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I. Introduction

Federal forms of government are a time-tested way of organising states. They are generally motivated by the need to accommodate territorially based ethnolinguistic and other socio-cultural diversities within a single political unit. There are also some fairly compelling economic arguments in favour of federalism. First, there can be substantial efficiency and welfare gains from decentralisation of spending responsibilities.² Second, decentralisation can help ensure efficiency in the production of public goods. Decentralisation can act as a surrogate for market discipline in ensuring efficiency in the production of public goods.³

Fiscal federalism has its economic problems as well. First, resource endowments and levels of economic development differ across regions, and in a federation, this regional disparity may be reflected in the ability of sub-national governments to provide public goods to the residents under their jurisdiction. Decentralisation can compromise the attainment of redistributive equity objectives through the length and breadth of the country.⁴ Second, fiscal devolution can also create problems in the maintenance of macroeconomic balance through stabilisation policies. The spending decisions of not only the central government but also the lower level governments affect macroeconomic equilibrium. Expenditure control is considerably more difficult under a federal set up with expenditure devolution than under a unitary system.⁵ Third, fiscal federalism — particularly with the devolution of tax raising powers — can lead to tax exportation among states and tax wars through exemptions and tax concessions. This can impair the development of a common market and retard growth.

How has fiscal federalism in India performed in economic terms? The aim of this paper is to throw some light on this important question by evaluating some selected economic aspects of the practice of sub-national public finance in the states.⁶

¹ A draft of this paper was presented at the Institute for Social and Economic Change (ISEC)-World Bank Institute conference on "Decentralisation and the Making of Sub-national Policy" at Bangalore on May 25, 1999, and at the First Meeting of the Global Development Network Conference, December 5-8, 1999 at Bonn.

² See, for example, Tiebout (1961), Musgrave (1969), Oates (1972).

³ See Tiebout (1956) and Gordon (1983).

⁴ See Prud'homme (1985), and Tanzi (1996).

⁵ Additionally, like many private goods, some public goods are also subject to economies of scale. There can be diseconomies of scale when expenditures are devolved to small local governments. Given the size of the Indian states, both in terms of population as well as area, this problem is likely to be of limited relevance in India.

⁶ There are 25 states in India and 7 union territories (UTs). The fiscal autonomy enjoyed by the UTs is limited relative to the states. The national capital territory

The paper focuses on three important issues: relative fiscal prudence of states *vis-à-vis* the centre, the extent of appropriate expenditure prioritisation by the states, and problems of tax exportation and tax harmonisation across states.⁷ The paper draws heavily on the work done by the National Institute for Public Finance and Policy (NIPFP). For example, it sometimes focuses on five states, namely, Assam, Haryana, Kerala, Punjab and Tamil Nadu. These states have been chosen not because they are particularly distinguished or disreputable in the conduct of their fiscal affairs, but because they have been recently studied by the NIPFP.⁸ Hopefully, they provide a good sample of the Indian states.

Evaluating fiscal policies at the state level is important at this juncture for three special reasons. First, a large fiscal deficit of the central government close to 10 per cent of gross domestic product (GDP) continues to complicate macroeconomic management in India. There is acute fiscal stress at all levels, particularly after the implementation of the recommendations of the *Fifth Central Pay Commission* for government employees.⁹ The combined deficit of the states is becoming as important as that of the centre. Furthermore, states have a large responsibility in the areas of education, health, infrastructure, and social security and welfare.¹⁰ There is a serious adverse impact on public expenditure in these areas because of acute fiscal stress. Second, a pronounced increase in the power of regional political parties ruling in the states *vis-à-vis* the coalition government at the centre may have its reflection in centre-state financial dealings as well. Third, with the ongoing fiscal devolution to the third tier, namely to *panchayats* and municipalities, after the 73rd and 74th amendments of the Constitution in 1992, it may be useful to have a look at the fiscal scenario at the second tier, namely the states.

The plan of the paper is as follows. Section 2 discusses the hard budget constraint on the states, a very important feature of fiscal federalism in India. Section 3 discusses the relative deficits of the centre and the states, and some facets of competitive politics of deficit at the centre and the states. Section 4 deals with the issue of expenditure prioritisation and management. Tax issues, including harmonisation and exportation, are discussed in section 5. Section 6 concludes with some observations.

(NCT) in Delhi is somewhere in between a state and a UT. In some analysis, it is considered as a state making the number of states 26 and the number of UTs 6.

⁷ The paper does not address the issue of impact of fiscal federalism on regional disparities.

⁸ See, Srivastava, Chattopadhyay and Rangamaninar (1998), Sen and Rao (1998), Srivastava, Chattopadhyay and Jena (1999), Rajaraman, Mukhopadhyay and Amarnath (1998), and Sarma, Naresh and Bohra (1998).

⁹ The *Fifth Central Pay Commission* was appointed by the central government to recommend revised pay scales for central government employees. However, as discussed later, the recommendations were also adopted by the state governments without much modifications.

¹⁰ The distribution of tax powers and expenditure assignment among the centre and the states according to lists I, II, and III of the seventh schedule (*Article 246*) and other constitutional provisions for fiscal federalism are well known and are described well by Mukherji (1991), and Vithal and Sastry (1998).

II. Hard Budget Constraints on the states

i) The setting

In India's federal structure, the states are faced with hard budget constraints. *Article 293* of the Indian Constitution mandates the states to obtain the centre's consent for borrowing if they are indebted to the centre. Much of the debt of the states is owed to the centre.¹¹ Thus, while the centre can plan its expenditure somewhat autonomously of its income stream and finance the resulting deficit by borrowing from the market and/or the central bank, namely, the Reserve Bank of India (RBI), a state can spend no more than its anticipated revenues plus "approved" borrowing limits. This is captured in figure 1.

In figure 1, revenue is measured along the horizontal axis and expenditure along the vertical. The 45-degree line indicates combinations of revenue and expenditure, where they are equal and the deficit is nil. If permitted deficit is equal to OD, then line DV — which is parallel to the 45 degree line — gives the maximum possible expenditure that can be incurred for a given level of revenue. For example, if revenue is equal to OA, then expenditure can be no more than AB, to contain the deficit at a level equal to OD.

