

Fiscal Refoms of States in India

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Abstract

More than a decade after the launch of the reform process, it seems that significant attention is still not paid to the fiscal reforms at state level. Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. The proposed study attempts to bring out the deteriorating trend in state finances of India in recent years and examine as to what extent the recent development of private investment by big industrialists will contribute to the reduction in public expenditure..

1 .Introduction

More than a decade after the launch of the reform process, it seems that significant attention is still not paid to the fiscal reforms at state level. Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. India's overall government spending, currently around 33% of GDP (Centre and states together) will need to be brought down substantially as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth. The states' increasingly large deficits mean their fiscal policy is an important factor not only in their own performance but in India's overall fiscal sustainability. Deteriorating finances have caused state spending on critical sectors such as health, education, irrigation, and infrastructure to decline below the levels required to make further headway against poverty. Concurrently, there has been an increase in spending on loss-making state enterprises and massive subsidies for power, water, irrigation, and transport. The remainder of the Study is organized as follows.

Section I provides overview of the Study. Section II deals with the objective, scope of study. Review of literature has also been done in this section .Section III enumerates the major causes of fiscal crisis. Section III gives analysis and assessment of the major deficit indicator of the State Governments .Section IV is with the conclusion.

Fiscal management of state governments in India is certainly a cause of worry. Fiscal position of state government in India is certainly a cause of worry. More worrisome is the fact by and large

state finances are deteriorating further with the obvious consequence of the central government finances. Finances of states are in worst shape. Revenue deficit has been rising alarmingly resulting in growing indebtedness of the government. Interest amount on its debt is presently more than what the state government spends on all economic services like agriculture, irrigation, power rural development etc.

2. Objective of study: In view of the above theoretical background the objective of the present study is to examine the background and to identify the major problem areas at state level. The Objective of the paper is to see whether fiscal reforms taken by the states for resources mobilization led to reduction in deficits. The present study level fiscal Reforms in India is to test the hypothesis that: "Fiscal Reforms have helped the states in improving their fiscal health". The study aims to test the hypothesis on macro level.

2.1 Research methodology: - Our study on the topic "Fiscal crisis 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 analyzed.

2.2 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. Rao, M. Govinda (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, Kerala, Orissa and West-Bengal for the purpose in studying the time series determinant. In this study, both the political and economic 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 summarizes 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, Stephen, Ashok, K. Lahiri and Nicholas (2000) in their article discuss 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, N.J. (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, J. Raja, Rao, Kavita R. (Jan 2002) in their paper discuss 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, N.J. (2003) in his work pointed to some extent 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 deleterious effect on regional imbalances of the country. Anand, Mukesh, Bagchi, Amaresh, Sen, K. Tapas (Jan. 2002) in their article has 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 causes leading to fiscal indiscipline among states, which call for corrective measures.

In a similar line Bagchi, Amaresh (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 beginning 10% 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, P.K. (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, J. Raja, Rao, Kavita R. (Jan 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.

3. Main causes of fiscal crisis

The principal cause for such imbalance is the fact that in spite of limited resources base that states has to cope with the significant growth in their committed expenditure like wages, salaries pension, interest payments which constitute a major portion of non plan expenditure. Causes of this imbalance are also well known the chief amongst them are the propensity of political leadership to counterproductive populism and avoidance of tough measures to stem the root. Political instability contributed to the above trend. It is not likely that there would be any drive towards financial prudence and corrective measures would be taken to stop the drain through pensions state electricity board, irrigation, state road transport corporation etc Therefore the question which assumes significance is that how long the state would sustain it.

3.1 Pensions : Salaries are such large part of government spending that they must be at the core of any expenditure restructuring effort. Salaries make up 30 percent of state governments spending. India's public private wage differentials are in fact among the highest in the world. In India about 40% of the state government employees are teachers. "Pensions are increasing at a faster rate due to the longevity of life". However, no major reform has been taken so far by state governments towards increase expenditure of salaries and pensions. As suggested by World Bank, for maintaining a policy of wage restraint will be avoidance of another pay commission leading to significant increase in real wages. New hiring is needed in the civil service in priority

areas; overall hiring restraint is justified because there are large areas of overstaffing as well as understaffing. Targeted retrenchment programmes would be the best way to free up space for new hiring but have not been successful in India. A second set of options through which much can be achieved is attrition based restructuring.

