit position at the State level has been increasingly becoming unsustainable in recent years, particularly since 1997-98.

Increasing fiscal imbalances in the States have not merely constrained their ability to provide efficient social and physical infrastructure; they have significantly contributed to macroeconomic instability in the country. The deficits incurred by the States constitute a

Figure 1: Trends in States' Fiscal Imbalances

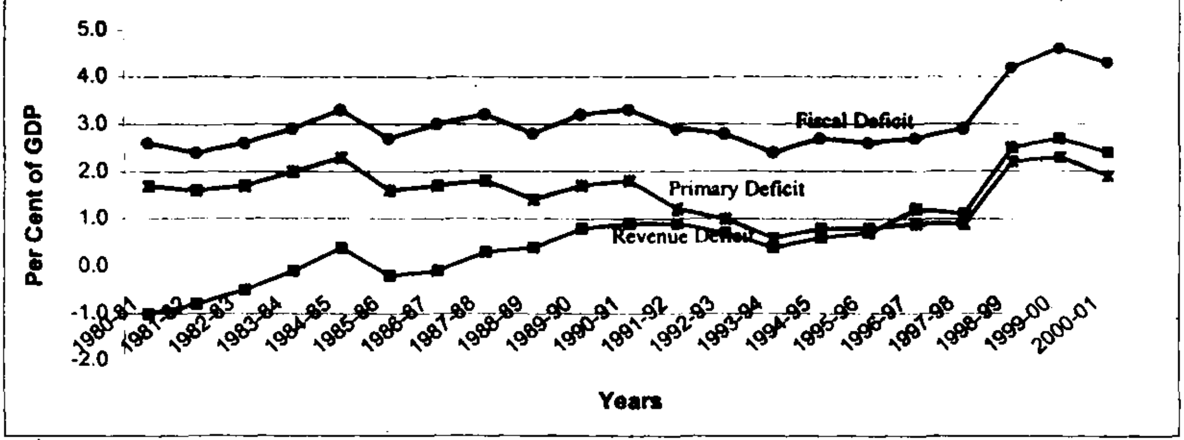


Table 1: Trend in States' Fiscal Imbalances

Year	Per Cent of Revenue Deficit to GDP	Per Cent of Fiscal Deficit to GDP	Per Cent of Rev. Def to Fiscal Def.	Per Cent of Primary Def. To Fiscal Def.	Per cent of States' Rev Def to Total Rev Def	Per cent of States' Fis. Def to Total Fis. Def	States' Capital Exp. As % of Total State Exp.	Per cent of States' Capital Exp. to GDP
1980-81	-1.0	2.6	-38.5	65.4	-250.0	34.7	26.0	3.6
1985-86	-0.2	2.7	-7.4	59.3	-10.5	33.8	20.0	2.9
1990-91	0.9	3.3	27.3	54.5	21.4	35.1	15.8	2.4
1995-96	0.7	2.6	26.9	30.8	21.9	40.0	14.0	2.0
1996-97	1.2	2.7	44.4	33.3	33.3	42.2	11.4	1.6
1997-98	1.1	2.9	37.9	31.0	26.8	39.7	13.3	1.8
1998-99	2.5	4.2	59.5	52.4	39.7	47.2	12.6	1.8
1999-00	2.7	4.6	58.7	50.0	43.5	48.9	12.6	1.9
2000-01 (RE)	2.4	4.3	55.8	44.2	40.7	47.3	13.1	1.8

Source: Public Finance Statistics, Ministry of Finance, Government of India.

significant and increasing proportion of the overall fiscal imbalances in the country. The States' fiscal deficit, which was just about 35 per cent of the total fiscal deficit in 1990-91, increased to almost one half of the total fiscal deficit in 1999-2000 (Table 1).

Attempts to contain fiscal deficits have caused a sharp decline in the quality of deficits as well. The share of revenue deficit in fiscal deficit increased from 38 per cent in 1997-98 to 60 per cent in 1998-99 following pay revisions. Hardening the resource position has crowded out capital expenditures. As a ratio of GDP, capital expenditure declined from 3.6 per cent in the early 1980s to 1.8 per cent in 2000-01. The share of capital expenditure in total spending declined from 26 per cent to about 13 per cent during the period. This has led to increasing infrastructure bottlenecks. Thus, the deterioration in the fiscal position of the States has rendered their fiscal operations increasingly unsustainable, contributed to macroeconomic instability and constrained the provision of social and physical infrastructure.

The deterioration in fiscal imbalances noted earlier is not just an aggregate phenomenon. It is seen in the case of each of the individual States. Annexure Table 1 shows that of the 14 non-special category States, six showed improvements in respect of revenue deficits and nine showed improvements in respect of fiscal deficits between 1995-96 and 1990-91 by varying magnitudes. In the case of the special category

States too, there was significant improvement in their revenue accounts (2.5% of NSDP) and fiscal deficits (4.7% of NSDP). However, subsequently, the fiscal situation deteriorated drastically and both revenue and fiscal deficits were higher in 1999-2000 in each of the States.

The States' fiscal deficits are financed mainly by market borrowings and central loans. According to Article 293 of the Constitution, if the States are indebted to the Centre, they have to seek its permission to borrow. However, all the States are indebted to the Centre and the States' market borrowing is determined by the Ministry of Finance in consultation with the Planning Commission and the Reserve Bank of India (RBI). In addition to these, States also get 80 per cent of the net collections of small savings. Other liabilities of the States are in the public accounts, mainly the provident funds.

The persistence of large and growing fiscal deficits in the States over the years has led to the steady accumulation of debt. The States' indebtedness as a percentage of GDP fell from 19.4 in 1990-91 to 17.8 in 1996-97, but increased thereafter to 23.1 in 2000-01. In fact, since 1995-96, the debt stock increased at the compound annual rate of 17.9 per cent, whereas the revenue receipts increased only at 11.2 per cent. Consequently, the share of interest payment in total expenditure increased from 13 per cent in 1990-91 to 21.6 per cent in 2000-01 to crowd out productive expenditures.

Fiscal Imbalances in Individual States

As shown in Annexure Table 1, deterioration in the fiscal situation coinciding with the pay revision after 1997-98 is seen in each of the individual States, and was particularly severe in Special Category States. Both revenue and fiscal deficits as percentages of NSDP in these States deteriorated by over six percentage points. In the case of 14 non-special category States, the revenue and fiscal deficits deteriorated by 2.8 percentage points to NSDP.

There was, however, wide variation in the deterioration in the fiscal situation in different non-special category States. The worst was in West Bengal, with both revenue and fiscal deficits as percentages of NSDP worsening by about 5 points. The deterioration in revenue deficit was very high also in Punjab (4.4), Rajasthan (4.2), and Maharashtra (3.7). In the case of fiscal deficits, marked deterioration was seen in Bihar (5.3), Punjab (3.9), Orissa (3.4), Gujarat (3.3), and Maharashtra (3.1). Thus, the severe deterioration in fiscal imbalances is seen also in some of the high income States and those that are traditionally known for their fiscal austerity, such as Gujarat and Maharashtra.