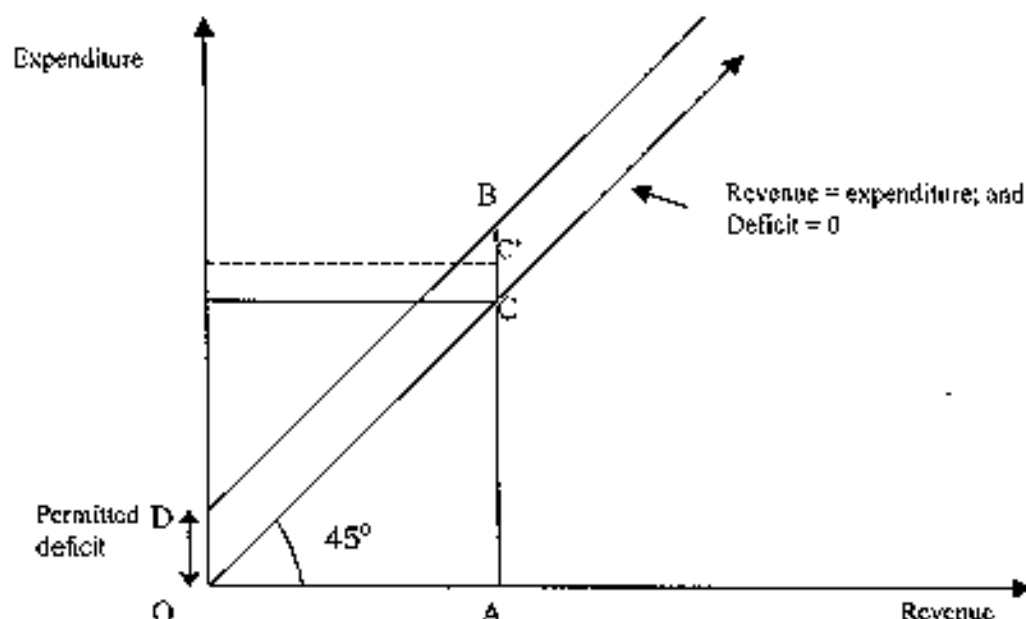
Given the hard budget constraint, persistent upward pressures on revenue expenditure result in a squeeze on capital expenditure. For example, if revenue expenditure is AC, then capital expenditure is BC. Any increase in revenue expenditure (for example, from AC to AC') without a corresponding increase in revenues and the approved deficit, results in capital expenditure falling below BC (to BC').

The asymmetric application of financing constraint on the centre and the states through restrictions on sub-national borrowings is not uncommon in federal countries. Because of a long history of bailouts, lack of transparency and dissemination of information at the sub-national level, reliance on market principles alone does not seem to work too well for enforcing borrowing discipline on sub-national governments.¹² Most countries follow either a cooperative framework for the design and implementation of debt control (for example, in Australia and Germany), or rule-based controls (for example, in the US). India follows administrative controls for this purpose.

¹¹ At the end of March 1999, out of a total debt of the states of Rs. 336,365 crore, over 60 per cent (Rs. 202,078 crore) were loans and advances from the central government. Furthermore, it may be noted that the states cannot borrow externally, and all debt of the states is of the internal variety.

¹² Brazil and Canada, after trying out market based solutions, went back to controls on sub-national borrowings. See Ter-Minassian (1997).

Figure 1. Hard Budget Constraint



ii) Not as hard as it looks

The borrowing constraint on the states in India, however, is not as hard as it looks. There are four sources of financing that tend to relax the constraint. These are: (a) public account; (b) ways and means advance (WMA) and overdrafts from the Reserve Bank of India (RBI); (c) guarantees; and (d) public sector enterprises (PSEs).

a. Public Account

The accounts of the government are kept in three parts: consolidated fund; contingency fund; and public account. According to the government, "Besides the normal receipts and expenditure of government which relate to the consolidated fund, certain other transactions enter government accounts, in respect of which, government acts more as a banker, for example, transactions relating to provident funds, small savings collections, other deposits. The moneys thus received are kept in the 'public account' and the connected disbursements are also made therefrom. Generally speaking, 'public account' funds do not belong to the government and have to be paid back some time or the other to the persons and authorities that deposited them."¹³ There are no separate cash balances for the 'consolidated fund of India' and 'public account', and the cash flows of the two accounts get merged.

The central government operates several small savings schemes through the 'public account' to spread the message of thrift to every household, and to mop up savings from areas beyond the reach of the banking network.¹⁴ Most of these schemes

¹³ Government of India (1999a), p.9.

¹⁴ These small savings schemes are framed by the central government under the *Government Savings Act, 1873* from the colonial period, and the *Government Savings*

enjoy tax benefit under sections 80L, 88 and 10 of the *Income tax act*. The net collections in small savings schemes and public provident fund (PPF) in post offices and banks in a state are shared with the states in the form of loans.¹⁵ Loans extended from the centre's budget on account of small savings, PPF, etc. have increased over time. For example, such loans increased from only Rs. 5,000 crore in 1993-94 to Rs. 23,788 crore in 1998-99.¹⁶

The central government does not have full control over the borrowings by the states through the small savings schemes. Any increase in small savings mobilisation results in an automatic increase in cash inflows to the states through the accepted sharing formula. Apart from the commendable reason of promoting thrift, the expectation of larger cash inflows may partly explain the enthusiasm of the states in mobilising small savings in their own jurisdiction.¹⁷

b. WMA and overdrafts from the RBI¹⁸

Twenty-three of the twenty-five states in India have voluntarily agreed to entrust their banking business to the RBI. The RBI provides WMA to the states banking with it to help them tide over temporary mismatches in the cash flow of their receipts and payments.¹⁹ Strictly speaking, such advances are repayable in each case not later than three months from the date of making that advance. There are two types of WMA — normal and special. Normal WMA are clean advances, while special WMA are secured advances provided against the pledge of Government of India securities. The RBI determines the maximum limits for normal and special WMAs for each state as multiples of the prescribed minimum balance required to be maintained by them with the RBI. These limits are periodically revised.

An amount drawn by a state from the RBI in excess of WMA is an overdraft. There is an overdraft regulation scheme in force since October 2, 1985. No state was allowed to run an overdraft for more than seven continuous working days between

Certificates Act, 1959 and Public Provident Fund Act, 1968 from the post-Independence period.

¹⁵ Such sharing started as an inducement to the states to join the centre in a cooperative effort to mobilise savings, and the share of the states was increased from April 1, 1987 from 2/3rd to 3/4th of the net collection in the state. The loans are repayable in 25 years with an initial five-year grace period for principal repayment and carried an interest rate of 14.5 per cent. The cost of small savings schemes (inclusive of cost of management such as agency commission) worked out to 13.04 per cent in 1996-97.