Pensions also form a mounting liability and as a source of fiscal vulnerability. Pension payments at the state government level have also risen sharply during the last 10 years. Pension expenditure of states as a proportion of revenue receipts rose from 5.4 percent in 1990-91 to more than 10 percent in 2000-01.

In the budget 2002-03, Government announced the introduction of a new restructured defined contribution pension system applicable in the first stage to new entrants to government service, except armed forces. Accordingly, the new pension system (NPS) was introduced from Jan 1, 2004 for Central Government employees recruited on or after that date. The NPS will be available on a voluntary basis to all persons including self-employment, professional and other in the organized sector. However, mandatory programmes under the Employee's Provident Fund Organization and other special provident funds continue to operate as per the existing system. The Union cabinet recently approved a proposal to introduce a legislative framework for NPS. An ordinance was promulgated on December 29, 2004 for the establishment of Pension Fund Statutory Regulatory and Development Authority (PFRDA) to undertake promotional, developmental and regulatory functions in the pension sector. However, no major measure has been taken in case of reforming the pension sector of state governments.

However, two types of reforms are underway—structural reforms to enable shifting to a cheaper and less fiscally risky defined contribution (DC) scheme and parametric reforms to contain the cost of the current pay, as you go system. GOI has announced a DC scheme for new civil servants, a scheme that will also be open to interested state governments and the unorganized sector on a voluntary basis. Several state governments have indicated their willingness to shift to a DC scheme and some have already announced that new employees will no longer be eligible for the old defined benefit scheme (Maharashtra, Tamil Nadu and H. P.)

3.2 Public Sector Undertakings: State Electricity Board and State Road Transport Corporation

A major source of revenue imbalances reflected in the disinvestment of the public sector is rooted in the poor profitability of the PSUs. The returns on capital invested by the Government in case of SEBs, and SRTC have been low.

The rationing regime that governs the supply of power to agriculture is an enormous source of fiscal pressures and discipline. The agricultural supply to farmers is unlettered and often free. Even if payments are required for electricity, they are lump sum and so the marginal cost to the consumer of an additional unit of consumption is zero. The biggest problem facing the power sector is the lack of commercial discipline in three areas that is, in the utility customer relationship, non-paying customers are frequently not disconnected and bills are often not paid. Second, is government utility relationship. Governments typically fail to compensate utilities for the losses incurred by them due to supply of power at non-remunerative rates, Third, on the utility supplier relationship utility lacking cash in part as a result of the payment defaults.

4. Deficit Indicators of State Government

The consolidated fiscal position of the State Governments showed noticeable improvement in the recent years owing to fiscal and institutional reforms, particularly the enactment of FRLs, higher devolution and transfers from the Centre as recommended by the TFC and improvement in tax buoyancy at the State level. The State Governments achieved a revenue surplus (0.6 per cent of GDP) in 2006-07 (Accounts) after a gap of nearly two decades and a historically low level of GFD (1.9 per cent of GDP). All the major deficit indicators, as ratios to GDP, were substantially lower as compared to the high level of deficits in the recent past (Table 1).

Apart from the substantial correction on the revenue account primarily owing to reduction in revenue expenditure, there was a decline in capital outlay by Rs.6,879 crore (6.6 per cent) and net lending by the State Governments in 2006-07 (Accounts) over 2006-07 (RE). This enabled the State Governments to reduce the GFD by Rs.36,405 crore (0.9 per cent of GDP) to Rs.77,508 crore (1.9 per cent of GDP) in 2006-07 (Accounts) from Rs.1,13,913 crore (2.7 per cent of GDP) in 2006-07 (RE). The consolidated fiscal position of States exhibited a primary surplus of Rs.15,672 crore in 2006-07 (Accounts) for the first time in the history of State finances. The deficit reduction envisaged in the budgets of 2008-09 reflects the commitment of the State Governments to undertake fiscal restructuring in the direction of fiscal correction path as suggested by TFC. The TFC had stipulated enactment of FRL by the State Governments as a precondition for availing the debt-relief scheme recommended by it.

