Federalism and Fiscal Reform in India

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Abstract

This paper attempts to analyse the experience of incentivising 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. The incentive schemes directly introduced by the central government include, accelerated irrigation benefit programme, accelerated power development and reform programme, Jawaharlal Nehru Urban Renewal Mission, education and health sector reforms. The reforms recommended by the Finance Commissions include incentivising tax reforms and fiscal restructuring and consolidation.

The review of the experiences of Indian fiscal federalism shows that the incentivising reforms have neither been an unqualified success nor have they been a total failure. There are interesting lessons to be learnt from the experiences for both designing the incentive schemes and implementing them. The paper summarises the lessons of experience. While incorporating these in designing and implementing incentive schemes can be useful in the short and medium term, what matters in the long run is the political incentive for reforms.

JEL Classification: H 30; H 71; H 74; H 77.

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Calibrating reforms in fiscal federalism is a major challenge. Although the "layer cake" perspective of fiscal federalism attempts to assign macroeconomic stabilisation and redistribution functions predominantly to the central government and a significant role to the sub-national governments in allocation, in reality, there is considerable overlapping of the functions. Furthermore, the actions of one level of government impacts on others. Besides, interdependence of economic policies necessarily results in overlapping and coordinating the policies between different levels of government is a major challenge faced in all multilevel fiscal systems. The problem is particularly important in coordinating the calibration of economic reforms as the interests and incentives of different levels of government do not necessarily coincide.

Fiscal federalism in India is faced with challenges of calibrating reforms in policies and institutions to meet the requirements of markets and globalisation. The fiscal system in the first 40 years was shaped by the requirements of public sector dominated, heavy industry-based import substituting industrialisation strategy and this has to be reoriented to respond to market-based development. The transition involves difficult initiatives in reforming both policies and institutions to ensure free flow of factors and products across the country. The states which have more developed markets and with greater market friendly environment will attract capital and skilled labour and develop faster than others. Furthermore, both central and state governments have to respond to the globalising environment. This requires creation of market-friendly policy environment and institutions. In the past, centralised planning had limited role to play in the sub-national governments in development. In addition, regulations and controls on quantities and prices introduced both as instruments to deal with centralised planning and to meet scarcity conditions, severely segmented the market.

Market-based development of the economy in a globalising environment requires significant change in the nature and quality of government intervention and in a federal fiscal system the roles of the central and sub-central governments will have to undergo a significant change. Ensuring a stable macroeconomic environment in a multilevel fiscal system requires coordination in stabilisation policies. Similarly opening up the economy results in loss of revenue from customs duty and recouping the revenue loss requires coordinated calibration of tax reforms at central and state levels. Furthermore, creating a market-friendly environment in an open economy requires provision of competitive standards of physical and social infrastructure, a tax system which raises sufficient revenue for financing public services with minimum distortions, responsive governance and ensuring climate for free flow of trade and investment across the country. While the sub-national governments will have to provide the public services assigned to them in efficient, responsive, and accountable manner, they have to calibrate counter-cyclical fiscal policy and redistribution functions in close coordination with the central government. An important precondition for market promoting federalism is the hard budget constraint because fiscally responsible decision can come only under such an environment and therefore the policies should be calibrated to avoid bail-outs and free-riding behaviour.

Calibrating market oriented policy in a globalising environment requires reforms in the institutions including reforms in federal fiscal arrangements. This includes the changes in the assignment system, institutions and mechanisms to coordinate the policies and resolve centre-state and inter-state disputes. These also involve, *inter alia*, reforms in the functioning of civil service, police, as well as judiciary. These issues of reform in institutions, discussed at length,[1] can be undertaken only in the medium-and-long term while in the short-term motivating the sub-national governments to coordinate their reforms with that of the central government will require incentives.

This paper analyses reforms in implementing fiscal policies in Indian fiscal federalism. It also analyses the mechanisms introduced to coordinate these policies between the central and state governments. Coordination in implementing policies is essential to ensure a stable macroeconomic environment, an efficient tax system, provide competitive levels of infrastructure, enable seamless nationwide market for factors and products, and to secure hard budget constraints. *Section 2* summarises the key lessons from the literature on the theories of fiscal federalism which will provide the framework for reforming both policies and institutions in Indian fiscal federalism. *Section 3* summarises some of the salient features of Indian fiscal federalism which impinge on efficiency and to underline areas requiring intergovernmental coordination in calibrating reforms. In *section 4*, we analyse and evaluate the content of reforms in incentivising the states to adhere to rule-based fiscal management, calibrating state tax reforms and in persuading the states to fast track reform in the sectors such as power and irrigation. The concluding remarks are presented in the last section.

2. Important Features of Efficient Fiscal Federalism

The theoretical developments in fiscal federalism are classified into the first and second generation theories. While the traditional theories called the first generation theories formerly assumed a benevolent state, the second generation theories draw on the developments in the theory of public choice and industrial organisation. In the first, the trade-off is presented in terms of efficiency gains from meeting diversified preferences and inability to internalise the spillovers at the sub-national whereas, in the second, the trade-off is in terms of better "accountability" of decentralised levels *versus* better coordination of policies to internalise spillovers (Seabright, 1996; Oates, 2005). There are three different strands in the second generation theories which analyse fiscal federalism in (i) the principal – agent framework; (ii) problems arising from the soft budget constraints and deriving motivation from the fiscal crisis precipitated by exploitation of "fiscal commons" leading to perverse behaviour of sub-national governments, particularly in Latin America; and (iii) outcomes from "yardstick competition" under the rubric of "competitive federalism". These developments help to identify some important features of efficient fiscal federalism which are summarised in the following.

One of the most important pre-conditions for efficient fiscal federalism is clarity in the assignment system. Not only that the assignment system should be clear as far as possible, but when there is overlapping, there should be systems and institutions to

[1] For a detailed discussion on the institutional reforms, *see*, Rao (2009) Rao and Singh (2005) especially, *Chapter 14*. *See* also Singh and Srinivasan (2006).

resolve it. Clarity in assignments does not only imply mere assignment of revenue and expenditure powers; it is also necessary to ensure that the functions of different functionaries within a level are unambiguous. Furthermore, the functions should be assigned according to comparative advantage.

An important feature of a successful system of fiscal federalism is the assignment of adequate revenue powers to sub-national governments to forge a strong link between revenue and expenditures at the margin. This is necessary for both efficiency and accountability reasons. Assignment of revenue powers is also necessary to ensure a hard budget constraint.

The transfer system should address the problem of imbalance between revenue and expenditure powers and should enable every governmental unit to provide comparable levels of public services at comparable tax rates. At the same time, it is important to ensure that the transfer system does not provide the incentive to "raid the fiscal commons". Ensuring proper incentive structure in the transfer system is critical to preventing the soft budget constraint. It is necessary to ensure that the transfer system does not enable the states to pass on the burden of their public services to non-residents. In addition to equalisation transfers, specific purpose matching (open-ended) transfer should be designed to compensate the public services provided by the sub-national governments, the benefit of which spill over the jurisdictions.

A major advantage of a multilevel fiscal system is the large common market, but the benefit can accrue only when not only all impediments to trade in factors of production as well as commodities are removed, but also mobility of commodities, capital and goods is facilitated. Ensuring a common market is at the heart of creating dynamism in fiscal federalism. Such impediments can be posed by policies restricting the movement of labour, capital, and commodities.

The literature on market promoting federalism shows that it is important to avoid soft budget constraints at both national and subnational levels. Efficient credit markets and a mature banking system alongwith a well developed debt market with efficient credit rating institutions is an important precondition for the centre to keep itself away from bailouts. Similarly, well developed land and property markets and efficient mobility of factors and products can prevent public decisions that impede the development of markets. These can promote intergovernmental competition and minimise incentives for bail outs. It is important to discourage protectionist policies at sub-national levels. Legislatively imposed constraints on deficits and requirement to balance the current budget should place a limit on fiscal expansion and ensure more productive public spending. Limitations placed on borrowings both internally and externally can also help to contain perverse incentives for fiscal expansion. It is also necessary to have well designed bankruptcy laws that specify the nature of fiscal crisis and the way it needs to be handled.