¹⁶ The financial year in India runs from April 1 to March 31. Thus, 1993-94 stands for April 1, 1993 to March 31, 1994.

¹⁷ The enthusiasm of both the centre and the states in mobilising finance through the Public Account is also clearly manifested by the permission to institutions such as mutual funds to invest in some major small savings schemes. Furthermore, there are also demands from some states that the advances related to small savings from the centre should be treated as a grant rather than a loan or as a loan in perpetuity. The system of accounting of loans to states and UTs against net small savings collections was changed with effect from April 1, 1999. Now, the states' shares of small savings are given to the states without incorporating such transfers in the centre's budget. They now form part of a fund in the 'public account'.

¹⁸ A good discussion of the issues is contained in Reserve Bank of India (1998).

¹⁹ This is done under section 17(5) of RBI Act, 1934.

October 1985 and October 1993, and for more than ten continuous working days between November 1993 and March 1999.

Persistent fiscal stress and consequent pressures on liquidity management have led to the frequent use of WMA and the overdraft facility by the states.²⁰ As there is no special requirement for the states to vacate the WMA drawn or overdrafts at the end of the financial year, many states have used WMA and overdrafts as a resource for financing their fiscal deficit.²¹ During April–September 1998, the average normal WMA availed of by the states (combined) and the average amount of overdraft drawn by them was Rs. 415 crore and Rs. 261 crore, respectively.

c. Guarantees²²

Changes in contingent liabilities or outstanding amount of guarantees are not part of the fiscal deficit.²³ But, such guarantees can act as a substitute for government expenditure in some cases. For example, a PSE of doubtful commercial viability can be given a guarantee to raise funds from the market instead of a grant or loan from the budget.

According to *Article 293(1)* of the Constitution, the state governments in India can give guarantees upon the security of the 'consolidated fund of the state' within such limits as have been fixed by the legislature of the concerned state. Only the State of Gujarat has had statutorily fixed ceiling on government guarantees right from the early-1960's. With effect from April 1, 1999, the State of Karnataka has imposed a ceiling on such guarantees, and more states are expected to follow.²⁴

The outstanding guarantees of states increased at an annual rate of 12 per cent from Rs. 40,318 crore at end-March 1992 to Rs. 79, 625 crore at end-September 1998. As at end-March 1997, the aggregate outstanding guarantees of 18 major states were equivalent to 9.1 per cent of their net state domestic product (NSDP). There is considerable variation in guarantees as a proportion of NSDP across states.

According to the *Technical Committee on State Government Guarantees*, "The rising deficits on revenue account have pre-empted financial resources from investment projects. In such a situation, the issue of guarantees as a compensatory

²⁰ For example according to the Reserve Bank of India (1998) (p.8), during April-October, 1998, sixteen state governments were in overdrafts with ten states taking frequent recourse.

²¹ Of course, the general requirement such as not being in overdraft continuously for more than a specific number of days applies to the end of the financial year as well. The WMA limits for states and the overdraft regulation scheme were revised from April 1, 1999 in line with the recommendations of the "Report of the Informal Advisory Committee on Ways and Means Advances to State Governments", Reserve Bank of India, Mumbai, November 1998.

²² A good discussion of the issues is contained in Reserve Bank of India (1999).

²³ International Monetary Fund (1986).

²⁴ The ceiling in Gujarat is in nominal terms, while in Karnataka it is 80 per cent of the revenue receipts in the year before last.

measure for maintaining the existing level of public investment is significant.²⁵ The discontinuation of statutory allocation of a part of the banking sector's resources to PSEs in 1993-94, and decrease in budgetary support to such PSEs for their capital requirements have also contributed to the growth of guarantees.²⁶ No ready estimates exist on the default position on loans guaranteed by state governments, but up to around the end of October 1998, guarantees of about Rs. 700 crore had been invoked.²⁷ Although guarantees provided by the states to projects of doubtful viability are a source of concern, the aggregate guarantees outstanding of 18 major states have come down from 10.3 per cent of NSDP at end-March 1992 to 9.1 per cent at end-March 1997.

d. Public Sector Enterprises

Some states have resorted to creative accounting *vis-à-vis* PSEs for softening the hard budget constraint. A standard method is as follows. Most PSEs have outstanding loans from their respective state governments. Repayments of such loans to the state government, even when the financial condition of the PSE does not permit such repayments, provide temporary financial succour to the state government and help them to relax their hard budget constraints. A recent example of how the PSEs can be used to ease the financing constraint of states is provided by the State of Punjab. Punjab government decided to supply power free of cost to agriculturists in 1997. The impact of this Rs. 207 crore operation on the fiscal deficit, however, was neutralised by adjusting the amount against unpaid interest dues by the Punjab State Electricity Board, a loss-making parastatal.²⁸

Thus, the budget constraint is somewhat less hard than what figure 1 suggests. Nevertheless, it is there and the budget constraint acts much harder on the states than on the central government.

III. Competitive Politics of Deficit of the centre and the states

i) The facts²⁹

The harder operation of the budget constraint on states *vis-à-vis* the centre is reflected in their relative deficit and debt figures. The fiscal deficit of the centre on the one hand and the states and UTs on the other were close to each other until the mid-1970s (table 1). But, the centre's fiscal deficit, measured as a proportion of GDP, ballooned from 3.26 per cent of GDP in 1970-71 to an all-time high of 9.38 per cent

²⁵ Reserve Bank of India (1999) p. 17.

²⁶ Some states have also given guarantees to attract private sector investment in infrastructure

²⁷ Partly in reflection of the risk associated with government guaranteed instruments, the RBI introduced a non-zero risk weighting of such instruments from 1998-99.

²⁸ See Rajaraman, Mukhopadhyaya, and Amar Nath (1998), pp. 27-28.

²⁹ In this section, the figures in table 1 relate to states as well as UTs. The relative share of the UTs in the aggregate for states and UTs, however, is small.