Table 3: Major Deficit Indicators of State Government (as percentage to GDP)

Year	Gross Fiscal Deficit	Revenue Deficit	Primary Deficit
1990-91	4.6	2.8	2.3
2000-01	4.2	2.6	1.8
2001-02	4.1	2.7	1.4
2002-03	4.1	2.3	1.3
2003-04	4.4	2.3	1.5
2004-05	3.4	1.2	0.7
2005-06	2.5	0.2	0.2
2006-07	1.9	-0.6	-0.4
2007-08	2.3	-0.5	0.1
2008-09	2.1	-0.5	0.1

Source: Reserve Bank of India Bullentin, various Issues

5.REFORMS MEASURES BY STATES

States have also undertaken sectoral measures to improve their finances. Several states have shown interest in undertaking a comprehensive review of

functioning of states public sector undertakings (SPSUs) including the closing down of non-viable units after providing suitable safety nets to employees including voluntary retirement scheme (VRS). States such as Tamil Nadu, Kerela, Haryana, Karanataka, Himachal Pradesh, Goa and Orissa have encouraged private sector participation in the transport and power generation sectors. Karnataka has come out with the policy paper on restructuring of state public sector undertakings (SPSUs) while Maharashtra has introduced a bill for restructuring of the (SPSUs). In order to strengthen the administrative machinery many states have initiated measures to computerize their records as well as their day-to-day functioning.

Efforts to phase out inefficient PSUs were also made at state level. The leaders states include Andhra Pradesh and Orissa. According to the available information from the ministry of

disinvestments, 19 states have identified 290 state level public enterprises for disinvestments out of which AP, Karnataka, Kerala and West Bengal account for nearly half of the PEs. Restructuring or closure has been initiated in 221 of these enterprises. So far 69 units have been closed down, 33 units have been privatized

States have also initiated measures to reform the power sector, which is crucial for the fiscal reforms. The main objective of these reforms was to mobilize private sector resources for augmenting power generating capacity. The power sector reforms have assumed critical importance in recent years. The measures taken by the states in this regard relate to the constitution of State Electricity Regulatory Commission (SERCs) for determining tariff structure, unbundling of electricity boards and to separate entities for power generation. State electricity Regulatory Commission has been constituted in 21 states out of these SERCs of 15 states have issued tariff orders. The states of A.P., Delhi, Gujarat, Haryana, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh have enacted their state electricity acts. Twenty-one states have signed Memorandum of Understanding (MOUs) with the Ministry of Power, Government of India to undertake reforms in time bound manner. The Debt Swap Scheme (DSS) operated during 2002-05 and Debt Consolidation and Relief Facility (DCRF) recommended by the Twelfth Finance Commission have created fiscal space at the State level in India by reducing the expenditure on interest payments. The rule-based framework adopted under FRLs brought in fiscal discipline to the States.

6. CONCLUSION

The ambitious project announced by private participants in area of health, power housing would neutralize or not. The moot question is will the private investment driven growth will contribute towards the reduction in state financial imbalance. Experience suggests that large public debts normally crowd out private investment. Does the above mentioned development defy this logic if it is simply a lesson of one of the political party (currently in power) with the private corporate sector.

The argument is that the volume of investment depends more on private sector participation rather than the plan expenditure of the state. Thus there is a good case for attracting private sector investment in Uttar Pradesh. But for private sector participation, a good governance is a prerequisite to sustain it in long run and private sector and government both stand to gain out of it. Montek Singh Ahluwalia 2000, emphasised the importance of private sector participation. According to him, any effort to increase the total level of investment does not much depend on the plan expenditure but on importance of private sector investment. The poor performing state like Uttar Pradesh suffers from handicaps in attracting private investment. So efforts must be made to attract private investment for robust growth. Causes of this imbalance are also well known the chief amongst them are the propensity of political leadership to counterproductive populism and avoidance of tough measures to stem the root. Political instability contributed to the above trend. It is not likely that there would be any drive towards financial prudence and corrective measures would be taken to stop the drain through pensions, state electricity board, irrigation, state road transport corporation etc. Therefore the question which assumes significance is that how long the state would sustain it.

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