There can be gains from intergovernmental competition. Competition can lead to efficiency gains in public service provision; it can also motivate innovations and productivity increases in public service delivery. However, to reap the gains, it is important to ensure that there is a measure of competitive equality and predatory competition does not take place. Unequal competition could be destabilising and can, in the extreme, break up the federation. This is particularly important in the context of globalisation as the states with more developed markets and infrastructure can reap higher benefits from access to domestic and international markets and grow faster than those with less developed markets and infrastructure. It is also important to regulate the competition, provide a negotiating platform and resolve inter-state and centre-state conflicts.

While these are general principles, the reform of institutions in different countries will have to take account of their specific characteristics. As stated by Oates (1999, p. 1145), "While the existing literature on fiscal federalism can provide some general guidance, …my sense is that most of us working in the field feel more than a little uneasy when proffering advice on many of the decisions that must be made on vertical fiscal and political structure. We have much to learn". It must also be noted that even as institutional reforms required for achieving the desired characteristics including the hard budget constraint continue, it may achieve tangible results only in the short-and-medium-term. Furthermore, even when most of the desirable characteristics are achieved, there are important issues of coordinated implementation of reforms, be it in the area of containing deficits and debt, tax reforms, or reforms in public service delivery. In many federal countries including India, these have been addressed through providing incentives to the states. This paper analyses the effectiveness of incentivising reforms in India.

3. Salient Features of Indian Federalism

(i) *Role of the States in Indian Economy*

While much of the discussion on economic reforms in India has focussed on economic liberalisation at the central level, there is relatively less attention on the reforms at the sub-national level.[2] This is not very surprising because, despite the crying need, reforms at the state level have been slow and inadequate. This is also unfortunate because, in spite of a heavy centripetal bias, Indian Constitution assigns a predominant role to the states in the provision of social services and co-equal responsibility in the provision of physical infrastructure. In fact, education and health are state subjects and their expenditure share is over 75 per cent of the total in spite of the recent initiatives by the central government in introducing schemes for universalising elementary education through *Sarva Shiksha Abhiyan* and National Rural Health Mission. In agriculture and irrigation too, where the states have a predominant role, there are serious problems still to be tackled in terms of liberalising policies and creating infrastructure for agricultural extension, transportation, storage, and marketing. A large number of irrigation projects continue to languish at various stages for want of adequate resources to complete them. In the power sector which is a concurrent responsibility, investment by the states in recent years in generation, transmission as well as distribution is negligible mainly because the electric utilities are unable to generate the surpluses needed for reinvestment on account of irrational pricing of electricity and poor operational efficiency. Similarly, the spending by the states on both maintenance of roads and bridges and creation of state highways, district and block level roads have been grossly inadequate. Ensuring basic standards of these social and physical infrastructures is critical for inclusive development of the country. The central government has initiated several schemes involving specific purpose transfers in the areas in states' domain and has

[2] Of course, there are some notable exception to this, and these are Rao (1996, 2001), Ahluwalia (2002).

made significant investments in the areas of concurrent responsibility. The design of the transfer schemes and the reforms initiated to change policies and measures undertaken to augment investments in social and physical infrastructure need to be critically analysed.

(ii) *Impact of Political Developments*

The increased involvement of the centre in states' domain and substantial central investments in concurrent subjects is, in part, the reflection of the political developments in the country. Although, the central intrusion into states' domain by introducing a large number of central sector and centrally sponsored schemes has been in vogue for a long time, the recent political developments have resulted in the centre bypassing the states and making direct transfers to the implementing agencies with adverse consequences on both accountability and efficiency. The emergence of coalition governments at the centre, regional parties in power in the states, and some regional parties being pivotal members of the coalition, has changed objective function of the political parties in a substantial measure. The decline in the time horizon of politicians and parties has only added to the focus of governments on short term gains rather than focussing on longer term developmental agenda. In this environment, when the opposing parties to the central coalition gain power in the states, to prevent them from getting electoral gains from central spending and to assert central ownership of these schemes, the government transfers funds directly to the implementing agencies. Besides fragmenting the transfer system, this gives rise to significant issues of design and implementation mechanism.

At the state level, the political developments pointed out above have resulted in two major outcomes. The first is the increased populism in the states in terms of significantly increasing subsidies and transfers and reluctance to levy user charges on various services even when they are of "non-merit" nature. The proliferation of populist schemes at the state level for short-term electoral gains is a case in point. In the same vein, reluctance to levy user charges on services results in large implicit subsidies which is a common feature in the states. In fact, proliferation of explicit and implicit subsidies has been a major problem in Indian fiscal federalism and despite a number of studies and two white papers placed in the Parliament on the issue in 1997 and 2004, very little has been done to phase them out or target them to the intended groups. The consequences of these subsidies have not only been to increase the fiscal deficits but also to distort the allocation of resources in unintended ways.[3]

The political economy factors have impacted on the pattern of resource allocation as well. Taking up a large number of projects for implementation without adequate plan for financial closure has resulted in thin spread of resources and significant time and cost overruns in many of the infrastructure projects in most of the states. There are several irrigation and power projects, some of them initiated three decades ago, still at various stages of completion. This led the Government of India to initiate an accelerated power development programme and accelerated irrigation development programme to prioritise these projects, but despite this, the progress has

[3] The study by Mundle and Rao (1991) first drew attention to the magnitude and composition of implicit and explicit subsidies in 1991, when the economic reforms programme was initiated. Subsequently, there have been several studies quantifying the subsidies and estimating its non-merit component following the methodology given in the first study. *See* also, Rao and Mundle (1993) and Mundle (2004).

been slow and the practice of taking large number of projects and spreading the resources thinly across several projects has continued.

(iii) Resolving Horizontal Imbalances

Indian fiscal federalism is characterised by a very high degree of horizontal fiscal imbalance. The per capita net state domestic product (NSDP) in the richest state (Haryana) in 2007-08 was over 5.4 times that of the poorest state (Bihar) even when only the large states are considered. Of course, the state with the highest per capita GSDP is the small state of Goa and if this is considered, the difference between the lowest and highest per capita GSDP state is 9.5 times. In this environment, fully offsetting the fiscal disabilities of poorer states would require massive transfers to be made to them which could significantly soften their budget constraints. In any case, in the Indian context, multiple agencies giving transfers and poorly designed transfer system has resulted in only a limited equalisation. In addition, regional policy of the centre and various sources of "invisible transfers" have led to a significant volume of inequitable resource flows.[4] Given the large differences in fiscal capacities of the states and the failure of the transfer mechanism to offset the fiscal disabilities of poorer states, there are wide variations in the standards of infrastructure and services provided across states, depending on their fiscal capacity. This in turn has led to significant differences in the flow of private investments. The inability to offset the fiscal disabilities of the states has also led to the introduction of several specific purpose transfer schemes to ensure minimum standards of services.

(iv) Co-ordinating Tax Policies in Fiscal Federalism

An important issue in calibrating tax reforms in a federal system is the need to coordinate the reforms at central and state levels. Efficacy of tax reforms will be greater when the reforms are carried out in a coordinated manner. As mentioned earlier, with globalising reforms introduced in 1991, when the import duties were reduced, there was a significant decline in central revenues. In contrast to many other countries which undertook domestic indirect tax reforms to recoup revenue loss from import duties, it was not possible to undertake this in India as the power to levy sales tax vests with the states. Thus, even as the central government undertook significant tax reforms following the report of the Tax Reform Committee (India, 1991), the gross tax revenue of the central government relative to GDP declined from 10.2 per cent in 1991-92 to 8.2 per cent in 2001-02.[5]

The principle of fiscal federalism requires linking of revenue-expenditure decisions of sub national governments at the margin. However, sub-national governments may not consider the overall interest of the economy while exercising their tax powers and this may result in significant inefficiencies. It is important to ensure that the taxation by the states does not violate the principle of the common market by impeding mobility of factors and products. It is also necessary that sub-national taxes do

[4] Pinaki Chakraborty *et. al.* (2009) find that the spread of central government expenditure on social and economic services across state, is skewed in favour of high income states. Similarly, Kavita Rao (2009) finds that the distribution of subsidies implicit in tax expenditures is inequitable.