The spread of the States with different ranges of revenue and fiscal deficits presented in Table 2 brings out the sharp deterioration. Of the fourteen major States in 1995-96, 13 States had revenue deficits of less than 3 per cent of the Net State Domestic Product (NSDP) in 1995-96. In contrast, in 1999-2000 revenue deficits in 10 States were more than 3 per cent and in six States it was more than 4.5 per cent. Similarly, fiscal deficit in 13 of the 14 major States was less than 5 per cent of the NSDP in 1995-96. In contrast in 1999-2000 it was more than 5 per cent in 11 States, while in 5 States it was more than 7.5 per cent.

By and large, the problem of fiscal imbalances is more acute in poorer than in richer States. A notable exception to this is that Punjab, though having the highest per capita SDP, had very high revenue and fiscal deficits. The correlation coefficient of per capita SDP with revenue deficit is -0.319 for 14 non-special category States and -0.438 when Punjab is excluded from the sample. The correlation coefficient of per capita SDP with fiscal deficit is -0.331 for non-special category States and -0.446 when Punjab is excluded. Thus, in general, the severity of fiscal crunch is felt more by the poorer than by richer States.

Table 2: Frequency Table of Fiscal Imbalances in States

Per Cent of NSDP	1990-91	1995-96	1999-2000
Revenue Deficit			
< 0	1	1	-
0-1.5	6	8	-
1.5-3.0	5	4	4
3.0-4.5	2	1	4
> 4.5	-	-	6
Fiscal Deficit			
< 2.5	2	1	-
2.5-5.0	6	11	3
5.0-7.5	5	2	6
> 7.5	1	-	5

Source: Estimated from *Reserve Bank of India Bulletins.*

Hidden imbalances and softening budget constraints

An important implementation rule for efficient fiscal decentralisation is the need to have a hard budget constraint for subnational governments (Bahl, 2002). Although in principle the States have hard budgets, in practice they can soften the constraint in a variety of ways (Lahiri, 2000; Anand, Bagchi and Sen, 2002). The practice of collecting taxes in advance and keeping contractors' bills pending is well known. The States can also increase their liabilities in the Public Account, particularly small savings loans. Another method used to create special purpose vehicles for investments in activities such as irrigation. They also resort to borrowing from public enterprises. In recent years the States have been borrowing heavily from financial institutions such as NABARD, LIC, HUDCO, and IDFC to finance infrastructure. We have already referred to borrowing from multilateral lending agencies. All these are in addition to the ways and means advances and overdrafts from the RBI.

Thus, the fiscal position discussed above does not reveal fiscal imbalances of the States in its entirety. There are significant contingent liabilities arising from the State government guarantees and indemnities given to urban local bodies, public enterprises and autonomous institutions. Available information shows that recorded contingent liabilities in 1999-2000 was Rs. 1,24,813 crore or almost 6.4 per cent of GDP.

Until the mid-1990s, the interest payments were kept artificially low due to financial repression. With the alignment of interest rates to market rates, interest outlay increased significantly. In addition, small saving is an expensive source of borrowing. Thus, both the volume of borrowing and the average interest rate have increased. Yet, small saving borrowing is an important method of overcoming budget constraint. In fact, some States (Karnataka) mandate that a proportion of salary arrears be invested in small savings.

Another major source of fiscal imbalance not reflected in the budgets is the loss incurred by public enterprises, notably, SEBs. In 2000-01, the estimated loss of SEBs was over 26,000 crore or 1.2 per cent of GDP. Of this, only Rs 6000 (0.2 per cent of GDP) is taken into account in the State budgets (by way of explicit subsidy given to SEBs). Poor performance of SEBs has had adverse repercussions on Central finances as well. As on 28 February 2001, the dues payable by SEBs to Central enterprises were Rs 41473 crore (2 per cent of GDP), comprising Rs 25727 crore as principal and the remaining as interest payments.

Many States have tried to overcome their immediate fiscal problems by taking structural adjustment loans from multilateral lending institutions. Notable among the States availing of such a facility are Andhra Pradesh, Karnataka and Uttar Pradesh from the World Bank, and Gujarat and Madhya Pradesh from the Asian Development Bank (ADB). Other States are also in the fray, seeking loans from these institutions. Although the Centre guarantees repayments of these loans, the States are required to initiate an action plan to improve their repayment capacity. However, while the loans have added to the States' indebtedness, fiscal reforms undertaken by them thus far have failed to address the fundamental issues of tax reforms, public expenditure restructuring and reform of SEBs satisfactorily. Unless the issue is addressed immediately, this could cause further deterioration in the States' finances.

Sources of Fiscal Imbalances in States

Trends in Revenues and Expenditures

Fiscal imbalances in the States are structural; expenditures have grown faster than revenues during the last decade by 2.2 percentage points and the difference has been increasing (Table 3). Given the difference between levels of expenditures and revenues, the growth rate differences translate into substantial revenue deficit. The slowest growing item was the transfers from the Centre (10 per cent). Given the precariousness of Central finances, it is unlikely that transfers will register a much faster growth than in the past. Nevertheless, it is important to rationalise the central transfers both from the viewpoint of designing them to offset States' fiscal disabilities and ensure minimum standards of services and incentivising them.

Restoring fiscal balance, however, will have to be achieved mainly by the States' own effort. Therefore, deceleration in the growth of different items of revenue is a matter for concern. Growth of the States' own tax revenues lagged behind the growth of revenue expenditures by about one percentage point. The growth of non-tax revenues was lower than that of revenue expenditures by four percentage points, mainly due to the States' inability to effect proper cost recoveries from public services provided and generate adequate returns from public investments.

The declining growth of revenues also points towards structural factors exacerbating fiscal imbalances. Notably, the growth of each source of revenue decelerated in the 1990s over the 1980s. The growth rate of the States' own tax revenue decelerated by 1.8 percentage points and non-tax revenue by 1.6 percentage points. Interestingly, in the 1990s, efforts to contain expenditures by the States reduced the growth rate of expenditures from 16.7 per cent in the 1980s to 14.8 per cent in the 1990s.

Thus, for over two decades, persisting outpacing in the growth rate of expenditures over revenues, States' revenues have increased public dissavings year after year. The deceleration in the growth of revenues has put increasing pressure on revenue and fiscal deficits. What is more, lower and decelerating growth in revenues has crowded out capital expenditures. Thus, the impact of fiscal constraint at the State level has not only been to create severe fiscal imbalance, but also to crowd out productive capital expenditures.

Declining revenue-GDP ratio is a major source of fiscal imbalances (Table 4). The revenue-GDP ratio in the States increased in the early part of the 1980s, but declined from 12 per cent in 1985-86 to 9.8 per cent in 1998-99. Of this, about 1.5 points decline was after the mid-1990s; it declined from 11.3 per cent in 1995-96 to 9.8 per cent in 1998-99. Since the mid-1990s, about 0.6-point decline was in Central transfers, a 0.5 point was in the States' non-tax revenues and 0.4-point was in States' tax revenues. Thus, the States' revenue - GDP ratio from each of the major sources has shown a declining trend during the 1990s and the decline has accelerated since the mid-1990s. This is really a matter for concern.

