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State Level Fiscal Reforms in India: Issues and Remedies

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Abstract

The Indian economy has undergone a paradigm shift and moved towards market-oriented reforms through deregulation, liberalization and openness of the economy leading to a higher rate of economic growth. However, the sub-national fiscal reforms did not respond to the reform program with similar effort and enthusiasm. The present paper critically examines Indian states have approached the process of fiscal management reform. The main purpose of the paper is to study the major issues governing state level fiscal reforms in India. This paper aims both to share the major state-level fiscal reforms in India to date, and to suggest what more can be done to speed up the reforms.

Keywords: Fiscal Reforms, States, Public Expenditure Management, Public Private Partnership

Introduction

India has experienced rapid economic growth over the past two decades, averaging about 6% per year. Sustaining and accelerating this progress, as per the country's development targets, will require an improvement in government effectiveness, not only at the central but also at the state level, given the extensive responsibilities of India's state governments for infrastructure and human development. But fiscal deterioration, especially acute in the late nineties, has weakened the development effectiveness of state governments in India by squeezing productive spending and reducing its quality, especially in the poorer states. As is well known, the fiscal situation of Centre & States has deteriorated continuously in 1990s, especially after 1997. The state governments of India have embarked on two pronged fiscal reforms i.e. (i) reducing deficits and (ii) better spending on priority areas, during last one decade. Before that, fiscal management was an alien term. In the light of the above discussion, the remainder of the paper is organized as follows. It presents the objectives and databases used in the study, followed by a discussion on the methodology used. Subsequently, it discusses the important components of public expenditure in India. Then, it discusses reforms finally, the conclusion is offered with implications.

The role of state governments is much diversified. The Indian constitution entrusted the states with functions both expensive and expansive such as agriculture, irrigation, roads and buildings, rural development, education, medical and public health and law and order along with revenue powers mostly inelastic in nature. Since the advent of five year plans these expenditure commitments have been increasing considerably. Public expenditure plays a very important role in economic development. Public expenditure is the expenditure incurred by the public authorities that is Central government, state governments and local bodies for the satisfaction of collective needs of the citizens for the promotion of economic and social welfare. The share of developmental expenditure of state governments is increasing at a faster pace than the Central government expenditure. This amply demonstrates the crucial role played by the states expenditure in the Indian Union. The growth of expenditure of the states was to fulfill the two objectives of economic growth and economic welfare. To attain these two objectives not only public investment but also private investment is also needed. Given the current tempo while a number of states will fulfill the target, others in all likelihood may fail to fulfill the target. So also the strategy of states appears to be ill-conceived. The revenue effort of the states cannot be said to be very impressive.

Finances in most States remained under stress during 2008-09 and 2009-10. In 2008-09, revenue account was impacted across 19 States largely due to the upward revision of salaries in a few States and the impact of a slowdown on own tax and non-tax collections. Poor Central tax collections also led to lower tax devolutions as a ratio of GSDP across 26 States, albeit partly compensated through higher grants from the Centre. Deterioration in revenue account was evident in higher GFD-GSDP ratios across the majority of States in 2008-09. Nonetheless, with the fiscal headroom generated in previous years, 21 States could continue to achieve revenue surplus in 2008-09. In 2009-10, many States were still in the process of implementing the revised pay structures which, along with the expansionary fiscal stimulus measures undertaken by many States, resulted in a more pronounced deterioration in the revenue account. The re-emergence of a revenue deficit after three years and higher capital outlay led to a higher GFD-GSDP ratio across States in 2009-10.

Objectives and Methodology

In view of the above theoretical background the objective of the present study is to examine the background and to identify the major issues at state level fiscal reforms in India. Our study on the topic “Issues of State level fiscal reforms in India ” is based exclusively on secondary data taken from various issues on “State finances” by Reserve Bank of India (R.B.I.), Public Finance Statistics, Government of India, Economic Survey, and Centre for Monitoring Indian Economy (CMIE).The trends in deficits of the all-states are also analyzed.