[5] Ironically, revenue from even the central indirect taxes too declined during the period. While the tax reforms in direct taxes resulted in increase in the tax revenue by one percentage point to GDP, the revenue from union excise duties declined by the same magnitude and the revenue from import duties declined by two percentage points resulting in the net decline by that amount.

not entail exportation of tax burden to non-residents. Furthermore, states may indulge in unstable competition by reducing the tax rates to attract investments or divert trade in their favour. Such a competition resulting in "the race to the bottom" only results in the states losing revenue and creating distortions in resource allocation.

Tax harmonisation both vertically between the centre and states and horizontally among different state governments is important from the viewpoint of minimising the collection cost, compliance cost, and cost to the economy in terms of the distortions disharmony creates. Of course, a uniform tax system is the most harmonious as it minimises all the three costs mentioned above. However, the very principle of fiscal federalism entails the choice to the states to vary their public service levels and tax rates. Thus, tax harmonisation in fiscal federalism involves a trade-off between welfare (efficiency) gains from fiscal autonomy and welfare (efficiency) loss from tax disharmony. While assignment of tax powers is important to link revenue expenditure decisions, it is important to ensure that individual states do not pursue tax policies that will have adverse impact on other states, do not violate the common market principle nor impede the development of markets. Any attempt to compare the tax system in unitary and federal countries, therefore, is inappropriate.

In India, the Constitution divides the tax powers based on the principle of separation. The tax powers are listed either in the union or the state lists but not the concurrent list. Although this was intended to prevent overlapping in tax powers, in effect, interdependence of tax bases of the centre and states could not be avoided. Thus, while agricultural income and wealth is subject to tax by the states, tax power on non-agricultural income and wealth has been assigned to the central government. As a result, it has not been possible to levy income tax on a comprehensive concept of income and this has opened up an important avenue for evasion and avoidance of the tax. In the case of indirect taxes, while the centre is assigned the powers to levy "excise duty on manufactured products" and through a later constitutional amendment, the taxes on services, the taxes on "sale and purchase of goods" are assigned to the states. Excise duty on manufactured products, in effect, is the manufacturers' sales tax. Thus, separation of tax powers has not prevented significant overlapping in the tax system.

The prevailing assignment of tax powers has not enabled the levy of efficient consumption tax system either by the central or state governments. At the central level, the tax on goods cannot be levied beyond the manufacturing stage and the states cannot levy integrated taxes on goods with services as they do not have powers to levy the tax on the latter. Furthermore, the central sales tax levied to track inter-state transactions has made the sales taxes levied by the states predominantly origin-based. There has been considerable attempt at reforming the tax system at both central and state levels to convert the cascading type sales taxes into value added taxes. Despite this, achieving the goal of transforming the tax system into a destination based consumption type goods and services tax continues to be a major challenge.

The state tax system in India is beset with a number of shortcomings. As mentioned earlier, the states have found it politically difficult to levy taxation of agricultural incomes except in the case of a few plantation crops and this has prevented comprehensive taxation and opened up avenues for evasion and avoidance of taxes on incomes. The long term reform in this area should essentially do away with the distinction between the sources of income. The states could be provided with concurrent tax powers to piggyback their levy on the base determined by the centre. Of course, there should be allowance to offset losses and deduction of payment of insurance against fluctuations in agricultural incomes. On the indirect taxes side, the state sales taxes, even after the reforms to convert them into value added taxes (VAT) have a narrow base as consumption of services is excluded and the continuation of the central sales tax makes them predominantly origin based. Furthermore, the entire indirect tax regime at the state level is segmented with a number of taxes coexisting such as purchase taxes, motor vehicles tax, passenger and goods tax, electricity duty, and entertainment tax which need to be unified into the goods and services tax. Finally, the state and local taxes impede free flow of goods and services across the country. While the central sales tax is a tax on the export of goods from one state to another, the levies such as entry tax and octroi are in the nature of taxes on import of goods into a local area. Administration of these taxes requires the erection of checkposts or physical barriers and this violates the principle of common market within the country. Coordinated calibration of tax reform therefore, is extremely important to evolve a competitive tax system in the country.

(v) Ensuring a Stable Macro Economy

An important precondition for a successful market promoting federalism is the prevalence of hard budget constraint at sub national levels. The fiscal arrangements instituted in the constitution recognised the importance of this and had constrained the states from having recourse to unlimited borrowing powers. Unlike the Latin American countries where unlimited international borrowing powers of the states was a cause of profligacy and bailouts resulting in soft budget constraints, the states in India do not have powers to borrow internationally. However, *Article 293* of the Constitution empowers the state governments to borrow from the domestic market, but if a state is indebted to the centre, it has to seek the permission of the latter to borrow. The plan assistance from the centre to the states until 2003-04 was partly in the form of loans. therefore, all the states are indebted to the central government. States' borrowing, in effect, means the Union Finance Ministry, the Planning Commission, and the Reserve Bank of India together determine the quantum of market borrowing to be allowed to each of the states every year.

Despite the above restriction, there are several ways in which the states have been able to soften their budget constraints. First, there are central government agencies such as the Life Insurance Corporation of India (LIC), National Bank for Rural Development (NABARD) and Housing and Urban Development Corporation (HUDCO) which have been authorised to lend money for specific sectors such as water supply, housing, and irrigation in the states. Second, the states can borrow the entire amount of subscriptions to small savings in their states from the National Small Savings Fund. Third, states may decide not to pay to electric utilities the subsidies arising from free supply of electricity to the farmers in any given year. Fourth, states can actually use the public enterprises to borrow funds from the banks to overcome their immediate requirements. Finally, in a system of cash accounting, to meet their liquidity problems, the states can collect taxes in advance from large taxpayers or delay payments to the contractors. There are also cases of the state governments securing borrowed funds from multilateral and bilateral agencies either to augment spending on specified sectors or for general budgetary support. Although the states are not allowed to borrow directly, they can persuade the centre to borrow for them and on lend the resources to the states. Although lending from multilateral and bilateral agencies to the states have reform conditions, the incentive structure and political economy may not result in enforcing the conditions and rather than improving the fiscal situation, it may in fact, further soften the budget constraint of the states (Rao and Chakraborty, 2007).

The problem with borrowing from various sources is not one of softening the budget constraint alone. There is a larger issue of coordinating the calibration of macroeconomic stabilisation policy between the centre and states. This requires exercising overall control of deficits and debt of the states at sustainable levels. Although borrowings of the states are mainly determined by the centre as mentioned above, there are instances when the states deficits are extremely high and outstanding liabilities build up to unsustainable levels. Besides securing loans which are outside the central control including the high interest bearing loans from the national small savings fund, the practice of central government advancing 70 per cent of the plan assistance as loans resulted in burgeoning deficits and build up of debt. From time to time, the Finance Commissions had to recommend rescheduling and write-off of loans. Over the years, this built the expectations of periodic write-off and demand for write-off became legitimate. The Twelfth Finance Commission finally recommended that the practice of central government lending plan assistance to the states should be given up and the loan part of the assistance should be accessed from the market. It also recommended an incentive based loan write-off to reduce the debt burden of the states as they improved their revenue deficits.

The introduction of various specific purpose transfer schemes from time to time has also led to softening the budget constraints of the states. As mentioned earlier, these schemes are in sectors belonging to either the state or the concurrent list and to the extent, the central government spends money, the states can substitute their own spending. Some of the schemes require matching contributions from the states. In the case of *Sarva Shiksha Abhiyan*, for example, the states are required to contribute 30 per cent as against the central contribution of 70 per cent. Although there no empirical studies available, it may not be incorrect to state that proliferation of central grants to augment several important social services has considerably softened their budget constraints.[6]

4. Incentivising Reforms: Indian Experience

The preceding analysis shows that effective calibration of fiscal reforms in a federal system requires proper coordination to ensure that the central and state governments do not work at cross purposes. As the states look at the reform issue from the perspective of their own electorate and not from the viewpoint of the nation, there can be significant differences in the perspectives between the centre and states in terms of both speed and content of reforms. In particular, macroeconomic stabilisation is mainly the function of the central government, but the states may not be interested in tightening their belt. Similarly, although the resources for anti-poverty intervention will have to be raised from the national taxpayer, implementation of these policies will require the cooperation of the state and governments. The information on who the poor are, where do they reside and why are they poor is available locally and therefore, the

[6] The soft budget constraint is the reason for some of the states introducing populist schemes for short term electoral gains such as giving free colour TV sets to the poor in Tamil Nadu or not charging for various services including free and unmetered supply of electricity to the farmers in several states.

governments closest to the poor are the ones most suited to implement these policies. Even in the case of undertaking the allocation function, the priorities and perspective can differ widely and coordinating the implementation of policy reforms is essential.