Table 3: Average Annual Growth Rates of States' Revenues and Expenditures

Percent

Item	14 Non-Special Category States		25 States	
	1980-81 to 1989-90	1990-91 to 1998-99	1980-81 to 1989-90	1990-91 to 1999-00
Own Tax Revenue	15.82	14.09	15.92	14.08
Own Non-Tax Revenue	13.13	11.51	12.54	12.38
Total Transfers	14.58	10.99	15.84	11.50
Total Revenues	14.91	12.62	15.30	12.83
Revenue Expenditure	16.69	14.82	17.07	14.94
Capital Expenditure	8.80	11.39	9.69	11.13
Total Expenditure	15.07	14.38	15.53	14.43

Source: Public Finance Statistics, Ministry of Finance, Government of India

Table 4: Per cent of States' Revenues and Expenditures to GDP

Year	1980-81	1985-86	1990-91	1995-96	1998-99	1999-00 RE
A. States' Revenues						
Own Tax Revenue	4.60	5.23	5.34	5.20	4.89	5.21
Own Non Tax Revenue	2.27	1.90	1.62	1.92	1.36	1.49
Own Revenues	6.87	7.14	6.95	7.12	6.25	6.70
Total Transfers	4.46	4.89	4.73	4.20	3.58	4.04
Total Revenues	11.33	12.02	11.69	11.32	9.83	10.74
B. States' Expenditures						
Revenue Expenditure	10.30	11.79	12.62	12.05	12.36	13.68
General Services	*	3.49	4.03	4.63	4.97	5.68
Interest Payments	0.85	1.06	1.52	1.84	2.02	2.30
Social Services	*	4.81	4.92	4.43	4.56	5.09
Economic Services	*	3.49	3.67	2.99	2.82	2.91
Capital Expenditure	3.62	2.94	2.37	1.87	1.67	1.81
Total Expenditure	13.92	14.73	14.99	13.92	14.02	15.50

Note: *Due to differences in budgetary classification, the figures are not estimated

Source: *Public Finance Statistics* (Relevant years), Ministry of Finance, Government of India

The declining revenue has contained expenditure-GDP ratio as well. Until 1990, the ratio increased by one percentage point. It declined by about the same magnitude until 1998-99 though in 1999-2000, it is expected to increase taking full effect of pay revision to 15.5 per cent. It is also seen that hardening resources and increasing pressure on revenue expenditures have crowded out capital expenditures. The latter declined from 2.4 per cent in 1990-91 to 1.8 per cent in 1999-2000. Further, within revenue expenditures, economic services declined from 3.7 per cent to 2.9 per cent during the period. Expenditure on social services declined from 4.9 per cent in 1990-91 to 4.6 per cent in 1998-99 until the effect of the pay revision increased it to 5 per cent. Expenditure on administrative services steadily increased throughout the two decades. Of particular concern has been the sharp increase in interest payments from 1.5 per cent in 1990-91 to 2.3 per cent in 1999-2000.

The trends show that in each of the States, except Kerala, there has been deceleration in the growth of revenues (Annexure Table 2). This has constrained increases in expenditures, particularly capital expenditures in every State. It is also seen that during the period 1990-2000, in general, the poorer States have performed worse than the better-off States. The lowest growth in own revenues was seen in Bihar (10.2%), followed by West Bengal (11.2%) and Uttar Pradesh (11.6%). In other poorer States such as Madhya Pradesh and Orissa too, revenues recorded low growth rates. This constrained the growth of expenditures, particularly capital expenditures, of States. Thus, capital expenditure in real terms declined in Madhya Pradesh (3.2%), and was virtually stagnant in Bihar (6.8%), Uttar Pradesh (7.2%), and Orissa (7.3%), even in absolute terms. The growth rates recorded in them were barely equal to the increase in wholesale price index. Punjab (3.2%) recorded the lowest growth in capital expenditures even though revenue receipts in the 1990s increased at 14.7 per cent because revenue expenditure increased at 15.8 per cent.

Reasons For the Slow Growth of Tax Revenues

Analysis shows that growth of each of the major State taxes has decelerated in the 1990s as compared with the 1980s (Table 5). Deceleration has been particularly marked in the case of taxes on land and agriculture, stamps and registration, state excises and sales taxes. The taxes on land and agriculture generate negligible revenue, and even this grew only at 8.7 per cent per year during the 1990s. Revenue from sales taxes constitutes two-thirds of the States' own tax revenues. Deceleration in the growth of sales taxes by about 1.7 percentage points is a major factor responsible for the decline in the States' tax revenue-GDP ratio during the 1990s, particularly after 1995-96.

Low revenue productivity of taxes on land and agricultural incomes has been a much debated issue. From the viewpoint of horizontal equity and revenue productivity, levying a tax on agricultural incomes is necessary. Yet, for want of political willingness, the architecture of the tax has remained only on paper. In fact, States have not been able to levy the tax even on agricultural income declared in the tax returns submitted to the Central Income Tax Department. Even the proposal to assign the tax to the rural local governments (Rajaraman and Bhende, 1998) has not found favour with the States. The fragmented nature of income tax has provided an easy avenue for evasion and avoidance of personal income tax.

One of the reasons for the deceleration in the growth rate of sales is its narrow base. Besides wide ranging exemptions and incentives, there is widespread evasion and avoidance of the tax. Besides, during the last decade, the services sector has grown at 7.8 per cent per year, much higher than both the primary (2.8%) and secondary (5.7%) sectors. Also, since the mid-1990s, over 70 per cent of the growth of the economy was attributed to this sector (Acharya, 2001). As the States are allowed to levy taxes on only goods, the production and consumption of services remains outside the tax net. In the medium term, buoyancies in States' taxes can be improved only when the States are enabled to extend sales taxes to services (Rao, 2001). This would also help to evolve a comprehensive destination-based value-added tax at the State level. This, however, requires amendment of the Constitution to put consumption of services in the concurrent list.

Table 5: Growth Rates and Buoyancies of Revenues and Expenditures

Revenue Item	Revenue-GDP Percentage		Growth Rates (Per cent per annum)		Buoyancy	
	1990-91	1999-2000	1980-90	1990-2000	1980-90	1990-2000
1. States' Own Tax Revenue						
Tax on Agricultural Income	0.14	0.08	14.52	7.18	1.08	0.60
Stamps and Registration	0.37	0.43	16.68	15.88	1.22	1.13
Sales Tax	3.14	2.96	15.27	13.39	1.11	0.94
State Excise	0.84	0.71	16.44	12.14	1.20	0.82
Taxes on Transport	0.31	0.26	9.56	12.06	0.69	0.82
Total Own - Tax Revenue	5.34	5.21	15.04	13.44	1.12	0.94
2. Own Non-tax Revenue	1.62	1.49	12.30	12.51	0.89	0.84
3. Transfers	4.73	4.04	15.52	11.68	1.11	0.77
Total Revenue Receipts	11.69	10.74	14.63	12.70	1.08	0.86

Source: Public Finance Statistics, Ministry of Finance, Government of India.

The bases of State taxes are rendered narrow also because of large-scale exemptions, evasion and avoidance of taxes. In the case of sales tax, for example, besides wide-ranging exemptions, there are generous schemes of incentives in terms of tax exemption and deferment. While the efficacy of such fiscal incentives in promoting industrialisation is limited, revenue foregone is significant. These incentives do not enhance the availability of capital in the country, but merely redistribute the existing capital in distortionary ways.