Review of Literature

There are many studies on state level fiscal reforms in India and related topics. This section deals with the review of such studies. A recent study was done by (De, 2012) which studies the trajectory of India’s fiscal policy with a focus on historical fiscal discipline frameworks, fiscal responses to the global financial crisis and subsequent return to a fiscal consolidation path.

(Rao, 1981) makes a modest attempt to study and to identify the determinant of tax revenue and non-plan revenue expenditure of the states towards making their medium term projections. The researcher has chosen the states of Karnataka, Kerela, Orissa and West-Bengal for the purpose in studying the time series determinant. In this study, both the political and economics determinants have been considered. The effects of various economic and political factors on the fiscal decisions of the four states are also quantified.

While discussing the determinants of non-plan revenue expenditure the study summaries that in all the four states except Orissa, the growth expenditure on various services is of providing them. Only in Orissa the growth in non-plan revenue expenditure is due to increased quantity of public services. The results of the study confirm 'Down's Hypothesis' that fiscal decisions are essentially guided by the desire to maximize the length of their tenure by the parties in power and are not influenced by their ideological doctrines.(Howes,. Lahiri and Nicholas , 2000) in their article discusses about the states level reforms in India. They also enumerate the causes that lead to the spread of state level reforms in India. According to them India cannot succeed with reformed and revived state governments. (Kurian ,1999) in his paper attempts to bring out the deteriorating trend in state finances in recent years. "Failure to contain wasteful expenditure and reluctance to raise additional resources" on the part of the states are the main problems afflicting most of the state finances.

Tax wars among the states government to attract private investment in the wake of economic reforms as well as competitive populism and the pay revision of employees led to starvation of funds of states. Unless drastic measures are resorted to without delay finances of states will collapse.(Chelliah and K. Rao, 2002) in their paper discusses about the rational ways of increasing the tax revenue of Central and state governments in India. According to them no serious effort has been made to modernize tax administration. The administration of all the states is manual based. A reform and modernization of the administration of the major taxes through computerization and strong deterrent action against tax evaders and corrupt taxmen are two important steps to be taken to increase revenues. (Kurian, 2003) in his work pointed to some expend success has been achieved at the Centre but there has been steep deterioration in the finances of the states. Any decline in the Union government and the associated fall in devolution to the states will have further deletions effect on regional imbalances of the country. (Mukesh, Bagchi, Sen, K ,2002) in their article have discussed about the causes of fiscal indiscipline at the state level. Weaknesses of the system of inter-governmental fiscal relations have been cited as prime caused leading to fiscal indiscipline among states, which call for corrective measures.

In a similar line (Bagchi, 2002) have observed even after a decade of correction the consolidated fiscal deficit (FD) of the government (Centre plus states) stood at about the same level at the close of decade as it is in the beginning10% of GDP. The crises in state finances have their origin in some deep-seated weakness of the fiscal system that call for structural reform. The weakness is in revenue system, budgeting system and system of inter government financial relations. If fiscal deficit is to bring down the weakness of the fiscal system noted above need to address frontally. The study conducted by (Bhargava, 2002) discussed about the state level fiscal reforms. The state should play complementary and supplementary role and performance to the efforts of the Centre to play and improve the fiscal situation. It is high time that agriculture income tax should be included in the constitution to raise the revenue of the states. (Chelliah, Raja, Rao, 2002) in their paper discusses about the rational ways of increasing the tax revenue of Central and state governments in India.

According to them no serious effort has been made to modernize tax administration. The administration of all the states is manual based. A reform and modernization of the administration of the major taxes through computerization and strong deterrent action against tax evaders and corrupt taxmen are two important steps to be taken to increase revenues Analysis shows that on a comparable basis fiscal deficit reduction has been marginal. On the contrary, other fiscal indicators have shown significant deterioration. Thus the claims about fiscal adjustment are illusory. Fiscal consolidation in India perhaps requires another crisis.(Rao, 2011) in his work attempts to analyze the experience of incentivizing economic reforms at the state level through central transfers to states. It reviews the experiences of the central government introducing incentives for reform directly through various specific purpose transfers as well as the incentive schemes recommended by various Finance Commissions.