In this section, we discuss the experience of the central government providing incentives to the states to carry out fiscal reforms in India in terms of their efficacy. We discuss the extent of success in providing incentives to the states to complete their long pending irrigation and power projects. We also examine the effectiveness of the incentives provided for improved fiscal management of the states, specifically in terms of containing their fiscal and revenue deficits. Another important reform selected for some detailed analysis is the incentive provided to undertake tax reforms at the state level. Finally, the paper critically evaluates as many as 12 grants made by the 13th Finance Commission for undertaking reforms in a variety of areas. While the incentive based reforms in irrigation and power sectors were introduced by the central government directly, the reforms to draw the roadmap for fiscal consolidation, incentivise the adoption of GST and a variety of other grants given in diverse areas have been based on the recommendations of the Finance Commissions.

(i) Incentive Based Reforms Directly Introduced by the Central Government.

(a) Accelerated irrigation benefit programme

Irrigation is an important economic service in which the states play a major role. Given that agriculture as well as water resources are subjects assigned to the states in the constitution, although inter-state river water is the domain of the central government. Irrigation is an essential infrastructure for enhancing the agricultural productivity and therefore, over the years, the state governments have made substantial investments. Given the importance of the investments in enhancing agricultural productivity and due to political pressures, the states have initiated large numbers of irrigation projects without proper financial closure of the projects. This has resulted in thin spreading of investments and consequently heavy cost and time overruns. Moreover, poor maintenance of assets created, improper distribution of available water and commercial non-viability of even those projects that are categorised as commercial are other areas of concern. In some states like Karnataka, irrigation projects were initiated even when there were objections from the lower riparian states and these were started as non-plan projects.

Accelerated Irrigation Benefits Programme (AIBP) was started by the central government to provide funds to facilitate completion of ongoing large and medium irrigation projects that could be completed within four years so that their benefits are availed of relatively quickly. For projects in Kalahandi, Bolangir, and Koraput (KBK) districts of Orissa, funding for project start was also available. Similarly, although only one project at a time was to be funded in a state, projects dating back to the Fifth Plan or earlier could be taken up together. For getting funding, only a project that did not have any other funding except through the budget was normally considered.

The funding pattern has undergone frequent changes. Initially started as a 50 per cent (of remaining project cost) loan assistance programme in 1996-97, it changed to a 66 per cent loan assistance for general category states and 75 per cent loan assistance for special category states in 1999-2000. These changed to 80 and 100 per cent respectively in 2002-03 for those states that agreed to undertake specified reforms.

During 2004-05, 30 per cent of the assistance to general category states and 90 per cent of the same to special category states were converted into grants. In 2005-06, only the grants part was provided to the states, asking them to raise the loan part within its own borrowing programme. In 2006-07, further changes were made with assistance amounting to 25 per cent of approved project cost for general category and 90 per cent for special category states (also for defined drought-prone areas and flood-prone areas as well as the KBK districts of Orissa, and tribal areas) were provided as grants; the states were to raise the rest on their own. Figures for actual releases since the start of the programme show that the biggest beneficiaries of this programme have been Maharashtra, Gujarat, Andhra Pradesh, Madhya Pradesh, Orissa, and Uttar Pradesh.

Frequent changes in the funding pattern have caused some uncertainty among the states about the reliability of projected resource flows. This being a proposal based system of allocation of funds, states with greater expertise in project preparation with adequate documentation have an advantage. Further, because of the counterpart funding requirement, relatively poor states have not been able to take advantage of the programme to the full; their high levels of indebtedness make them wary of further debt. This is in fact a more general point that applies to most programmes with matching requirements.

(b) Accelerated Power Development and Reform Programme (APDRP)

The availability and quality of power supply has become one of the major constraints to economic growth in India. In this sector, distribution (largely in the public sector under state electricity boards or companies) has been identified as the key problem area, impacting other aspects of power supply too. Hence, reform in the distribution of power has been a public priority for some time. Among various initiatives including fresh legislations during the last decade, Accelerated Power Development Reforms Programme (APDRP) was a central government initiative to provide the state level power utilities adequate funds for undertaking the necessary measures to strengthen the power transmission and distribution system through upgradation of worn-out assets, reduced power losses, improve commercial viability with universal metering and pricing, and such other steps. The funding was through central assistance to the tune of 50 per cent of the approved project costs, of which half was given as grant, and the other half as loan. The states were to raise the other 50 per cent as counterpart funds, through loans from sector-specific sources like Power Finance Corporation or any other source of their own, including market borrowing.

With 75 per cent of the project costs to be financed through loans, the states were not too enthusiastic about this scheme; moreover, the various constraints faced by such major reforms (strong vested interests) proved to be serious enough to produce only limited impacts. The scheme has been revamped recently with a prefix ‘R’ added (for revised) as a central sector scheme. It has two parts: the first covers introduction of information technology (IT) for generating baseline data, energy auditing and accounting, and consumer services; the second part addresses the usual problems of power distribution (the key requirement being reduction of power losses). R-APDRP has a significantly different funding pattern, even though it is still based on loans; it is provided that the loans will be converted to grants upon successful achievement of the targets to the extent of the full amount for the first part of the scheme (IT) and up to 50 per cent of the loans for the second part. Thus it is intended to be a results-based grant programme.

The entire gamut of reforms in the power sector is, of course, far wider in scope starting from the reorganisation of the sector through unbundling of the generation, transmission and distribution aspects, corporatisation, privatisation and setting up of state level Electricity Regulatory Commissions (ERC) to improvement in delivery and pricing of power. Some of these have been adopted by a large number of states (e.g. unbundling and setting up of ERC), while some others have not been adopted by many states (complete privatisation of distribution has been undertaken by only two states – Orissa and Delhi). Since several reforms in this sector are complementary to one another, the success of R-APDRP also cannot be taken for granted.

(c) Urban reforms

Jawaharlal Nehru National Urban Renewal Mission (JnNURM) is a central government programme for urban development with two broad sets of objectives – (a) improvement in the coverage and supply of urban infrastructure along with rejuvenation of urban local bodies; and (b) tackling the problem of urban slums through resettlement and other measures and providing basic services to the urban poor. Areas covered under (a) include urban transport, sewerage and sanitation, water supply, and construction of public facilities, among others. Assistance is given to implementing agencies, usually urban local bodies, parastatals or special purpose vehicles set up to carry out the proposed programmes, on the basis of city development plans prepared by them. The assistance is provided as grants, with the expectation that these resources would be adequately leveraged by generating further investment including private investments.

(d) Education sector reforms

In the area of elementary education, *Sarva Shiksha Abhiyan* (SSA) or 'Education for All' programme has been a large central government intervention to speed up full coverage of children aged 6-14. The basic idea that drove this programme was to substantially increase access to education through establishment of primary schools within one km. and upper primary schools within 3 km. of every village with a minimum prescribed population. Thus, the focus was on school infrastructure and included assistance for repairs and maintenance, and additions to existing infrastructure as per norms. Additionally, the programme provided for assistance towards district level and block level resource centres, teachers' training, teaching-learning material and a small untied grant for teachers. Some encouragement was given in the scheme to build up the stake of the local bodies and parents of schoolchildren in the affairs of the school as well. Assistance was available for innovative activities (left unspecified) too. However, the overwhelming part of the cost of providing education, namely the salaries of teachers remained by and large the responsibility of the state governments.