It is necessary to state that the prevailing tax system has caused severe distortions due to complexity in its structure, cascading of the tax due to input and capital goods taxation, and wide-ranging incentives and exemptions. In addition, Union Territories have been subnational tax havens. Similarly, exemption given to sales in Canteen Stores meant for armed forces has been subject to widespread misuse of both sales tax and State excise duty. Finally, providing exemptions on sales on the basis of end use of the commodity not only provides an easy means to evade taxes but also leads to severe allocative distortions. It is necessary to put an end to such discretionary exemption practices.

The problem is similar with other taxes as well. Levying of registration on transfer of immovable property at high and differentiated rates has led to widespread evasion of the tax by undervaluing the value of the property transacted. Absence of a mechanism to objectively determine the benchmark values by stratifying properties according to the factors influencing the value of land and cost of the building has led to widespread evasion of the tax being an acceptable practice in the society.

Lack of proper information system and administrative machinery to implement taxes is a general shortcoming in all the States. Much remains to be done to simplify the tax system and strengthen administration and enforcement of the tax. There is hardly any co-operation between one tax department of a State and another, much less between Central and State tax departments. Complications in the tax system add to complexity in administration and most States are ill-equipped to administer the taxes designed to fulfil multiple objectives, thus adding to compliance cost and reducing revenue productivity.

Declining Non-tax Revenues

Inability to recover reasonable returns from the large investments has been a major reason for the low and declining growth in non-tax revenues. By March 31, 1999, outstanding investments of the States in statutory corporations were Rs. 75,000 crore and about Rs. 42,000 crore was invested in the government companies. Together, they yielded hardly any return. In most cases, public enterprises do not recover even a fraction of the capital cost and depreciation, besides not generating any return on investments (Government of India, 2000).

Almost 85 per cent of the investment in State-level public enterprises is on electricity utilities. Poor financial performance of SEBs has been a major cause of drain in States' exchequers. The Electricity (Supply) Act, 1948 stipulates that State Electricity Boards (SEBs) should yield 3 per cent return on their net fixed assets. With the value of fixed assets at Rs 68,000 crore, they should have contributed Rs 2,040 crore to revenues. In actual practice, however, they generated a commercial loss of Rs 23,000 crore or 33.8 per cent of the value of fixed assets in 1999-2000 (Government of India, 2001). The losses excluding the State government subsidy amounted to Rs 18,200 crore.

While the average cost of power by the SEBs was Rs. 2.83 per unit, the average revenue realised was only Rs. 1.99. The difference was due to poor efficiency in the supply of power and irrational pricing policies. The transmission and distribution losses were high (23.7 per cent), mainly due to the theft of power. Subsidy to the agricultural sector was estimated at Rs 24,541 crore and Rs 8,103 crore was due to domestic consumption. Industrial and commercial sectors had to pay more than the average cost and the excess payment amounted to Rs 8,407 crore. After accounting for a Rs 4,800 crore explicit subsidy given by the States, the uncovered losses were Rs 20,032 crore. Further, the financial position of the SEBs has been showing a steady deterioration over the years. Unless immediate steps are taken to improve efficiency, ensure universal metering and rationalise the tariff structure, the SEBs will continue to strain State finances.

The above picture of financial drain due to poor functioning of SEBs hides the enormous inter-State differences (Annexure Table 3). In Andhra Pradesh, in 1999-2000, commercial losses were more than the value of capital stock! The losses were more than 50 per cent of the value of capital in West Bengal (66%), Jammu Kashmir (57%), Madhya Pradesh (56%), Rajasthan (52%) and Gujarat (52%). The efficiency parameters and the volume of subsidy too varied widely among the States. Of even more concern is the fact that the commercial losses as a ratio of net fixed assets have shown a steady decline in all the States right through the decade of the 1990s, and the policy measures implemented thus far have been ineffective in reversing the trend.

Restoring fiscal balance is inextricably linked to the improvement in the SEBs and State Road Transport Corporations (SRTCs). In fact, SEBs loss adds to the deficit by an additional Rs. 26,000 crore or about 1.3 per cent of GDP. With this, revenue deficit is estimated at close to 3 per cent of GDP. Similarly, losses of SRTCs in 1997-98 amounted to Rs 1,282 crore and their finances have shown a steady deterioration over the years. The situation is similar with other State enterprises as well. The Accountant Generals' reports in many of the States point out that there are a number of State-level public enterprises with accumulated losses amounting to several times the value of their fixed assets.

Poor fiscal condition of the States should also be attributed to poor cost recovery from public services. The National Institute of Public Finance and Policy (NIPFP) study for 1996-97 showed that cost recovery in social services was as low as 8.4 per cent of the cost of providing services and in the case of economic services it was 16.6 per cent. Analyses of various social and economic services in Karnataka show that cost recoveries are not only low but also have shown a decline over the years. (Rao and Amar Nath, 2001). Detailed sector-wise studies in Karnataka demonstrate considerable scope for raising revenues from targeting subsidies in agriculture (Deshpande and Bhende, 2001), irrigation (Raju and Amar Nath, 2001), power (Vivekananda, 2001), industry (Gayithri, 2001), higher education (Narayana, 2001) and water supply sectors (Saleth and Shastri, 2001). The studies show that the malice of poor cost recovery does not lie merely in uneconomic pricing of these services. Often, the problem is one of poor efficiency in their provision, and increasing the prices will simply pass on the burden of production/distribution inefficiency to the consumers.

Unbridled Growth of Expenditure

Disaggregated analysis of State expenditures (Table 6) brings out some important stylised facts with implications for macroeconomic stability and allocative and technical efficiency in the States' public expenditure policy. These are:

- Despite attempts to contain the growth of expenditures during the decade 1991-2000, the States' revenue expenditure - GDP ratio increased by 0.9 point. This contributed to the severity of fiscal imbalance at the State level broadly by the same magnitude as the reduction in the revenue-GDP ratio. The share of revenue expenditures in GDP increased from 12.6 per cent to 13.7 per cent during the period.

- A substantial proportion of increase in revenue expenditures is due to interest payments. Both the volume of liabilities and average rate of interest have increased significantly. As an increasing share of States' loans are used for revenue expenditures, the vicious cycle of higher interest payments increasing expenditures feed back into larger borrowings. The problem is exacerbated by low productivity of even capital expenditures. The proliferation of projects spread the resources thinly and inadequate financial allocation causes severe cost and time over-runs.

- The principal reason for increase in expenditures, however, is the pay and pension revision. Impact of the pay revision has been much more severe on the States than the Centre because the share of salary expenditure in the States is higher and revisions had to be extended to aided institutions and local bodies besides government administration. Thus, general service expenditure, excluding interest payment, increased by almost a one percentage point during the decade reflecting the increases in pay scales and pension payments. Almost 0.7 point increase was just in two years beginning 1998-99. Overall, much of the 1.3 percentage point increase in non-interest revenue expenditures seen in the last two years could be attributed to the implementation of pay revision. In absolute terms, compensation to employees (pay and pensions) in States increased from Rs 73,432 crore in 1996-97 to Rs 89,748 crore in 1997-98 and further to Rs 1,11,891 crore in 1998-99. Thus the increase of Rs 16,000 crore in 1997-78 was followed by an additional increase of Rs 22,000 crore in 1998-99 (Acharya, 2001, p. 48).