Table 1. Deficit of the centre and states and UTs

(In rupees crore)

	Fiscal deficit		Revenue deficit	
	states & UTs	centre ^a	states & UTs	centre ^a
1970-71	923	1,297	17	-163
1971-72	1,068	1,727	-9	100
1972-73	1,397	2,525	70	-17
1973-74	1,471	156	118	-237
1974-75	1,268	2,133	-402	-764
1975-76	1,123	2,559	-953	-887
1976-77	1,545	3,740	-1,097	-280
1977-78	2,081	3,681	-1,019	-429
1978-79	2,697	5,450	-1,135	-292
1979-80	2,929	6,385	-1,548	696
1980-81	4,353	8,446	-900	1702
1981-82	4,289	8,667	-1,310	293
1982-83	5,101	12,334	-889	1,254
1983-84	6,482	13,429	-218	2,398
1984-85	8,308	17,417	898	3,498
1985-86	7,806	23,184	-544	5,565
1986-87	9,369	26,341	-21	7,776
1987-88	10,988	27,044	1,038	9,137
1988-89	11,363	30,923	1,825	10,514
1989-90	14,796	35,632	3,507	11,914
1990-91	18,151	44,632	5,107	18,562
1991-92	18,422	36,325	5,652	16,261
1992-93	20,000	40,173	5,059	18,575
1993-94	19,610	60,255	3,475	32,716
1994-95	26,673	57,704	5,575	31,029
1995-96	32,022	60,243	8,734	29,731
1996-97	36,429	66,732	16,065	32,654

Note: Minus (-) sign denotes surplus.

Source: 1. States and UTs:

Indian Economic Statistics/Indian Public Finance Statistics, Ministry of Finance, Government of India (various issues).

Include Pondicherry, a UT with legislature, and from 1993-94 the National Capital Territory of Delhi which too has a legislature.

2. Centre:

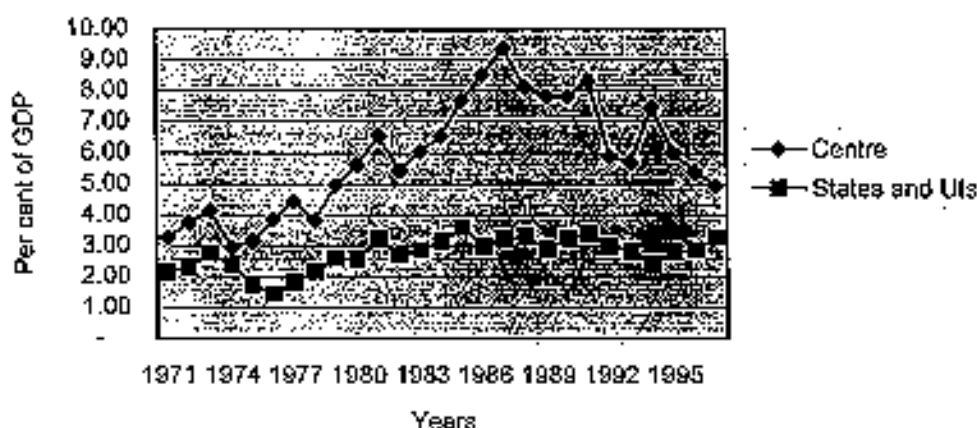
Finance Accounts of the union government - Controller General of Accounts (annual). Centre includes the central government and the UTs which do not have a legislature.

of GDP in 1987-88 before declining gradually to about 5 per cent in the mid-1990s.³⁰ On the other hand, the combined fiscal deficit of the states and the UTs - again measured as a proportion of GDP - after growing from 2.14 per cent in 1970-71 to

³⁰ The GDP figures used in the calculations are GDP at current market prices (old series). The new series of GDP is available only from 1993-94.

3.39 per cent in 1990-91, has remained contained below 3.25 per cent in the subsequent period (figure 2).

Figure 2. Fiscal deficit of the centre and the states and UTs
(As per cent of GDP)



In line with the lower deficit, the debt of states grew from Rs. 23,959 crore to Rs. 336,365 crore between end-March 1981 and end-March 1999, while the total liabilities of the centre grew from Rs. 58,129 crore to Rs. 864,232 crore. In 1996-97, the average rate of interest on states' debt stood at 11.24 per cent compared to 9.5 per cent for the centre.³¹

In the deficit race – which is a race to the bottom – the centre has been well ahead of the states. The centre's deficit at 6 per cent of GDP was more than twice the combined deficit of 2.8 per cent of the states and UTs in 1994-95. All the states are indebted to the centre and require the centre's permission to borrow.³² Thus, they have a financing constraint, and limited access to borrowed funds may have prevented the fiscal deficit of the states from running away like that of the centre.

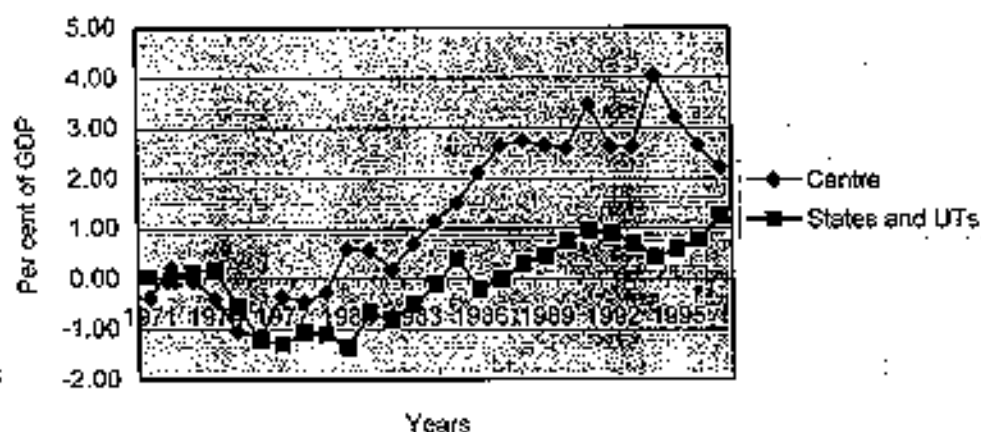
³¹ Derived as gross interest payment of Rs. 25,576.4 crore in 1996-97 as a proportion of Rs. 227,544 crore (average of Rs. 212,228 crore and Rs. 242,863 crore, the figures of outstanding liabilities at end-March 1996 and 1997, respectively) for the states. For the centre, the figure has been derived as interest payment of Rs. 59,478 crore in 1996-97 as a proportion of Rs. 625,971 crore (average of Rs. 592,125 crore and Rs. 659,817 crore, the figures for outstanding liabilities at end-March 1996 and 1997, respectively). The marginal rates are higher for both, but the differential remains. Without this differential the centre would have had a larger share of the deficit.

³² Right from the days of the second Finance Commission (1956-57), high indebtedness of the states to the centre and the consequent debt-service burden has been a subject of some concern in India. Debt relief has been provided by various Finance Commissions, starting from the Sixth. Only the Ninth Finance Commission did not recommend any debt relief. Those recommended by the Tenth Finance Commission were linked to fiscal management and reforms.