The funds were provided on the basis of annual work plans built up from the block level to arrive at the state level plan. Thus, the assistance was formally demand-driven in nature. The assistance was envisaged as a matching grant programme starting with 85:15 ratio, with the state contribution gradually rising over a period of ten years to 50 per cent. With some interim modifications, the terminal sharing ratio will be applicable in 2011-12. A special education cess was levied on income tax to defray the cost of this programme. A condition of at least maintaining the state's own base year expenditure was imposed to ensure additionality of SSA expenditures. While this programme has largely succeeded in meeting its immediate objective of filling the infrastructure gap, states are somewhat worried about the large number of additional teachers that have been appointed for the new or expanded schools as per norms. The salary of these additional teachers would be a substantial additional expenditure for the states, coupled with the rising share of annual SSA costs. There have been some questions raised about the actual pattern of assistance across states; these do not seem to be inversely related to educational attainment indicators, as one would expect. Within states also, district-wise patterns indicate the same feature.

The surge in reported enrolments and retention rates in elementary education were aided by the implementation of the central government mid-day meal programme. Formally introduced earlier, it was seriously implemented only after the Supreme Court exhorted the central and state governments to do so at the turn of the century. This is a scheme that was actually a state level initiative originally, with the state of Tamilnadu definitely the leader. Under this scheme, foodgrains are supplied by the central government along with a specified amount for defraying cooking costs, the state government supplying the other foodstuff.

(e) Health sector reforms

National Rural Health Mission (NRHM) is the major central government programme in the area of health, primarily the domain of the states. It has an evolving structure, having begun in 2005 by putting together a number of disease specific programmes. This programme also has elements replicated from state level innovations like *in situ* female health workers with basic training (e. g. *Mitanin* in Chhattisgarh) or low cost insurance (Karnataka).

This programme began as a fully grants-based assistance system, changing into 85:15 (centre: state) cost sharing during the 11th Plan and then to 75:25 during the 12th Plan. Safeguards are being put in place to ensure that central assistance does not substitute states' own expenditures. The allocation of available funds among states is not on the basis of any prescribed formulae but district plans collated at the state level.

(ii) Reforms Undertaken on the Basis of the Recommendations of Finance Commissions

(a) Tax reforms

As mentioned earlier, the lack of coordination in tax reforms was one of the reasons for the decline in the tax ratio during the decade of 1990s. Although the Tax Reform Committee (India, 1991, 1993) and the NIPFP study on domestic trade taxes (NIPFP, 1994) provided the blueprint for reforms and there was considerable discussion among the states through the Committee of State Finance Ministers, which was renamed as the Empowered Committee of State Finance Ministers, the actual implementation lagged behind. There was some attempt at harmonising the sales tax system to avoid tax competition, but the reform transforming the cascading type sales taxes with several rates to a value added tax with two rates was not accomplished until April, 2005. Even with this reform, the central sales tax which makes the tax system predominantly origin based has continued and there are still problems of relieving the taxes on inter-state transactions.

Implementing a major reform like the value added tax at the state level required the centre to assure that the loss of revenue if any, owing to implementation of reforms, will be compensated fully by the central government. Interestingly, as the economy during 2005-08 experienced high growth rates averaging more than 9 per cent, and due to better tax compliance resulting from the introduction of VAT, actual compensation paid to the states in four years beginning 2006-06 amounted to about Rs. 10095 crore which is less than 0.1 per cent of the sales tax collection.

Even after the introduction of VAT, the tax base continued to be narrow and a large number of other consumption taxes co-exist with the VAT. The narrow base is due to the fact that the states can levy taxes only on goods and not on services. Besides, there are a large number of exemptions (not the same set) in every state. There are several other consumption taxes which contribute to inefficiency and distortions and some of them impede the free flow of goods across the country. Considering these and based on the recommendations of the Task Force on Indirect Taxes (India, 2003) and later, the Report of the Task Force on the implementation of FRBM Act, the Union Finance Minister, in his budget speech of 2006 stated, "…It is my sense that there is a large consensus that the country should move towards a national level Goods and Services Tax (GST) that should be shared between the centre and the states. I propose that we set April 1, 2010 as the date for introducing GST".

It was generally presumed that the GST will be a game changer and the tax reform needed to make the tax system efficient and productive. Therefore, the 13th Finance Commission, in its ToR was required to take into account, "…the impact of the proposed implementation of Goods and Services Tax with effect from 1st April, 2010, including the impact on country's foreign trade" and not work out the detailed modalities of implementation itself. Instead, the Commission went about detailing the outline of "the model GST" – with features such as minimum exemptions, a single rate of tax on all goods and services uniformly levied across states, zero-rating of exports, and ensuring destination based tax to ensure seamless trade across the country. It also recommended the "grand bargain" to be conducted between the centre and states with six elements namely, the design of GST to evolve the model GST, operational modalities, binding agreement between the centre and states with contingencies for changing rates and procedures, implementation schedule, disincentives for non-compliance and the procedure to claim compensation. It recommended a compensation package of Rs 50000 crore for any loss of revenue and that if all elements of the grand bargain are not satisfied, the compensation will not be payable.

Any desirable tax reform should minimise the cost of compliance as well as the distortion cost while not increasing the cost of collection (Bird and Zolt, 2004) and GST reform is expected to minimise all the three costs though, the claim made by the NCAER study that the levy will result in an estimated GDP increase in present value terms between Rs 14.69 crore and Rs 28.81 crore seems to be much too exaggerated. Although the detailed methodology of the study is not available even in the NCAER study report, the very fact that the study is based on 2003-04 input-output table indicates that the productivity gains since 2003-04 including those arising from the introduction of VAT replacing the cascading type sales tax has not been taken into account. In any case, with the type of shortcomings in the quality of data, to place faith in such estimates demands a leap of faith. This is not to state that the reform is not important. Surely, this will not be a "game changer" as the 13th Finance Commission believes. In fact, the introduction of VAT was a game changer and the GST reform should be seen as only the next step in the reform process.

The point is that tax reform is a process and not an event and if the design aspects are not negotiable in the "grand bargain", it is doubtful whether the reform can go further at all. Even more retrograde was the estimate of revenue neutral rates made by the GST task force. There are several problems with these estimates and to take four different estimates and taking an average shows that the task force itself does not have the conviction in any one of the methods (Rao and Chakraborty, 2010). While everyone desires that the rate of tax should be low, to show a highly underestimated rate as revenue neutral as the task force did, forced the states to adopt extreme positions. Not only that the revenue neutral rate estimated by the task force is far below what the states believe it to be, but there are wide variations in the revenue neutral rates across states. Thus, even if the central government gives compensation for three years, if there is a permanent decline in the revenues, the states with high revenue neutral rates fear loss of revenue, legitimate concern.

It is important to note that the consumption tax reform involving the central and state governments will have to make a compromise between tax uniformity and fiscal autonomy. While the aim should be to get the fundamentals of the reform right, compromise is unavoidable and the solution may have to settle at less than the best from the point of view of tax uniformity but allow some measure of fiscal autonomy. To state that the "GST grant compensates for the seeming limitation in fiscal autonomy by enhancing expenditure autonomy through compensation payments and additional formulaic transfers" (p. 71), is to misunderstand the concept of fiscal autonomy altogether. First, compensation is given against the loss of revenues and not a bribe for adopting the GST reform. Second, fiscal autonomy under fiscal decentralisation means manoeuvrability to change standards of public services by changing tax rates and not simply softening the budget constraint to spend more money.

Indeed, ideal design should be the goal, but in many states the socio-political considerations may not allow them to adopt uniform minimum exemptions and a single uniform rate. In fact, even as economists recommended moving over to a single rate of VAT in Sweden recently, the government found it impossible to change over to a single rate. Everyone knows that equity is better served by better targeting expenditures and not by having high and multiple rates and yet, political perceptions are hard to change. Bird and Gendron (2007, p. 13) show that in European Union the standard rate of VAT varied from 15 to 25 per cent with a mean of 19.4 per cent and except for Denmark, every other European country has one or more rates in addition to the standard rates. It is not to argue that having multiple rates is desirable and surely, every effort should be made to minimise rate differentiation from the viewpoint of reducing the collection cost, compliance cost to the taxpayers, and distortions in the economy. But these are political decisions and compromises are unavoidable. The Commission's approach of insisting on "all or nothing" rules out compromises altogether.