- Despite significant increase in the salary component of social services expenditures, expenditure-GDP ratio remained more or less constant at about 5 per cent of GDP. Constancy in social services expenditure-GDP ratio in the wake of increasing salary cost implies reduction in non-salary inputs with an adverse impact on their quality.

- The impact of the declining revenue-GDP ratio and inevitability of meeting the increasing commitments on pay and pension revisions and interest payments have been to crowd out capital expenditure-GDP ratio from 2.4 per cent in 1990-91 to 1.8 per cent in 1999-2000. Within revenue expenditures, sharp decline in the expenditure-GDP ratio in respect of economic services signifies the inability of the States to make adequate provision for maintenance of physical infrastructure. The effect has been to put pressure on both the availability and quality of the physical infrastructure.

- A major structural cause of expenditure proliferation is the artificial, and often meaningless, distinction made between plan and non-plan expenditures. Implicit in this is the assumption that plan expenditures are productive and non-plan expenditures are not. This is incorrect, for a number of projects classified as 'plan' in the revenue account are merely salary payments that are not productive. Similarly, completed plan schemes are classified as 'non-plan'. Maintenance expenditures on roads, irrigation works and buildings are certainly productive and inadequate provision for these to contain non-plan expenditures has been a major shortcoming in expenditure management in States. Often, for convenience and strategic reasons (as for example, inter-state river disputes), some developmental projects are initiated in the non-plan side. Hence, the classification itself is unscientific, and this has led to inadequate expenditure allocation to the maintenance of assets. Emphasis on increasing the plan size in every successive plan, irrespective of resources position, has caused proliferation of plan schemes even when they

Table 6: Trends in State Governments' Expenditure

Expenditure Item	Percentages of States' expenditure to GDP		Growth rate (percent per annum)	
	1990-91	1999-00	1985-95	1990-2000
Total Revenue Expenditure	12.62	13.68	15.16	13.92
1. General Services	4.03	5.68	17.85	16.84
Of which - Interest Payment	1.52	2.30	19.99	17.39
2. Social Services	4.92	5.09	13.30	13.82
Education	2.73	2.91	14.44	14.09
Health and Family Welfare	0.81	0.75	12.58	12.71
3. Economic Services	3.67	2.91	14.41	9.75
Agriculture and Allied Activities	1.10	0.88	13.33	9.83
Rural development	0.88	0.69	13.20	9.35
Irrigation	0.60	0.48	11.99	11.53
Power	0.17	0.29	29.33	14.59
Industry and Minerals	0.21	0.12	11.40	8.12
Transport and Communications	0.41	0.29	13.95	9.77
Capital Expenditure	2.37	1.81	9.48	10.55
Total Expenditure	14.62	15.50	14.24	13.48

cannot be justified on economic considerations. As already mentioned, emphasis on increasing the plan size has also had the effect of allocating expenditures to a large number of projects resulting in the thin spread of resources, causing time and cost over-runs.

- Increasing emphasis on plan expenditures by containing non-plan expenditures has had another undesirable effect on State finances. One way to increase the plan size is to classify some of the expenditures considered as 'non-plan' in earlier years 'plan'. Besides, the emphasis has shifted to revenue expenditures under the plan category. During earlier plans, the revenue component of plan expenditures in non-special category States was only about 30 per cent and therefore, the grant-loan component of plan assistance was 30:70. At present, the revenue component of plan expenditures is almost 55 per cent and the consequence of this has been to finance increasing proportions of revenue expenditures from borrowed funds, year after year.

Inequity and Disincentives from Central Transfers

Reform in the transfer system is outside the purview of individual States. Yet, it is important to address the issue so that the transfer system is adequate, efficient and equitable. The fiscal adjustment at the Centre has decelerated the growth of transfers to the States from 14.6 per cent in the 1980s to 11 per cent in the 1990s. It is also necessary to note that the transfer system has not been able to offset fiscal disabilities satisfactorily (Rao, 1992, Rao and Singh, 2002). The income elasticity of transfers for 14 major States declined from -0.35 in 1990-91 to -0.20 in 1998-99.

The problems associated with Central transfers are well known and have been analysed by several studies. Multiple agencies dispensing transfers have constrained targeting the general purpose transfers to offset fiscal disabilities. It would be appropriate to make all current transfers through the instrumentality of the Finance Commission and all loan assistance through the Planning Commission. Planning should be confined to infrastructure projects and plan - non-plan distinction in the revenue budget should be done away with.[2] The Finance Commission grant has serious design problems, and the 'fiscal dentistry' is alleged to have had the consequence of widening 'budgetary cavities'.

The specific purpose transfers comprise the central sector and centrally sponsored schemes. There has been a proliferation of these schemes and at present they number more than 175. Besides spreading the resources thinly, these programs distort States' choices in expenditure allocation, multiply bureaucracy and cause a thin spread of resources across several schemes. As centrally sponsored schemes also require matching contributions from the States, the extent of distortion in resource allocation is higher and expenditure centralisation is much larger than what is indicated by the expenditure shares of the States.

Based on the recommendation of the 11th Finance Commission, attempt is being made to incentivise the revenue deficit grants. It is proposed to earmark 15 per cent of the deficit grants recommended by the Finance Commission with an equal contribution from the Centre to be distributed to the States according to their fiscal performance. Each State will be given a share in excess or short of its initial eligibility (population share), depending on its fiscal performance. The States will be required to put out their Medium Term Fiscal Reforms Programme (MTFRP) and performance will be measured on the basis of a single monitorable fiscal objective, improvement in the revenue deficit by at least 5 per cent of its revenues. If a State fails to fulfil the condition, the fund will be rolled over to the next year. If the withheld portion is not claimed by 2005-06, the fund will lapse. Of the 28 States, 12 have already signed the Memorandum of Understanding (MOU) with the Centre to operationalise the scheme and the remaining are expected to follow. The problem with the scheme is that the amount of funds available for incentive payments may not be enough to incentivise the transfers. Further, the scheme is designed to incentivise only incremental changes in revenue deficit irrespective of the size of the deficit. Moreover, the Centre, which is a bigger source of fiscal imbalance, has not put in any scheme to rein in its own deficits, and even the Fiscal Responsibility Act proposed to bring in a measure of discipline, has been a non-starter.

Efficiency Implications of Subnational Fiscal Operations

Need for Efficiency in Subnational Fiscal Policy

Efficiency in terms of both minimising distortions in tax policy and cost effective provision of services has not received much attention. This can partly be explained by the fact that in a closed economy, inefficiencies of tax and expenditure systems are neither transparent nor important. It is therefore, not surprising that emphasis has been to raise revenues to finance large public sector plans, without concerning about allocative distortions. Indeed, policy makers pursued multiple objectives from the tax policy besides raising revenues to complicate the tax systems. These included equity, regulating consumption, attracting investment and regional allocation of resources. Competition among the States to attract trade and investment has added to the complexity. On the expenditure side, the emphasis has been to increase the plan size in every plan, with no emphasis on efficiency in resource use. Thus, even performance measurement, if done at all, has been in terms of inputs or meeting financial targets and not outputs or outcomes. Thus, allocative and technical efficiency in the design and implementation of public spending policy has not received any attention.