Even in terms of the revenue deficit, the centre's performance has been considerably poor. Both the centre, and the states and the UTs had a revenue surplus until 1978-79. In fact, the revenue surplus of the centre, and the states and UTs were roughly equal at 1.2 per cent of GDP until 1975-76. The centre's revenue balance started deteriorating from 1976-77 and turned into a deficit in 1979-80. The states' and UTs' revenue balance also came under pressure but turned into a deficit only in 1984-85. By 1984-85, the centre's revenue deficit was as much as 1.5 per cent of GDP. After incurring revenue deficit in 1984-85, the states and UTs produced a revenue surplus in the two years of 1985-86 and 1986-87. The revenue balance of the states and UTs has been a persistent deficit since 1987-88. But it has been considerably less than that of the centre. Thus, the centre's revenue deficit has fluctuated between 2.2 per cent to 4.04 per cent of GDP. The revenue deficit of states and UTs, on the other hand, has been well below 1 per cent of GDP except for 1996-97 and 1997-98 (figure 3).

The Constitution assumed a fiscal imbalance with the centre having relatively more revenues than spending, and accordingly made provision for transfers to the states. The constitutional assumption of a transferable surplus has been invalidated by the central fiscal stance. Ever since 1982-83 the centre has had a fiscal deficit greater than the fiscal transfers (including share of taxes, grants and loans net of recoveries) to the states and UTs. For example, in 1998-99, according to the revised estimates for the centre, the revenue deficit was Rs 60,474 crore and the fiscal deficit was Rs 103,737 crore while transfers to states and UTs were limited to Rs.95,058 crore.

Figure 3. Revenue Deficit of the centre and the states and UTs
(As per cent of GDP)



Thus, even without any transfers to the states and UTs, the centre would have had a fiscal deficit and only a small revenue surplus. As early as in 1969, the Fifth Finance Commission had noted that the Government of India was "not in the happy situation of certain other federal governments" which had large surpluses, and "the preemptive character of the financial needs of the union constitutes a limiting factor in

formulating the scheme of transfers to the states." Devolution under fiscal federalism in India has become an exercise in distributing deficits.

ii) Probable reasons

In 1999–2000, the combined deficit of the states is expected to be close to that of the centre. Populist policies, such as the supply of free power to farmers and cheap power to households, inadequate water charges, supply of subsidised rice, and the inability of states to mobilise additional resources promised at the time of formulating the five-year plans have contributed to the worsening of the fiscal position of the states. At a more fundamental level, the states' catching up with the centre in terms of the deficit can be attributed to three factors.

First, there are 'systemic factors'. According to Bagchi (1998): "Finding that large revenue deficits had afflicted all states, and that too at about the same time, the *Tenth Finance Commission* felt that 'systemic' rather than state-specific factors were at work. What these factors are remains to be fully researched. At one level it would appear that populist politics and the unbridled free rider instinct, 'the tragedy of the commons', are the root cause of the chronic problem. Messages emanating from the new institutional economics suggest that the problem may have its origin in the failure of the institutions — of which federal fiscal relations constitute a vital component — to enforce accountability and provide incentive compatibility in the matter of public expenditures and revenue raising."³³

Second, there is the emulation of the centre by the states in an environment of competitive politics. For example, according to the Ministry of Finance, Government of India, "The implementation of the *Fifth Central Pay Commission* recommendations at the centre also provided a benchmark for pay revisions at state level. This has led to a substantial increase in their salary and pension outgo thereby adversely affecting the fiscal health."³⁴

As long as the same political party was ruling both at the centre and in the states, the internal political party processes such as diktats from the 'party high-command' could be utilised to drive a wedge between the fiscal stance of the centre and that of the states. The rise of regional parties and their coming to power in the states have brought an end to the era of the same party ruling everywhere. Furthermore, the advent of coalition politics from the 1970s has gradually changed the power equation between the centre and the states. While intense competition between political parties for winning state elections in the short run have reinforced the populist policy pressures at the state level, coalition governments at the centre have found it difficult to "harden" the budget constraints on states. The centre's leadership in deficit reduction by setting its own house in order appears to be important in this context. There may be no inherent incompatibility between fiscal prudence and competitive politics with diverse parties ruling at the centre and in the states. But, the

³³ Bagchi (1998).

³⁴ Government of India (1999b), p. 23.

moral authority of the centre, which has been considerably eroded by its persistent high deficits, has to be restored through rapid fiscal consolidation.

Third, the design of Finance Commission (FC) grants-in-aid of revenues to states (according to *Article 275* of the Constitution) may have had a bias towards legitimising incipient deficits arising from inadequate revenue efforts and imprudent expenditure decisions in the past. The dependence of the states on the centre for grants-in-aid of revenues has increased over time. A large part of the debt of the state governments is debt to the centre and the interest on such loans were and are determined by the centre. The interest charge on such loans, which is an automatic charge on the revenue account, is taken care of by the FC in its overall assessment of resource requirements.

There is need for moving away from the 'gap filling' culture in fiscal devolution, and to have a set of proper incentives for state governments to improve their fiscal positions, cut down deficits and reorient expenditure to developmental heads. The Eleventh FC, which is expected to recommend fiscal devolution for the years 2000-01 to 2004-05, is currently seized of the issues.

IV. Expenditure Prioritisation and Management

i) A large role for states in expenditure

In India, in 1997-98, the budgeted expenditure of states and UTs accounted for 56.5 per cent of the combined budgeted total expenditure of the centre, states and UTs of Rs. 383,567 crore. The states' and UTs' share of government expenditures — both current and total — have remained more or less the same at around 57-58 per cent from 1955-56.³⁵ The states have a very large role in the fields of education and health. According to calculations by Ahmad, Hewitt and Ruggiero (1997), in the three years ending in 1986, of the combined expenditure by the centre and the states, on average, the states accounted for as much as 90 per cent of the expenditure on education and 70 per cent of the expenditure on health.

There has been some intrusion of the centre in many areas of expenditure. For example, dissatisfaction with states' performance and a desire to pursue a uniform policy throughout the country led to the shifting of population control and family planning, forests, education, and trade and commerce in several essential items from the 'state list' to the 'concurrent list' through constitutional amendments. In many areas, the centre has also intruded in allocation decisions under the purview of the states through centrally sponsored schemes. Nevertheless, the states in India continue to play an important role in the scheme of general government in the country. Apart from maintaining the police and public order, states have exclusive jurisdiction over

³⁵ Rao and Sen (1996), p.91.

public health and sanitation, roads (except national highways) and bridges, agriculture, water supply and irrigation.

ii) Wages and interest crowding out capital and other essential expenditure

One of the most striking features of Indian public finance at the sub-national level has been the crowding out of capital and other essential expenditure — including developmental and operation and maintenance (O&M) expenditures — by increasing revenue expenditure mainly owing to higher interest payments and wages. Within the hard budget constraint of states, higher wages naturally displace other expenditure. Similarly, increasing deficits crowd out development expenditure through the dynamics of debt.