The recommendations of the 13th Finance Commission have pushed the states to a defensive position and each state has been increasing the tax rate on the prevailing VAT with a view to secure assurance on adequate compensation if and when the reform is undertaken. Thus, in some ways the report of the Task Force of the 13th Finance Commission has been retrograde. Of course, the entire reform now is mired in controversy and each state has taken a bargaining position it considers appropriate, even as the Union Ministry of Finance has assured the states that it will provide compensation for any loss of revenue. In any case, it is unlikely that the reform will be implemented even in April, 2011 and hopefully, the issues pertaining to constitutional amendment and the structure and operational aspects of the dual GST will be resolved in time to implement the reform at least by April, 2012.

(iii) Fiscal Restructuring and Consolidation Reforms

(a) Recommendations of the 11th Finance Commission

The latter part of the 1990s saw a sharp deterioration in the fiscal situation at both central and state levels. Most analysts attribute the problem to significant pay and pension revision, but there are other important factors that contributed to the deterioration. These include sharp decline in the central revenues from customs and excise duties, increase in the interest burden due to both increasing volume of indebtedness and higher interest rates and continued proliferation of subsidies and transfers. The gross tax revenue of the centre relative to GDP declined from 10.2 per cent in 1991-92 to 8.2 per cent in 2001-02 and this was due to two percentage point decline in customs duties, one percentage point decline in union excise duties which was offset by one percentage point increase in direct taxes. Interest payments as a ratio of central revenues increased from 40.3 per cent in 1991-92 to 53.4 per cent in 2001-02. Even as revenue receipts relative to GDP showed a declining trend, the revenue expenditures as a ratio of GDP increased from 6.8 per cent in 1991-92 to 14.1 per cent in 2001-02. All these factors culminated to create the worst fiscal imbalance scenario in 2001-02 with the revenue and fiscal deficits as ratios of GDP at 7 per cent and 10.3 per cent respectively (*Table 1; Figure 1*).

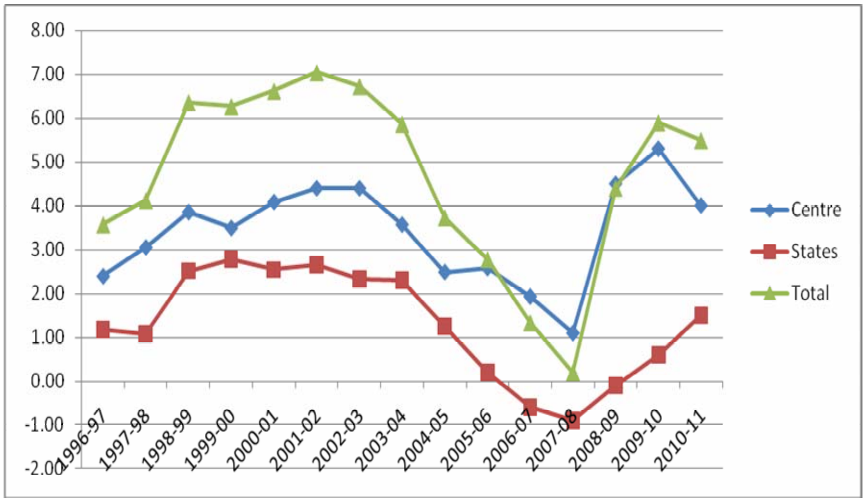
Table 1: Fiscal Indicators of Central and State Governments

(percent of GDP)

	State			Centre			Consolidated		
	Revenue deficit	**Primary deficit**	**Fiscal deficit**	**Revenue deficit**	**Primary deficit**	**Fiscal deficit**	**Revenue deficit**	**Primary deficit**	**Fiscal deficit**
1996-97	1.2	0.9	2.7	2.4	-0.2	4.1	3.6	1.3	6.4
1997-98	1.1	0.9	2.9	3.1	0.5	4.8	4.1	2.1	7.3
1998-99	2.5	2.2	4.3	3.9	0.7	5.1	6.4	3.7	9.0
1999-00	2.8	2.4	4.7	3.5	0.8	5.4	6.3	3.8	9.5
2000-01	2.5	1.8	4.3	4.1	0.9	5.7	6.6	3.7	9.5
2001-02	2.7	1.4	4.1	4.4	1.5	6.2	7.0	2.9	10.3
2002-03	2.3	1.3	4.1	4.4	1.1	5.9	6.7	2.4	10.0
2003-04	2.3	1.5	4.4	3.6	0.0	4.5	5.9	1.4	8.9
2004-05	1.2	0.7	3.4	2.5	0.0	4.0	3.7	0.6	7.4
2005-06	0.2	0.2	2.5	2.6	0.4	4.1	2.8	0.6	6.6
2006-07	-0.6	-0.4	1.9	1.9	-0.2	3.4	1.3	-0.6	5.3
2007-08	-0.9	-0.65	1.4	1.1	-0.9	2.7	0.2	-1.6	4.1
2008-09	-0.1	1	2.6	4.5	2.6	6	4.4	3.6	8.6
2009-10 (RE)	0.6	2.1	3.2	5.3	3.2	6.7	5.9	5.3	9.9
2010-11 (BE)	1.5	2.8	3.5	4.0	1.9	5.5	5.5	4.7	9.0

Source: Budget Documents of Central and State Governments

Figure1: Fiscal Imbalance in India



Although macroeconomic stabilisation is predominantly a central function, coordination in fiscal management is extremely important in calibrating counter-cyclical fiscal policy. Right from the late 1980s, lack of fiscal discipline at both central and state levels has been a matter of concern and various Finance Commissions beginning the Sixth have expressed their misgivings about this. However, it is expected that the central government will behave in a responsible manner as the adverse consequences of poor fiscal management could impact electoral outcomes. In order to motivate the states to follow fiscal discipline, providing appropriate incentives was thought to be the right method. Thus for the first time, the Eleventh Finance Commission (EFC) was given the task of *inter alia*, "review the state of finances of the Union and States and suggest ways and means by which the Governments collectively and severally may bring about a restructuring of the Public Finances so as to restore budgetary balance and maintain macro-economic stability." As the main report was subjected to criticism[7] that the commission did not consider the fiscal performance of the states, an additional term of reference was given to "…draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the State and recommend the manner in which the grants to the states to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme."

The Commission pooled 15 per cent of the fiscal gap grants it had recommended in the main report and added an equal amount from the centre to create an incentive fund and allocated it according to the population shares of the states. Individual states were to get this incentive amounts in full on the basis of the extent to which they fulfilled the single monitorable target – a minimum improvement of 5 percentage points in the ratio of revenue deficit/surplus and revenue receipts every year with 1999-2000 taken as the base year. The available incentive grant was not to lapse for any state until the last year of the award

[7] The severest criticism was by the Chief Minister of Andhra Pradesh whose party was a pivotal coalition partner at the centre.

period, when the lapsed amounts were to be added to total pool available for qualifying states. The Ministry of Finance, Government of India, was the agency implementing the scheme and a Monitoring Committee was also set up with official and non-official members to oversee the implementation of the scheme.

This scheme was to be elaborated though a Medium-Term Fiscal Restructuring Policy (MTFRP) by each state, with the MTFRP aiming for compression of gross fiscal deficit to 2.5 per cent of GSDP, reduction of revenue deficit to zero, and limiting interest payment to less than 18-20 per cent of revenue receipts. Specific recommendations on the medium-term growth of salaries and wages and interest payments, as well as reduction in explicit subsidies were also made. Four areas were singled out for special attention in the context of reforms – (a) fiscal reforms including those in taxation, non-tax revenues, public sector employment and public expenditure; (b) power sector reforms; (c) restructuring of public sector undertakings; and (d) budgetary reforms, particularly in the context of enhancing transparency.