In open economies, it is imperative to minimise distortions in tax policy, ensure proper pricing of quasi-public goods and services provided by the State governments and improve efficiency in public service delivery. Achieving competitiveness in the economy calls for minimising relative price distortions arising from subnational tax and pricing policies and providing high quality physical infrastructure and ensuring human development.

Efficiency Implications of Subnational Tax Policy

Subnational tax policy causes inefficiencies in resource allocation by distorting relative prices and violating the principles of common market in a federation. The tax policy can cause excessive and unintended distortions from the pursuit of multiple objectives, year-to-year, and ad hoc policy changes guided by exigencies of revenue or responding to special interest groups rather than providing a stable and accommodating policy environment. Similarly, violation of the principles of common market arises from the impediments placed on free movement of factors and products throughout the federation. Such impediments segment the markets and create inefficiencies in resource allocation.

Sales tax - the most important source of the states' own tax revenue is also the most important source of distortion. Administrative considerations have led to the levy of the tax predominantly at the first point of sale. All pre-retail sales taxes cause cascading. The tax is levied also on inputs and capital goods, and this exacerbates the problem. Pursuit of multiple objectives has caused minute differences in the tax rates. Inter-state competition in sales tax to attract trade and investments has complicated the tax structure further. In this 'race to the bottom' the Union Territories have played a destabilising role. The competition has led the States to adopt the self-defeating schemes of fiscal incentives in terms of sales tax holiday and deferment. In addition, to meet exigencies of revenue, the States have levied turnover taxes, additional sales taxes and entry taxes. All these have contributed to complicated, cascading and opaque tax systems. The tax on tax, mark-up on tax and tax on mark-ups have altered relative prices in unintended ways. The complicated tax systems and wide discretions to officials have resulted in negotiated tax payments and high compliance costs. In addition, the Central sales tax levied by the exporting state has distorted relative prices and segmented the market. This has also been a major source of inequitable inter-State tax exportation.

Despite widespread awareness of the distortions caused by octroi,[3] the States of Gujarat, Maharashtra, Orissa and Punjab have assigned their urban local bodies to levy Octroi, the tax on the entry of goods into local areas for consumption, for use or for sale. In these States, this levy is a major source of market segmentation, impedes internal trade, and causes allocative distortions and rent seeking. In addition, as this is a check-post based levy, it enlarges scope for rent seeking. In spite of the awareness of the ills of the levy, it has continued to be levied by urban local bodies in some states.

The taxes on the transfer of property, as they are levied at present, have hindered the development of the organised market for immovable properties in the country. The levy of high and differentiated rates of stamp duty and registration fees has led to widespread undervaluation of immovable properties and evasion of the tax. There is no incentive for honest reporting of the value of transactions and this prevents the development of a transparent market for immovable properties. The levy has hindered the very development of a transparent organised market for immovable properties.

It is often said that 'tax administration is tax reform'. A major source of distortion in the subnational tax policy in India is a weak administration and ineffective enforcement mechanism. Complicated tax structures, weak governance and a poor information system contribute to poor compliance of the tax. Enforcing a complicated tax system requires sophisticated administrative machinery. The prevailing administrative machinery is unable to effectively enforce the tax. An effective enforcement mechanism not only reduces revenue productivity of the tax system, but also causes serious distortions and inequity.

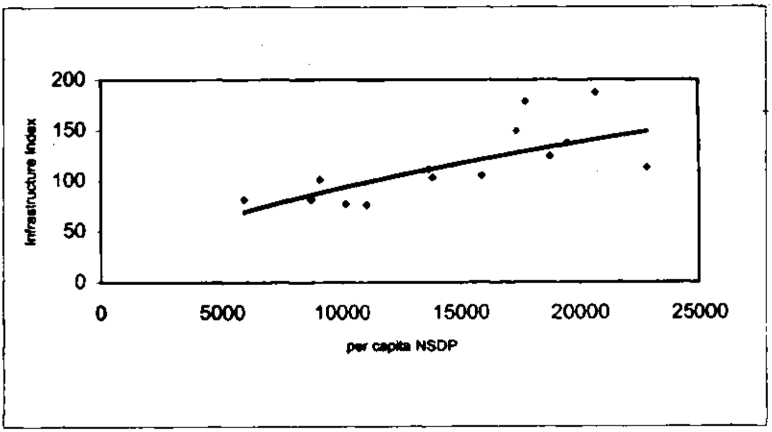
Efficiency Implications of Subnational Expenditures

Productivity of sub-national expenditures depends upon the efficiency in public service provision and creation of an accommodating business environment. While efficiency in the provision of public services has important implications for the volume of resources/savings that should be drawn from private investment, volume and spread of physical and social infrastructure provided by public expenditures determine the private business environment. If it is assumed that the central public finance operation is neutral in its impact across regions, resource distortion can be caused by the spread of inter-State differences in the provision of physical and social infrastructures.

For providing required standards of public services and effecting their even spread across the country, all the States should be enabled to provide a given normative bundle of public services. This does mean that all the States should provide an identical bundle of public services. Of course, as for those services with high merit such as basic education and healthcare, it is important to ensure that all States provide a certain minimum normative standards. In respect of other services, the emphasis has to be provision of infrastructure at standards necessary to harness their resource potential.

Analysis shows significant positive relationship of infrastructure availability with per capita NSDP (Figure 2). This indicates the fact that the Indian federation has failed to offset the fiscal disabilities of the States. Though the infrastructure standards in the States with low per capita NSDP are lower, even when these States are resource rich they are unable to exploit their growth potential. This does not necessarily mean that the low level of per capita income or their low growth rates have been caused necessarily by infrastructure constraints. In fact, both low level of income and poor state of infrastructure facilities are consequences of the shortcomings in policies, their implementation mechanisms and institutions.

Figure 2: Relationship Between Per Capita NSDP and Infrastructure Index



Sources: 1. Infrastructure Index: *Report of the Finance Commission,* Ministry of Finance, Government of India. 2000

2. Per capita NSDP: *Central Statistical Organisation,* Ministry of Planning, Government of India

Ten Years of Subnational Fiscal Reform and Challenges Ahead

The last decade has seen a steady deterioration in State finances. To a considerable extent, the deterioration has been caused by deceleration in central transfers and spillover of the central policy on pay revision. Nevertheless, the States have not done any good to themselves either. There has been a steady deterioration in the States' own tax revenues, significant drain on their resources due to losses from public enterprises and proliferation of implicit and explicit subsidies and transfers. Thus, despite a decade of reforms, fiscal consolidation at the State level has remained elusive.

An additional dimension to the States' finances in recent years has been in the lending by multilateral lending institutions (World Bank and ADB) to States. Although the loans are made conditional on the States undertaking effective fiscal reforms, there is a tendency to dilute the conditions, as eventually the repayment liability for loans lies with the Centre. Loan pushing by these lending institutions can result in excessive borrowing by the States. Besides the usual problems associated, these loans carry the additional foreign exchange risk as well. It is extremely important that the effective fiscal reforms programme should be put in place to avoid serious problems arising from excessive borrowing.