Datta (2009) says public-private partnership model has emerged as the favored model of project execution in India, especially in infrastructure, health and education. Tomar, (2013) observes that fiscal reforms have initiated a right kind of approach to maintain fiscal discipline in the Indian economy and the Indian economy has met it successfully at the national level however there has been some problems at the state level. Fiscal reforms have brought a new vision and mission for the government both central and state towards competitiveness and efficient mode for managing the economy .Kaur, Gursimran, 2014 made a modest attempt in this paper to redesign the fiscal reform process relating to revenue mobilization, expenditure restructuring and debt reforms in future.

The Thirteenth Finance Commission has been constituted against the backdrop of strong fiscal correction and consolidation by most of the state governments. The vertical and horizontal imbalance among the different sub national governments may lead to uneven development of the economy, unless corrected by an efficient system of inter-governmental transfers in the process of fiscal transfers, the Thirteenth FC may opt to include the efforts to increase non-tax revenue as a criterion for horizontal devolution and may consider giving due weight to the need to enhance social sector expenditure as a criterion for horizontal sharing. (Kumudini, Rakhe, Gajbhiye, 2008). Mohanty (2014) says effective management of the state finances in India is crucial in triggering higher inclusive growth. Analysis of the past data shows that there has been substantial improvement in the management state finance of Odisha in terms of significant decline in key deficit indicators in state finance, effective liquidity management and prudent debt management.

Major Issues of State-level Fiscal Reforms
The major issues relating to the finances of the States in the current context are presented in the next section. In the issues of fiscal reforms following are the important items:

Revenue Augmentation: One of the major issues of state-level fiscal reforms is revenue augmentation. For better resource mobilization focus should be on efficient utilization of existing resources through simplification and rationalization of tax structure, better enforcement, tax compliance and review of users charges particularly power, water transport etc. by factoring into the variability of input costs.

The major source of states revenue is sales tax. Introduction of Value Added Tax has increased the revenue buoyancy as the coverage expands to value addition at all stages of production and distribution chain. Now another challenge is to implement one of the biggest taxation reforms in India -- the Goods and Service Tax (GST). The date of implementation of GST is to set on August 2012. The implementation of GST will lead to the abolition of other taxes such as octroi, Central Sales Tax, State-level sales tax, entry tax, stamp duty, telecom license fees, turnover tax, tax on consumption or sale of electricity, taxes on transportation of goods and services, et cetera, thus avoiding multiple layers of taxation that currently exist in India.

GST is likely to improve tax collections and boost India's economic development by breaking tax barriers between States and integrating India through a uniform tax rate. Both Centre and state will benefit from it. It is estimated that India will gain $15 billion a year by implementing the Goods and Services Tax as it would promote exports, raise employment and boost growth. It will divide the tax burden equitably between manufacturing and services.

Expenditure Management: Beside revenue raising measures another important issue of the reform is expenditure austerity, efficient spending and proper expenditure management which are of great importance to improve the quality of expenditure. On the expenditure side of states there are two types of expenditure developmental and non-developmental expenditure of states which are cause of worry. The non-developmental expenditure is growing at a faster pace than the growth in developmental expenditure. There are two main areas where non developmental expenditure has increased quite sharply, interest payment and pensions. These two expenditures are eating about one fifth of the state’s revenue receipts. On both of these items states have little control. The rising proportion had made the fiscal management of states difficult.

For assessment of the quality of expenditure restructuring, certain performance indicators have to be identified. Several states have proposed to conserve resources by compressing non-plan expenditure. Along with the economy measures such as freeze on non-essential recruitment, reviewing manpower requirements and to cut in establishment expenses are also done. Efforts are underway to review the organizational structure of major departments to active rationalization, efficiency and economy. Some states aim to undertake a comprehensive rationalization of posts and introduce appropriate voluntary retirement scheme (VRS) in the coming years. Zero-based budgeting may be adopted in order to contain expenditure. The state government of Maharashtra and Madhya Pradesh is conscious of the impact of impending wage revisions on state finances.