The government salary bill both at the centre and the state governments appears to 'be disproportionately high and rising. The government wage bill in the states as a per cent of the respective state GDPs (GSDPs) has gone up by 2 to 4 percentage points during the current decade.³⁶ There is need for the states to reconsider the policy of uniform salaries across states and the centre. But, this is unlikely to come about until the FC refuses to accept such uniformity spontaneously for its award calculations. At the same time, the centre has to provide leadership in changing the general orientation of governments as 'employment agencies' with the organisational motto of 'of the employees, by the employees, and for the employees.'

Persistent deficits have resulted in a continuous increase in states' debt, and increasing debt has led to a growing proportion of the states' revenue resources getting spent on interest payments. The rise in interest payments has been particularly sharp after the liberalisation of interest rates and reduction in the statutory liquidity ratio (SLR) of banks.^{37, 38}

Capital expenditure as a proportion of their total revenue receipts have progressively declined from 19.6 per cent to 11.5 per cent between 1980-81 and 1996-97 (figure 4). Expenditure on interest payments, on the other hand, increased from 7.5 per cent of total revenue receipts in 1980-81 to 16.7 per cent in 1996-97. No data is readily available on aggregate expenditure on wages and salaries by all states.

³⁶ For example, salaries as per cent of GDP went up from 7.5 in 1990-91 to 8.9 in 1997-98 in UP, from 5.5 in 1990-91 to 6.7 in 1997-98 and further to 8.4 in 1998-99 in Rajasthan, and from 8.4 in 1993-94 to over 11 in Orissa in 1998-99. The centre's salary bill went up by 78 per cent from Rs. 14,895 crore in 1995-96 to Rs. 26,484 crore in 1998-99 (BE).

³⁷ The Tenth FC in 1994 defined the 'fiscal stress zone' as the zone where interest liability exceeds 17 per cent of current expenditures and classified Bihar, Orissa, Rajasthan and Uttar Pradesh as belonging to that category.

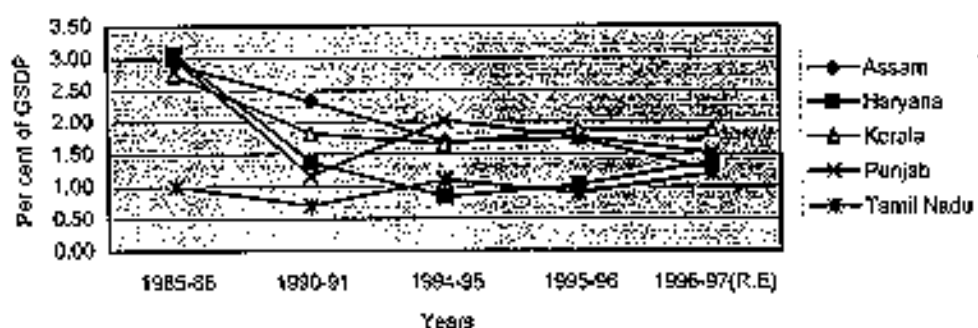
³⁸ The SLR, whereby banks have to invest a specified proportion of their outstanding domestic net demand and time liabilities in 'approved' securities bearing low interest rates, has been brought down in stages from 38.5 per cent on April 3, 1992 to 25 per cent from the fortnight ended October 22, 1997.

Figure 4. All States: Capital Expenditure and Interest Payments as proportions of Total Revenue Receipts



Data from individual states confirm the squeeze on capital expenditure and increase in interest payments in recent years. For example, in Assam, Haryana and Punjab, capital expenditure as a proportion of GSDP decreased by 1.5 to 1.7 percentage points between 1985-86 and 1996-97 (figure 5). During the same 11-year reference period, in Kerala the decline was a modest 0.9 percentage point. Only in Tamil Nadu, it actually increased by 0.2 percentage points. In these same states, there was a rapid increase in interest payments of as much as 2.3 per cent of GSDP in Punjab, 1.6 per cent of GSDP in Kerala, and between 0.4 and 0.9 per cent of GSDP in Assam, Haryana and Tamil Nadu (figure 6). The higher interest payments in Punjab reflect the 5.7 times rise in the debt stock from Rs. 1,793 crore to Rs. 12,096 crore, and an increase in the rate of interest on market loans from 7.37 per cent to 11.28 per cent between 1985-86 and 1995-96.

Figure 5. Selected States: Capital Outlay as a per cent of State GDP



Data on wages and salaries available from individual states studied by the NIPFP suggest that there have been large increases in such outlays, particularly in recent years after the implementation of the *Fifth Central Pay Commission's* recommendations. In some states overstaffing led to a ballooning of the wage bill even before the recent pay revision. In Assam, for example, wages and salaries for the

state government employees accounted for over 10 per cent of the GSDP in 1994-95, and the wage bill for the government rose by 13 per cent per year between 1986-87 and 1994-95. There is considerable variation in government employment and salary bill across states. For example, in 1994-95, wages and salaries in Punjab and Haryana at around 5 per cent of the states' respective GSDPs were half that in Assam and Kerala (figure 7).⁵⁰