There were a number of problems with both design and implementation of the proposed scheme. First, the volume of incentive linked grants was too small to make any significant difference to the outcomes. As far as the design is concerned, monitoring of fiscal performances of the states was done on the basis of the single measure of revenue deficit to revenue receipts ratio. Each state, irrespective of the *level* of its deficit has to reduce the percentage of revenue deficit to its total revenue by 5 percentage points if it was to get the incentive linked grant. Thus, the size of the prevailing revenue deficit was not a consideration in setting the target for deficit reduction. Furthermore, the denominator in the performance measure, revenue deficit to revenue receipts can change not only due to states' own effort but also due to changes in the volume of central transfers. The main issues were that there were too many recommendations that were not necessarily consistent with the desired change in the single monitorable indicator. The idea of making grants-in-aid to meet assessed deficits conditional upon reforms were also debated. These have been discussed in detail in the literature and the 12th Finance Commission which was asked to review the scheme did not recommend its continuation.

(b) 12th Finance Commission

The finances of both central and state governments started showing improvement since 2001-02, due to improved tax collections owing to the acceleration in the growth of the economy and due to the higher base effect, as the salary hike was already completed. Even so, because the structural causes of fiscal imbalance had not been addressed, concerns on large deficits persisted. In fact, in spite of the fiscal reform facility introduced by the Eleventh Finance Commission, the fiscal deficit of the states relative to GDP increased from 4.64 per cent in 1999-2000 to 4.97 per cent in 2003-04 as against the target of 2.97 per cent, and the revenue deficit declined only marginally from 2.82 per cent to 2.67 per cent as against the target of eliminating it. Therefore, the ToR of the Twelfth Finance Commission (TFC) stated, "The Commission shall review the state of the finances of the Union and the States and suggest a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth" (India, 2004).

The Commission worked out a restructuring plan and set the target for the consolidated fiscal deficit at 6 per cent of GDP; the revenue deficit was to be eliminated by 2009-10. The target for the centre was set at 3 per cent of GDP and for each of the states at 3 per cent of GSDP. It recommended that each of the states should enact a fiscal responsibility legislation with a view to eliminate revenue deficit and compress fiscal deficit to 3 per cent of GSDP by 2008-09. This was made a precondition for availing the debt relief and followed a two-pronged approach: first, a general scheme of debt relief applicable to all the states and second, a write off scheme linked to improvement in fiscal performance. The Commission consolidated and rescheduled the central loans to states until end March 2005, repayable in 20 years and bearing an interest rate of 7.5 per cent. The repayment due of central loans to states after the consolidation and rescheduling during 2005-06 to 2009-10 was to be written off by the extent of absolute reduction in the revenue deficit as compared to the base year (average of 3 years, 2001-04).

Interestingly, there has been a significant improvement in the fiscal situation at both central and state levels since 2003-04 until 2008-09, when it deteriorated sharply because of a variety of factors. The consolidated fiscal deficit declined relative to GDP from 8.9 per cent in 2001-04 to 4.1 per cent in 2007-08 (*Table 1*). Similarly, revenue deficit declined from 5.9 per cent in 2003-04 to 0.2 per cent in 2007-08. Furthermore, improvements were seen at both central and state levels (*Figure 1*).

In 2008-09, however, there was a sharp reversal of the trend. The fiscal deficit increased sharply from 4.1 per cent in 2007-08 to 8.6 per cent in 2008-09 and further to 9.9 per cent in 2009-10. Similarly revenue deficit increased from 0.2 per cent in 2007-08 to 4.4 per cent in 2008-09 and further to 5.9 per cent in 2009-10. Deterioration in the fiscal situation was seen both at the central and state levels though it was much more in the former.

Was the improvement in the fiscal situation until 2007-08 attributable to the fiscal restructuring plan of the TFC? The answer to this question is seen in the detailed analysis of the fiscal performances of the centre and states.[8] There were a number of problems in achieving the targeted reduction in revenue and fiscal deficits. First, the central government resorted to a lot of "creative accounting" to push deficits outside the budget such as issuing oil and fertiliser bonds. Second, even with this, the centre could not achieve the target of phasing out revenue deficit and even in the best year (2007-08) it was one per cent of GDP. Third, to the extent that there was improvement in fiscal deficit, it was mainly due to increase in the income tax revenues and to some extent revenue from service tax. The former increased mainly due to the introduction of tax information network (TIN) and its effective implementation. This was also partly due to the swapping of high interest bearing with low interest bearing debt. However, non-interest bearing expenditures continued to increase contrary to the detailed restructuring plan worked out by the Task Force for the Implementation of FRBMA. (India, 2004a). Thus fiscal responsibility legislation has had very little to do with the improvement.

As far as the states are concerned, between 2003-04 and 2007-08, there was 2.8 percentage point improvement to GDP in the revenue deficit position and this has helped to reduce the fiscal deficit by 2.1 percentage points. It is also seen that improvement in the revenue deficit due to larger revenue collections was 2.1 points or about 78 per cent and the expenditure reduction was only due to lower interest payments. Of the 2.1 points improvement in revenues, the contribution of own tax revenues was 0.7 points and tax devolution and grants from the centre contributed to 1.4

[8] For a detailed analysis of the fiscal trends in centre and states, *see,* Rao (2009).

percentage points improvement and the latter was mainly due to the buoyancy of income tax and service tax revenues. On the expenditure side, the adjustment was only 0.6 percentage point and this is almost entirely due to lower interest payments. Besides lowering of interest rates due to the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and to some extent, write off of debt repayment as per the recommendation of the TFC have contributed to the improvement.

Surely, economic slowdown in 2008-09 has adversely impacted on the state finances significantly. Available information on the revised estimates for 14 states for 2008-09 shows that the position has deteriorated as owing to the slowdown in the economy and declining tax devolution and the revenue surplus is likely to be reduced by about 0.2 per cent of GDP and fiscal deficit might increase by about 0.7 per cent. Most of the states for which information is available only began to undertake the pay revisions and when the fiscal positions in other states are also considered, the states taken together may not generate any revenue surplus and may end up with the fiscal deficit of about 3.5 per cent of GSDP which is equivalent to 3 per cent of GDP. While these targets conform to the targets set by the TFC in the fiscal restructuring plan, the situation is far from being comfortable. This is because, in the following year (2009-10), when the impact of pay revision in all the states are more substantially effected and the impact of economic slowdown on the states' own tax revenues and tax devolution is taken account of, substantial revenue deficit is likely to re-emerge and the fiscal deficit may therefore increase substantially.

Was the deterioration in the fiscal health in 2008-09 due to the fiscal stimulus given to combat the economic slowdown? A closer examination shows that the slippage was mainly because there was significant under provision of expenditures in the 2008-09 budget estimates and during the course of the year expenditures had to be provided to fund the commitments made in the budget. Although the budget speech announced the implementation of the recommendations of the Sixth Pay Commission, increase in the coverage of the National Rural Employment Guarantee from 200 districts to 600 districts, introduction of the loan waiver scheme and additional allocation to various flagship programmes, expenditure liabilities on these accounts were not included and therefore, a massive supplementary demand had to be placed in the Parliament. Thus, the deterioration in the fiscal situation was not due to any stimulus package, though, these expenditures certainly provided additional stimulus to the economy. At the state level too, the implementation of pay revision has resulted in both revenue and fiscal deficits exceeding the limits placed by the fiscal responsibility legislations.[9] Of course, two states, Sikkim and West Bengal did not choose to enact the legislations; also Punjab and Kerala, even when they passed the legislations, observed the targets only in their violation.

(c) Thirteenth Finance Commission

The revised road map for fiscal consolidation charted by the 13th Finance Commission is, in many ways, a continuation of the map laid down by the 12th Finance Commission. The fiscal deficit target is set to be consistent with the targeted debt to GDP ratio. The consolidated debt to GDP ratio is targeted to decline from 78.8 per cent

[9] The deficit targets were relaxed by 0.5 per cent in 2008-09 and a further 0.5 per cent in 2009-10. Even so, several states appear to have exceeded the revised deficit targets.

in 2009-10 to 67.8 per cent in 2014-15. In consistence with this, the fiscal deficit is supposed to be reduced from 9.5 per cent to 5.4 per cent during the period. The central government is required to reduce its outstanding debt to GDP ratio from 54.2 per cent in 2009-10 to 44.8 per cent in 2014-15 and its fiscal deficit target is set to reduce from 6.8 per cent to 3 per cent and revenue deficit from 4.8 per cent to a surplus of 0.5 per cent during the period.