The states government of Maharashtra and Madhya Pradesh has decided that in future all teachers in primary and secondary schools will be recruited by the panchayats and not by the state governments. The salary of the teachers will also be paid by the panchayats and their wages will be lower than the state governments. Management of medical colleges and district hospitals in the states will be managed by registered societies. The composition of government expenditure should be restructured in favour of priority areas like education, primary health care, water supply, sanitation and infrastructure like roads and bridges, expenditure on salaries, pensions, interest payments and subsidies should be restrictedly controlled and monitored. Since the recommendations of the sixth Central pay commission have a bearing on the states in terms of reference of salary and allowances should bear relationship with the revenue expenditure of the states, the adoption of such recommendations should be evaluated independently by an expert committee. Development expenditure on social and economic services, particularly education, medical and public health, family welfare, irrigation, roads and bridges and rural development were priority areas for expenditure allocation during 2011-12, although the growth in expenditure in some of these sectors is budgeted to be lower.

State level Public Sector Enterprises Reforms: Even among public enterprises that are making profits, many are inefficiently run and are overstaffed. Some are subject to political interference in India, the financial health and management of public sector undertaking has been a cause of concern in the last few years.

Many states have proposed to restructure their public sector undertakings in order to make them profitable and competitive entities. To address this issue, Karnataka has come out with a policy paper on restructuring of public sector undertakings, while Maharashtra introduced a bill for setting up a Board for restructuring of the public sector undertakings. In order to restore the financial viability of electricity Boards some states have signed Memorandum of Understanding with the Central Government for reforming power sector. Several States have set up SERC (State Electricity Regulatory Commissions) in order to determine electricity tariff in rational manner.

Power Sector Reforms

A growing area of concern for the States is the significant increase in financial losses of the State power distribution utilities which carry both a direct as well as an indirect burden on the finances of State governments. Besides budgetary support to the SPUs through subsidies, grants and loans, the States also extend guarantees for loans taken by the power utilities from financial institutions. SPUs are making huge cash losses due to non-revision of tariffs over extended period of time on the one hand, and non-realization of subsidies from the State government, on the other. The deterioration in financial performance of SPUs is expected to have significant implications for the finances of States.

The power sector reforms have assumed critical importance in recent years. The measures taken by the states in this regard related to the constitution of State Electricity Regulatory Commissions (SERCs) for determining tariff structure, unbundling of electricity boards into separate entities for power generation, transmission and distribution, increasing power tariffs, measures for reducing transmission and distribution losses, etc. State Electricity Regulatory Commission (SERC) has been constituted or notified in 21 States. Of these, SERCs of 15 States have issued tariff orders. The States of Andhra Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh have enacted their State Electricity Reforms Acts which provide, inter-alia, for unbundling/corporatization of SEBs, setting up of SERCs, etc. The SEBs of Andhra Pradesh, Delhi, Haryana, Karnataka, Orissa, Rajasthan and Uttar Pradesh have been unbundled/ corporatized. Twenty-one States have signed Memorandum of Understanding with the Ministry of Power, Government of India to undertake reforms in a time bound manner.

Deficits

State should undertake reforms to reduce the deficits levels that would reduce the fiscal burden and improve allocative efficiency .It would also improve regulation and efficiency in delivery of public services and to reduce the role of government in non-essential areas through privatization, disinvestments and decentralization. The main cause of these rising deficits is the growing revenue expenditure particularly, wages and salaries, pensions, burden, of interest payments, losses of public sector enterprises particularly power utilities declining Central transfers as a proportion of GDP and inappropriate user charges have contributed in large measure to this deterioration. The slower growth in revenue in relation to expenditure and ambitious plan outlays of states compounded the problem. Further more and more states resorted to off budget borrowings constrained by limitations on raising public debt through the budgetary process. In order to achieve this objective, the reforms structure should aim at achieving fiscal sustainability by restructuring expenditure, to make it more productive and at strengthening the revenue raising machinery to maximize the yield from the existing revenue sources.