Figure 6: Selected States: Interest Payments as a per cent of State GDP

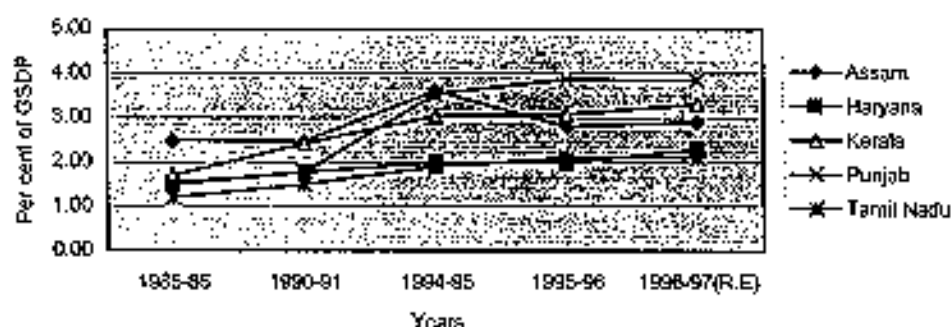
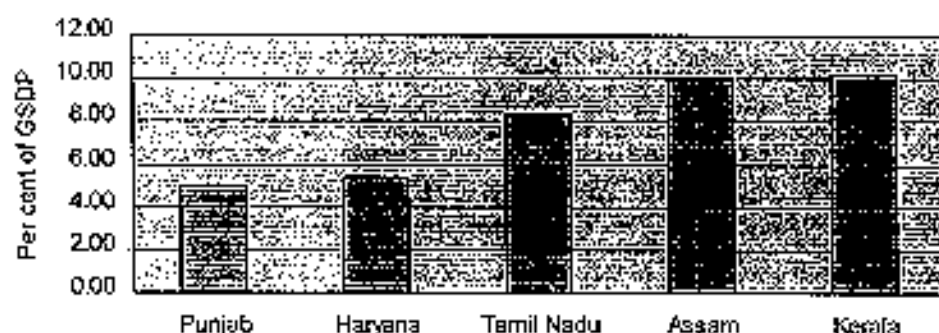


Figure 7: Selected States: Compensation to Employees as a per cent of State GDP, 1994-95



Extra employment created by some states in previous years has left their permanent mark on the states' revenue budgets through higher pension and terminal benefits payable to retirees. A more or less uniform salary structure across states as well as between the states and the centre having become an accepted norm,

⁵⁰ Some allowance needs to be made for low-income states' high wage bill-to-GSDP ratios. The ratio may be expected to come down with increases in per capita income.

employment rationalisation appears to be the only option available to ease the pressure of the salary bill on government expenditure.⁴⁰

There is no doubt that government salaries will need to be revised upwards to neutralise the rise in the cost of living, and to make them conform to efficiency wages and competitive norms with the private sector. But, such revision without a reduction in the number of employees can result in fiscal stress. The latest round of pay revision according to the recommendations of the *Fifth Central Pay Commission*, without any downsizing of the government, is estimated to have raised expenditure on administrative services as much as by 80 per cent in 1998-99.⁴¹

iii) Subsidies

Subsidies pre-empt a large part of the general government resources in India. According to an NIPFP study "In 1994-95, aggregate government subsidies (centre and states) amounted to Rs. 136,844 crore, constituting 14.35 per cent of GDP at market prices in that year."⁴² Nearly 69 per cent of the budgetary subsidies in India emanate from the state budgets. An analysis of the data for 15 major states in 1993-94 revealed that subsidisation is much higher and recovery rates correspondingly lower at the state level than at the centre.⁴³ The overall recovery rate for social and economic services taken together was only 5.81 per cent of the total cost.

The study treated all general services, secretariat expenses in social and economic services, and expenditure on natural calamities as public goods, and excluded the cost of their provision from the calculation of subsidies. It divided social and economic services into two groups: merit and non-merit, on the basis of "perceived strong externalities associated with the merit services."⁴⁴ The merit social services were: elementary education, public health, sewerage and sanitation, information and publicity, welfare of scheduled castes (SCs), scheduled tribes (STs), and other backward castes (OBCs), labour, social welfare and nutrition. Merit economic services encompassed: soil and water conservation, environmental forestry and wildlife, agricultural research and education, flood control and drainage, roads and bridges, space research, oceanographic research, other scientific research, ecology and environment, and meteorology.

Out of the total subsidy of Rs. 73,100 crore provided by the 15 major states in 1993-94, non-merit subsidies at Rs. 52,096 crore accounted for as much as 71.3 per

⁴⁰ Reduction in the retirement age will require some additional financing. Such a reduction results in adverse cash flows. The reduction in the retirement age from 60 to 58 in the state of Rajasthan from March 1999, for example, is estimated to have resulted in a cash outflow of Rs. 750 crore for 12,000 additional retirees.

⁴¹ The impact of the pay revision on state budgets is not fully reflected in 1997-98 or even 1998-99. Many states deferred the pay revision from 1997-98 to 1998-99, and impounded the arrears of pay revision (with effect from January 1, 1996).

⁴² Srivastava and Sen (1997), p. 65.

⁴³ The states are Andhra Pradesh, Bihar, Goa, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, and West Bengal.

⁴⁴ Srivastava and Sen (1997), p. 17.

cent. Analysis of the relation between per capita income and per capita subsidies revealed that not only does per capita subsidy tend to go up with increases in per capita income (elasticity: 0.77), but non-merit subsidies tend to go up faster (elasticity: 0.84). Fortunately, recovery rates of non-merit services — particularly non-merit economic services — tend to go up faster with per capita income (elasticity: 1.3). Nevertheless, given the initial low recovery rate of only 7.6 per cent for non-merit services, subsidies tend to increase with modest increases of per capita income.

In 1993-94, the aggregate investment (equity and loans) in state-owned PSEs in the 15 major states was Rs. 16,378 crore. According to Srivastava and Sen (1997), "The total cost of these investments in terms of interest payable by these states on this amount at their respective average effective rates was Rs. 1,842 crore. With a receipt of only Rs. 95 crore, the subsidy works out to Rs. 1,747 crore with a recovery rate of only 5.15 per cent..."^{45,46}

After the NIPFP study by Srivastava and Sen in March 1997, the Government of India circulated a discussion paper based on the study among the members of the Indian Parliament in May 1997. Although there appears to be a near unanimity about the need for eliminating the non-merit subsidies and targeting benefit groups in a more accurate manner, concrete steps for such a programme are yet to be drawn up. There is fragmentary evidence that subsidies as a proportion of GDP may be coming down over the years.⁴⁷ But, the reduction is not fast enough either to make a significant dent on the fiscal deficit of the centre or the states, or to open up fiscal space for augmenting public sector outlays on elementary education, preventive health care, roads, and other essential areas.

Subsidies in India have a pro-urban bias and are not targeted to the poor. The prevalence of such subsidies at the sub-national level in a country with the majority staying in villages and with widespread poverty is at first sight inconsistent with the known advantages of expenditure decentralisation.⁴⁸ However, two factors should be taken into account in reaching a conclusion. First, relative to the states, the share of the centre in merit-subsidies is much smaller than its share in non-merit subsidies.⁴⁹ This is a weak indirect evidence of the decentralisation theorem at work. Second, the relative political power of the urban, rural, the poor and not-so-poor voters in India, in spite of universal adult franchise, may not be strictly in proportion to their numbers.

⁴⁵ Srivastava and Sen (1997), p. 57.