The 13th Finance Commission has recommended the revised roadmap for fiscal consolidation and in order to impart effectiveness to the process, it has made a series of recommendations to make the FRBM process (i) transparent and comprehensive; (ii) sensitive to countercyclical changes; and (iii) institute a system to effectively monitor the compliance. The measures to make the system comprehensive and transparent include preparation of a more detailed medium term fiscal plan (MTFP) to put forward detailed estimates of revenues and expenditures and to make it a statement of "commitment" rather than merely one of "intent". It has recommended a number of micro measures such as putting forward the economic and functional classification of expenditures as a part of MTFP, preparing the detailed statement on central transfers to states, reporting compliance costs on the major tax proposals, presenting the revenue consequences of capital expenditures, fiscal fallout of PPPs, preparation of an inventory of vacant land and buildings valued at market prices by all departments and enterprises. The Commission has recommended that the values of parameters underlying the projection of revenues and expenditures in the MTFP should be made explicit and the band within which the parameters can vary when there are exogenous shocks while remaining within the FRBM targets. It has also recommended that the nature of shocks warranting the relaxation of FRBM targets should be specified. The stimulus to the states should be in terms of larger devolution rather than increased borrowing limits and the centre should meet this additional cost. Most importantly, the Commission has recommended the setting up of a committee which will eventually transform into a Fiscal Council to conduct an annual independent public review and monitoring of the FRBM process. The Council should be an autonomous body reporting to the Ministry of Finance, which in turn should report to the Parliament on matters dealt with by the Council.

Many of the recommendations are important, but the question is whether the Commission has gone beyond its mandate to micro manage the process. In fact, some of the recommendations such as keeping the inventory of land and buildings are important to ensure the comprehensiveness of the budget but may not be feasible for the immediate implementation of the FRBM. For the present, it should be enough to make both the centre and states to get a comprehensive picture of their financial assets and liabilities including the list of guarantees given. Of course, requirements such as presenting compliance costs of various tax proposals have formidable data problems with the taxpayers unwilling to disclose the costs such as the amount of bribe paid to tax officials. The NIPFP study in 2002 by Arindam Das-Gupta had to rely on a small sample to make the estimates. Experience has also shown that FRBMA can be successful only when the government, not just the Finance Ministry, has a strong will to embrace fiscal discipline. Mere passing of the FRBMA and presenting the detailed MTFP with all the details recommended does not translate the intent into commitment. Has the government not been presenting the documents on outcome budgeting and revenue foregone from various tax exemptions and concessions without much effect? Furthermore, without the involvement of the various spending departments in the preparation of MTFP, it will be impossible to ensure discipline from them. How much faith can we repose on the capacity of the proposed committee which will evolve into a Fiscal Council to undertake independent review and monitoring of the process? Given that the Council will be appointed by the Finance Ministry and will report to it, how independent will the review be and how effective will the monitoring process be? In any case, without the government's willingness, institutions cannot ensure fiscal discipline and it remains to be seen, how far the Government will move in this direction.

An important feature of the 13th Finance Commission's recommendations is a plethora of conditionalities imposed on both central and state governments. Ideally, the recommendations implementing the reforms should rely on the mechanism of incentives to enforce them and specific purpose transfer is the most important instrument used. When properly designed, these can be very effective, particularly in altering the spending priorities of the states to ensure minimum standards of services in respect of services with significant inter-state spillovers. In some cases incentives should be mixed with penalties in order to make the conditions effective.

Surely, there are economic reasons for giving conditional transfers and stipulating conditions is a part of providing incentives to ensure provision of normative minimum standards of the specified service. In designing the conditions and recommending implementation mechanisms, however, some important factors must be kept in mind. First, the incentives should be sufficiently sizeable and effective to make the parties comply with the conditions. Second, it is important to ensure that the conditions imposed are within the capacity of the parties to comply. Third, the conditions should be well designed. It is particularly important to target the conditions to ensure that the penalty for failure to comply will be on the non-compliant, and not others. Furthermore, the targets should be realistic and when the issue involves negotiations and agreements between the centre and states on the one hand and among the states *inter-se* on the other, although it is desirable to set ideal targets, in the given environment of political economy, the conditions should be flexible enough to accommodate departures from the ideal.

As mentioned above, the 13th Finance Commission has recommended a plethora of conditions both to ensure minimum standards of expenditure and to incentivise central and state governments to undertake reforms. Indeed, both complying with and enforcing the various conditions is going to be a challenge and some states have questioned the conditionalities on the grounds of encroachment in their fiscal autonomy. There are also issues of enforcing conditions when these do not involve either 'carrots' or 'sticks'. In fact, the conditions imposed on the centre do not involve either incentive payments or penalty. Furthermore, there is an asymmetry in the enforcement of conditions. In the case of the states, the enforcement will be done by the central government whereas for the latter, it is both the player and the umpire. This exemplifies what has been said: while the Finance Commissions can only bark at the centre, they can bite the states!

Apart from the large number of conditions, there are problems of design and implementation. First, unlike in the case of 12th Finance Commission which recommended debt write off and rescheduling linked to fiscal adjustment, the 13th Finance Commission's conditions to the states' fiscal consolidation does not entail any incentive payments except in the case of the states which did not pass fiscal responsibility legislation as required by the 12th Finance Commission. Failure to stick to the fiscal restructuring plan would deprive the states of their state-specific grants. Of course, the central government will have the role of enforcing the other conditions but can it withhold any portion of tax devolution or revenue gap grants for non-compliance? How can the conditions be enforced on the central government?

5. Concluding Remarks

The experience of incentivising reforms at the state level cannot be termed an unqualified success by any means, nor is it a total failure. There are elements of incentives which have succeeded though, but on the whole, it has not been able to accomplish the objectives in entirety such as ensuring standards of essential physical and social infrastructure, motivating the tax reforms in states, urban renewal, or fiscal prudence.

The fact that the experiments were not an unqualified success does not mean that the attempt should be given up. They provide valuable lessons for improving the design and implementation mechanisms. Firstly, it is important for the central government to follow what it preaches. In particular, the central government should provide a clear lead in fiscal consolidation and only then can it motivate the states to follow disciplined calibration of fiscal policy. Unfortunately, there is no way the central government can be incentivised in undertaking reforms. It is difficult to solve the problem of soft budget constraint at central level and only electoral dissatisfaction arising from poor policy calibration can motivate reforms. Second, the reforms should have an impact on the margin of the targeted variables. Therefore, considerable effort should be made to design the targets. Third, the incentives should be strong enough for the states to adopt them. If they are not strong enough, they will fall on the wayside. The example of the 11th Finance Commission to link the grants with the reduction in revenue deficits was simply not accepted by the states. Similarly, there were grants recommended for the creation of data banks on *panchayats* by the 11th Finance Commission which was simply not undertaken.

It must also be noted that while incentivising reforms at the state level can motivate reforms in a limited way this cannot be a substitute for hardening the budget constraint. In other words, it is important to undertake reforms to ensure hard budget constraints at the state level. The reform recommended by the 12th Finance Commission, of avoiding the centre lending to the states and bringing market discipline to states' borrowing is therefore an important one. The compulsions of coalition politics have resulted in several measures through which the states have been able to soften the budget constraint and bringing about market discipline among the states is an important challenge.

In the final analysis, political incentive is the best incentive to undertake economic reforms and there are examples, though isolated, to show that the long term reform policies can also be the political winners. The important long term reform of governance and developmental policies undertaken in Gujarat and more recently Bihar, have been politically rewarding as well. In fact, this has the potential to trigger healthy intergovernmental competition at the states level thorough the "Salmon mechanism" which can lead to improved developmental outcomes. Under this, the electorate as well as the opposition parties in the state benchmark the performances of the better performing states and pressurise the incumbent government to provide the benchmarked standards of services (Breton, 1996; Salmon, 2006). While this can be a long term solution, in the meantime, it is necessary to experiment with various types of incentives.

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