The Fiscal Responsibility and Budget Management Bill Act 2003 (as amended) which became effective from July 5, 2004 mandates that the Central Government to eliminate revenue deficit by March, 2009 and to reduce fiscal deficit to on amount equivalent to 3 percent of GDP by March 2008. The rules also prescribe the format for the medium term fiscal policy statement, the fiscal policy strategy statement and the macroeconomic power work, which are required to be presented to parliament along with annual financial statement. Thus the Fiscal Responsibility and Budget Management Bill of Center in turn will also affect the states. Deterioration of states began much later than that of Centre. The fiscal crisis of some of the states government is more acute and an important constraint in their development. The program revolves around creating a Rs. 10,607 crores of Incentive fund. The corpus of this fund would come from 15 revenue deficit states identified by the Eleventh Finance Commission. These states would contribute 15 percent of their revenue deficit grants to the fund with a matching grant from the Center. The states that implement reforms would be eligible to draw funds from this Incentive fund. Each of these states would have to improve their revenue deficit as proportion of their receipt by at least 5 percent annually between 2000 and 2005. The states, which do not follow the set timetable for reform would forgo their share of withdrawals from the Incentive, fund in that financial year. In case they make up in the following year, they would have to meet the previous as well as current year's targets to draw from Incentive fund. Further during the first four years, no amount of funds would be transferred to another state. However, if any state were not able to draw the amount indicated on the basis of the performance of the first four years the amount undisbursed would form part of common pool. This would be distributed to performing states in the fifth year on prorates basis.

The state governments collectively account for about half of the aggregate fiscal deficit in India. Table 1 shows the deficit of State Governments of India during the period 1990-1991 to 2009-2010. Table 1 shows the deficits as percentage of GDP. The key indicators of deficits of state governments are gross fiscal deficit, primary deficit and revenue deficits. The gross fiscal deficit of state government was 3.3% of GDP in 1991-92, which increased to high level of 4.7% in 1999-00 and then declined to 1.8% in 2006-07 but then further increased to 3.2% in 2011-12(B.E) it is estimated to fall to2.2%.As a proportion of GDP, revenue deficit which was 0.9% of GDP in 1991-92 then increased to 2.5 per cent in1998-99 to 2.7 per cent in 2000-01, declined to (-0.2) per cent in 2011-12 (BE). It may be noted that Primary Deficit of states as percentage of GDP was 1.8% in 1991-92 which increased to 2.4% in 1999-00 and then declined to -0.5% percent in 2007-08. The recent estimate of primary deficit was 0.6% in 2011-12(B.E).(Table 1).

The ThFC has worked out a fiscal consolidation roadmap for the states requiring them to eliminate their revenue deficit and achieve a fiscal deficit of 3 per cent of their respective GSDP, latest by 2014-15.

Table 1: Key Deficit Indicators of the State Government (As Percentage to GDP at Current Market Prices)

Year	GROSS FISCAL DEFICT	GROSS PRIMARY DEFICIT	REVENUE DEFICIT
1990-91	3.3	1.8	0.9
1991-92	2.9	1.2	0.9
1992-93	2.8	1	0.7
1993-94	2.4	0.6	0.4
1994-95	2.7	0.8	0.6
1995-96	2.6	0.8	0.7
1996-97	2.7	0.9	1.2
1997-98	2.9	0.9	1.1
1998-99	4.3	2.2	2.5
1999-00	4.7	2.4	2.8

2000-01	4.1	0.2	2.7
2001-02	4.2	1.5	2.6
2002-03	4.1	1.3	2.2
2003-04	4.4	1.5	2.3
2004-05	3.3	0.7	1.2
2005-06	2.4	0.2	0.2
2006-07	1.8	-0.8	-0.8
2007-08	1.5	-0.5	-0.9
2008-09	2.0	0.1	-0.5
2009-10	2.9	1.2	O.5
2010-11(RE)	2.7	1.0	0.3
2011-12(BE)	2.2	(-0.2)	(0.6)

Note: 1. Data for 2010-11 is Revised Estimates and Data for 2011-12 is Budget Estimates.
Source : Budget documents of the State Governments.