The record of fiscal conditionality at the State level has not been very enthusing. A number of States with poor fiscal performance have had to seek repeated refuge with the Ministry of Finance for bailouts from overdraft regulations after signing MOUs, the contents of which were not made public. Despite this, it was found necessary to give a directive to the Finance Commission to link transfers with monitorable programme of reducing revenue deficits. This implies the irrelevance of those MOUs. In terms of both the size of the transfers linked to fiscal performance and its design, it is very much doubtful whether the new MOUs will inculcate greater fiscal discipline among the States.

In order to get a comprehensive picture on the state of their finances, most non-special category States have decided to publish their contingent liabilities. Some of the States, notably Andhra Pradesh, Karnataka, Kerala, Maharashtra, Tamil Nadu and Uttar Pradesh have, in recent years, brought out White Papers to increase the public awareness of their problems. Some of the States have also prepared a medium-term fiscal plan for policy institutional reforms to restore fiscal balance in the medium term of five years. Initiatives have also been taken by appointing tax reforms Commission and Administrative Reforms Commission in States such as Karnataka, to undertake in-depth analysis and make detailed recommendations on tax reforms and administrative restructuring. Some of the States are also in the process of initiating measures to legislate on the fiscal responsibility to provide legislative control over fiscal imbalances.

However, these measures have become merely cosmetic and have not been able to arrest declining revenues and increasing revenue expenditures. The States have contained expenditures until 1997-98 by compressing spending on creation and maintenance of infrastructure. After the pay revision, even the pretence of containing expenditures had to be given up as the pay revision increased expenditure - GDP ratio by two percentage points to destabilise State finances. The sharp increase in salary outlay also reduced technical efficiency in social services expenditures.

Even though the new market friendly environment is marked by a reduced role of the government, the State will have to face the challenge of providing quality social and physical infrastructure. This would require a much larger expenditure allocation. In particular, increasing allocation to human development in the wake of dwindling revenues and competing demands from other services will be the most difficult challenge the States will have to face in the short and medium term. Restructuring the administrative machinery, downsizing of bureaucracy and prioritising expenditure allocation to provide quality infrastructure and creation of business friendly environment are the critical challenges the States are faced with to achieve fiscal consolidation. Equally important is the need to contain expenditures on interest payments. It is important not to resort to high cost sources of borrowing through small savings schemes.

Increased provision for social sectors and physical infrastructure can be made only when the slide in the revenue-GDP ratio is reversed. The declining trend in the States' own revenue ratio since 1990-91 has to be reversed. The States have no means to tax either the production or consumption of services and increasing the tax ratio is likely to present a serious challenge to the States. The challenge is even more serious to improve productivity of non-tax revenues. In an era of fragmented polity and coalition politics, the States have found it difficult to increase the user charges and fees. Measures to effect significant cost recoveries on quasi-public and private services and phasing out loss making commercial public enterprises are necessary to ensure revenue productivity and reduce distortions.

Fiscal fortunes of the States are inextricably intertwined with the power sector reform. As mentioned earlier, commercial losses of the SEBs alone amounted to 1.2 per cent of GDP in 2000-01. SEBs owed Rs. 41473 crore or 1.9 per cent of the GDP to the Central Public Sector Undertakings at the end of February 2001, consisting of 1.2 per cent as principal and 0.7 per cent interest payment. Thus, improvement in SEBs would have a favourable impact on central finances as well. However, this requires significant policy and institutional changes. These include measures to improve physical productivity, reduce transmission and distribution losses and rationalisation of tariffs. Despite discussions on the unbundling of electricity supply industry, privatisation of generation and distribution and measures to improve productivity, much remains to be done in terms of both designing the policy reforms and implementing them. Many States have appointed regulatory commissions, but they do not have the power and functional autonomy to determine tariffs according to long-run marginal cost (LRMC). Most regulatory commissions do not have the expertise to undertake scientific studies to determine tariffs based on LRMC as they are filled with retired bureaucrats. The most important impediment to the power sector reform is political will.

Other areas of reform pertain to restructuring various State-level public enterprises. Some States have taken initiatives in this regard, but much remains to be done. Most public enterprises, even when they are of commercial nature, have accumulated losses more than their asset values. Voluntary retirement schemes (VRS) have been initiated in some States, but invariably, the more productive employees avail this opportunity. Moreover, the social consequences of such measures have not always been desirable as the emphasis has been to reduce employment and not rehabilitation and retraining of retired employees.

Micro-level reforms of the tax systems are equally important to ensure that the resources for investment in infrastructure are generated in the least distortionary manner. The States have taken initiatives to substitute the prevailing cascading type sales tax with Value Added Tax (VAT) by April 2002. Transition to VAT is necessary not only to impart efficiency to the tax system but also to enhance revenue productivity. There is, however, a real danger of this reform being implemented in a half-baked manner.

A number of conceptual and operational issues have to be resolved before making a transition to VAT. These relate to the treatment of declared goods, additional excise duty items and even more important, inter-state sales and purchases. Besides, a destination-based comprehensive VAT being a tax on goods and services, it is necessary to enable the States to levy taxes on services. Therefore, the Constitution should be amended to provide concurrent power of taxing services to States. The proposal to give selected services to States will create complications, create distortions in the tax system and result in only a distorted VAT.

There is much to be said for sequencing sales tax reforms. Although the State Finance Ministers' Committee listed the steps in 1995, neither have the States nor has the Centre followed them. The first step involved in the exercise is to set the floor rates and it was hoped that inter-state competition would result in the convergence of the actual rates around the floor rates. Such a transition would have helped to achieve both simplification and harmonisation of the sales tax system. Unfortunately, the non-cooperative game played by the States and Union Territories has imparted greater complexity and disharmony to the tax system. From this position, transition to the VAT with two rates would not be easy. Simplification of the tax system, strengthening the administrative and enforcement machinery, introduction of the self assessment scheme, creating a robust information system and computerisation of tax administration are important steps that would improve voluntary compliance of the tax.

Thus, the States have to traverse far in restructuring their finances. These require reforms in expenditure and tax systems, power sector reform and restructuring state enterprises, administrative re-engineering, building up of a proper information system and computerization of tax administration. What has been achieved so far is negligible. The fiscal reform journey towards achieving fiscal balance and consolidation and generation of quality infrastructure and a competitive environment will be long and arduous while the opposition to reforms from vested interests will be strong. Political will and administrative competence, creating an awareness of the need for reform among the general public are the most important ingredients that will be needed in abundance to achieve the desired goals.

Annexure 1
State-wise Fiscal Imbalances
(Percent of NSDP)

State	1990-91		1995-96		1999-00	
	Revenue Deficit	Fiscal Deficit	Revenue Deficit	Fiscal Deficit	Revenue Deficit	Fiscal Deficit
Andhra Pradesh	0.46	2.79	1.03	3.36	2.34	5.16
Bihar	2.17	6.11	2.81	4.09	5.45	9.37
Gujarat	2.51	6.42	0.34	2.71	2.75	6.01
Haryana	0.16	3.04	1.35	3.84	3.02	5.76
Karnataka	0.33	2.30	-0.12	2.76	1.71	3.29
Kerala	2.67	5.06	1.15	3.71	3.88	5.49
Madhya Pradesh	0.62	3.17	0.83	2.85	2.93	4.45
Maharashtra	0.09	2.65	0.43	2.93	4.11	6.03
Orissa	0.19	5.98	3.38	5.85	6.24	9.35
Punjab	3.36	7.67	1.31	3.98	5.74	7.93
Rajasthan	-0.76	2.45	1.67	6.13	5.92	8.85
Tamil Nadu	1.74	3.55	0.44	1.79	3.09	4.16
Uttar Pradesh	2.16	5.39	2.29	4.28	4.68	7.24
West Bengal	3.03	4.85	1.86	4.02	6.71	9.06
Major States	1.33	4.18	1.17	3.50	4.06	6.34
Special category States	-0.40	8.04	-2.53	4.65	3.70	10.69
All States	0.93	3.30	0.73	2.60	2.94	4.75

Notes: 1. All States is sum of 25 States

2. For States, Major States and Special States it is ratio to NSDP new Series.

3. For All States it is ratio to GDP new Series.

Annexure II

Average Annual Growth Rates of States' Revenues and Expenditures

Percent

State	1980-81 to 1989-90					1990-91 to 1999-00				
	Own Tax Revenue	Own Revenues	Revenue Expenditure	Interest Payments	Capital Expenditure	Own Tax Revenue	Own Revenues	Revenue Expenditure	Interest Payments	Capital Expenditure
Andhra Pradesh	17.15	16.57	17.13	22.28	11.15	14.30	13.76	15.54	20.99	7.84
Bihar	14.28	19.57	16.36	21.31	10.63	11.78	10.18	10.89	11.29	6.78
Gujarat	16.05	16.34	17.90	24.70	8.13	14.92	15.51	16.56	18.51	14.77
Haryana	15.79	15.87	17.19	21.58	6.94	13.33	14.86	17.66	19.38	9.79
Karnataka	16.43	14.78	16.49	22.55	6.78	14.61	14.20	15.09	18.43	10.99
Kerala	15.97	13.33	15.68	23.77	8.92	16.98	16.61	16.62	18.53	14.44
Madhya Pradesh	16.20	14.40	16.89	23.62	6.48	14.03	12.95	14.65	17.44	4.30
Maharashtra	15.77	15.44	16.67	24.31	9.13	14.16	13.13	15.45	18.87	13.66
Orissa	16.60	12.93	14.73	22.66	12.67	12.47	12.36	15.20	18.52	7.30

Contd.

Percent

State	1980-81 to 1989-90					1990-91 to 1999-00				
	Own Tax Revenue	Own Revenues	Revenue Expenditure	Interest Payments	Capital Expenditure	Own Tax Revenue	Own Revenues	Revenue Expenditure	Interest Payments	Capital Expenditure
Punjab	14.22	13.42	16.47	16.21	15.86	12.44	14.68	15.78	27.54	3.15
Rajasthan	17.05	14.39	17.71	20.53	7.62	15.72	13.35	15.63	20.92	12.87
Tamil Nadu	14.61	13.54	16.27	17.53	2.90	15.24	14.38	13.28	20.78	22.48
Uttar Pradesh	15.43	14.87	17.84	24.20	7.53	13.14	11.64	13.54	19.53	7.18
West Bengal	16.26	14.24	14.78	19.77	9.90	11.23	11.25	15.44	21.45	21.18
Major States	15.82	15.10	16.69	22.00	8.80	14.09	13.50	14.82	19.26	11.39
Special States	19.36	12.99	21.14	28.06	17.00	13.79	17.30	16.12	16.03	9.42
All States	15.92	14.95	17.07	22.50	9.69	14.08	13.68	14.94	18.99	11.13

Note: Growth rates have been estimated by fitting semi-log trend lines.

Annexure III

Performance of State Electricity Boards and Electricity Departments - Selected Indicators

State	Plant Load Factor (Per cent)	Forced Outages (Per cent)	T & D losses (Per cent)	Share of of Agri. Consump-tion (Per cent)	Cost of Supply (Paise/ kwh)	Average Price per Unit (Paise/ kwh)	Commer-cial Losses (Rs. crore).	Rate of Return on Capital (Per cent)
State Electricity Boards								
Andhra Pradesh	83.2	5.9	31.0	40.5	295.5	177.0	2755.2	-130.7
Assam	18.2	52.0	35.0	3.1	511.4	312.1	357.5	-31.5
Bihar	19.7	40.6	22.0	20.2	318.5	200.1	679.8	-47.9
Durgapur Projects Ltd.	24.8	49.5						
Delhi (DVB)	49.9	22.6	45.0	1.2	490.1	283.8	1209.3	-34.0
Gujarat	63.4	12.9	19.4	43.2	307.7	206.0	2577.0	-52.0
Haryana	53.0	26.3	25.0	44.7	343.1	214.7	944.3	-41.9
Karnataka	82.3	2.8	30.0	46.3	255.5	204.9	781.8	-30.9
Kerala			20.8	4.4	244.3	187.5	266.7	-9.3
Madhya Pradesh	69.4	10.6	20.5	44.9	260.8	159.9	2173.5	-55.6
Maharashtra	71.7	9.2	16.7	32.5	261.2	229.7	961.0	-10.7
Meghalaya			20.3	0.1	229.9	131.4	52.6	-24.7
Orissa	85.6	1.6	6.0		184.2	138.7	332.8	-29.5

Contd.

Punjab	74.7	9.5	16.9	32.5	247.2	171.6	1304.1	-37.6
Rajasthan	82.3	3.7	22.0	36.9	334.6	194.4	1512.3	-52.6
Tamil Nadu	72.3	10.9	16.5	27.2	253.1	209.1	1227.2	-18.2
Uttar Pradesh	49.8	25.6	25.0	34.2	288.1	182.0	4154.9	-25.1
West Bengal Power Development Corporation	56.2	19.3			143.9			
West Bengal (SEB)	39.8	31.6	28.0	12.2	318.4	223.4	859.1	-66.9
All SEBs	**63.7**	**15.6**	**23.7**	**31.9**	**283.7**	**199.9**	**23027.9**	**-33.8**
Electricity Departments								
Arunachal Pradesh			20.5		608.0	150.0	52.4	
Goa			24.3	1.1	283.7	280.0	4.0	
Manipur			40.0	6.0	431.5	163.0	69.0	
Mizoram			42.5		516.1	96.0	49.2	
Nagaland			28.5		393.3	189.9	28.8	
Pondicherry			13.3	9.1	177.5	167.0	12.1	
Sikkim			20.0		209.0	100.0	12.8	
Tripura			28.0	**21.9**	294.0	96.3	83.3	
All EDs			**23.5**	6.7	**277.6**	**186.5**	**311.5**	
All India	**67.3**	**13.1**		**31.6**	**283.6**	**199.0**	**18537.6**	

Source: Annual Report on the Working of State Electricity Boards and Electricity Departments, Planning Commission, Government of India, June 2001.

Notes

1. Fiscal deficit is the total borrowing requirements and is defined as total expenditure minus total revenues and capital receipts. Revenue deficit is the excess of revenue expenditures over revenue receipts. Primary deficit is fiscal deficit excluding the interest payments.

2. For a detailed analysis of these issues, see Rao and Singh, 2002.

3. Octroi is a tax on the entry of goods into a local area for consumption, use or sale. This is a check-post based levy collected at entry points into urban local bodies.

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