Conclusion and Recommendations

In spite of extensive fiscal reforms undertaken during the nineties, India's public finances face numerous problems. While the taxation system remains distortionary and fragmented, government expenditures remain inefficient in providing public and merit goods to the desired extent. Vertical imbalance and horizontal disparities characterize the federal fiscal system. The fiscal reform years have witnessed a sharp rise in the fiscal imbalance and deterioration in state finances.

The institutional measures adopted by the State governments such as Fiscal Responsibility and Budget Management (FRBM) Acts, Value Added Tax (VAT), New Pension Schemes (NPS), and setting up of Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) have helped states to consolidate their finances in the last decade. The tax measures taken by the government is insufficient. As for the states non-tax revenue is concerned it showed an increasing trend but was less than the increase in the tax revenue of states. Thus states should devise more and more ways to increase their receipts to meet their expenditure obligations.

Some of the recommendations for improving the finances of states are as follows:

1) Users' charges should be rationalized to attract funds from the debt market through bonds and debentures. Interest on the consumers should be protected through regulatory bodies as envisaged in the telecommunication and power regulatory authorities. Users' charges should be index limited to input costs and process of periodic revision should become automatic.
2) There must be careful review of all centrally sponsored schemes and only the schemes in extremely important activities such as primary health and family planning, education, drinking water etc. should be continued. In case of SEBs, the generation of electricity can be privatized. The state governments must continue the activities of transmission and distribution. The decentralization of these functions thorough proper public agencies can help in the more effective and economic transmission and distribution function.

3) There should be complete privatization and the government should get out of the production of all private goods except for strategic sectors. But instead on the question whether there should be wholesale privatization we should agree the financial burden on the government. Following menu of suggested reform in this sector may be (a) Sell or close down loss making public enterprises producing all non-strategic private goods in phased manner or (b) Private shareholding should brought into profit making public enterprises. For bringing private sector equity into public enterprises and reducing the government stake involves disinvestments as well as issue of new equity.
4) Reforms of the transfer system should be accompanied by a widening of the tax powers of the states and review of the system whereby large responsibilities are cast on them without regard for the consequences on their expenditure budget. It would be better to determine the share of the states in aggregate Central taxes rather than as a percentage of two specified taxes. This would require Constitutional amendment and discussed in detail by all the concerned parties government expenditure vigilance committee' should be set up to monitor public expenditure.
5) Recourse to the PPP mode for project financing is encouraged so that it frees valuable fiscal space for the provision of public goods in areas where such financing may not be forthcoming. PPP projects in sectors that come under the purview of the State governments such as urban amenities, State highways and minor ports have increased in recent years. Some States like Maharashtra, Andhra Pradesh, Karnataka and Gujarat have undertaken far more PPPs than others.

To conclude, it may be noted that there is an urgent need for governance reforms, transparency in the development delivery mechanism and fiscal reforms ensuring that the public funds are utilized according to sound financial practices and not diverted for gaining political mileage through wasteful public functions and populist announcements. Timely and regular audit of public expenditure as well as judicious use of public funds is imperative to ensure transparency and good governance along with improving public access to information, fixing responsibility to strengthen accountability .Key to taking the reforms further in India is reforms at the state level. That undoubtedly will require considerable brainstorming as it not only involves considerable political management but also change management. The first phase of reforms, which started in 1991, essentially concentrated on reforms at the Central government level. The second round though still incomplete looks at infrastructure, financial and labour reform and to the level of the States and district local bodies. At the same time, the need for the hour is to ideate on the third generation of reforms in India.

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