⁴⁶ Until 1998-99, Orissa was the only state that attempted to mobilise proceeds from disinvestment. In 1998-99, Orissa budgeted Rs. 600 crore from the proceeds of disinvestment of holdings in state PSEs.

⁴⁷ Although methodologies differ, subsidies (centre and states combined) as a proportion of GDP has come down from 15.2 per cent in 1992-93 according to Tiwari (1996) to 14.35 per cent in 1994-95 according to Srivastava and Sen (1997).

⁴⁸ For a privately supplied good, the consumers express their demand by bidding up (down) the price of a good in short (excess) supply. For a public good, there is no such mechanism to capture the demand. So, how much of the public good should be supplied? Should more be spent on roads or on water supply? Democratic elections together with decentralisation can help in making the expenditure decisions more responsive to demand.

⁴⁹ See Srivastava and Sen (1997), p. 66.

iv) Need for expenditure prioritisation

Expenditure management through appropriate prioritisation and control is important for any government. The tension between containing the deficit and providing adequate outlays for the relevant heads makes expenditure prioritisation an even more important issue in India than what it is in many other countries. There is need for more schools, hospitals, roads, hydroelectric and multipurpose irrigation projects, etc., on the one hand, and sticking to fiscal prudence, on the other. One of the traditional ways of safeguarding the fiscal balance is through a strict adherence to appropriate budgeting techniques and procedures.

Loans should primarily be raised to create capital assets that pay for its repayments and interest servicing, i.e., productive and self-liquidating capital expenditure. If they are raised to create assets such as flood protection works, school building or dispensaries, or to meet current expenditures, then adequate provisions should be made for their debt servicing out of the revenue account. There appears to have been a progressive relaxation of appropriate budgetary checks from the mid-1950s. "In 1955 the Government of India advised the state governments that all expenditure on capital assets, that is durable or fixed though not necessarily productive or self-liquidating assets, should be held eligible for being serviced out of loans, and the amortisation of such loans need not be treated as a charge on the revenue except to the extent that the state governments were bound to provide in accordance with any law or any specific undertaking given in the case of any loan."⁵⁰

In 1971, the RBI advised the states that it was not necessary to provide on revenue account for depreciation funds.⁵¹ Prior to April 1975, loan notifications of states contained a clause stating "the Government will also make such annual contributions to a Sinking Fund to be utilised towards amortisation of their open market loans as they may, from time to time, decide to be necessary."⁵² From 1975, the clause regarding the 'sinking fund' in loan documents of state governments ceased to exist.⁵³ According to the Fourth FC, "The diversion of large items of unproductive or inadequately productive capital expenditure from the revenue to capital budgets made it possible to show a balanced revenue budget and go on balancing the capital budgets also by fresh borrowings. As the sources and purposes of borrowing were numerous and ever on the increase, no serious question about the soundness of the new system projected itself for some time on the attention of the governments." Although the subsequent FCs have recommended a more prudent approach, the Eighth FC (1984) surprisingly stated, "We see nothing wrong in the growth of public debt. While it is, no doubt, preferable that public debt is discharged through public savings, in the event of such savings being inadequate or required for achieving a better economic and social goal, there is no harm in discharging old debts by taking new loans."⁵⁴

⁵⁰ The Report of the Fourth FC (1965), para 148.

⁵¹ Seventh FC Report (1978), para 2.29.

⁵² See Vithal and Sastry (1998), pp. 281-282.

⁵³ The creation of a sinking fund, even when states have a revenue deficit, can increase transparency without affecting the net credit from the banking system to the states.

⁵⁴ Report of the Eighth FC (1984), para 14.16.

There is an urgent need to move away from practices that encourage excessive and undeserving expenditure. Expenditure reprioritisation is essential for bringing down the fiscal deficit and augmenting outlays on items such as basic education, primary health care, and roads.

V. Tax Issues – Harmonisation and Creating a Common Market

The structure of revenues in states may be described by the two-thirds' rule: (1) total tax revenues account for about two-thirds of total revenues; (2) own tax revenues account for about two-thirds of total tax revenues; and (3) sales tax revenue accounts for a little less than two-thirds of own tax revenues (table 2). Sales tax is the most important revenue source of the states. While additional resource mobilisation through non-tax revenues critically hinges on an overhaul of the subsidy regime, sales tax rationalisation constitutes an important outstanding item in the reform agenda not only for additional resource mobilisation but also for improving the economic efficiency of the system.

i) Sales tax: existing system

The states can levy sales tax on the sale of all commodities except newspapers; and on the sale of some selected services such as transportation (road and inland waterways) and entertainment. Sales tax comprises general sales tax (GST) levied as well as retained by the states and central sales tax (CST) levied by the centre but collected and retained by the states. Since the end of the eighties, most states have been levying a first-point sales tax, whereby a tax is levied on the first sale in the state, usually by a manufacturer or an importer.⁵⁵ However, as an additional revenue raising measure, many states also levy additional tax and/or surcharge on selected dealers (on the basis of location or size of turnover).⁵⁶ GST applies on intra-state sale while CST applies on inter-state sale. Under GST, inputs are accorded concessional treatment in all the states.⁵⁷ However, no such tax concession is allowed in respect of machinery and equipments, or for inputs used in the distribution of goods.⁵⁸

⁵⁵ NIPFP (1999).

⁵⁶ Additional tax is charged as surcharge (SC) on GST or as turnover tax (TT) at a low rate. Five states charge SC as well as TT. These are Andhra Pradesh, Bihar, Gujarat, Kerala and West Bengal. In addition to these five states, another six states, namely, Goa, Haryana, Jammu & Kashmir, Orissa, Punjab and Uttar Pradesh levy SC, and three states, namely, Karnataka, Tamil Nadu and Tripura levy TT. See Aggarwal and Selvaraju (1998).

⁵⁷ The state of origin can not charge its GST on inter-state sales to registered dealers, and on consignment or branch transfers. Some specified goods are considered to be of importance in inter-state trade, commonly referred to as "declared goods". On these goods, the rate of GST can not exceed 4 per cent and these goods can not be taxed more than once under the GST Act.

⁵⁸ NIPFP (1994), p.16.

Table 2. States' Revenue Receipts⁹⁹
(In rupees crore)

	1996-97	1997-98 (RE)	1998-99 (BE)
Tax revenues	106,139.1	125,007.9	147,094.5
Revenues from own taxes	71,101.5	84,958.9	100,393.1
Income tax	1,010.5	1,080.1	1,235.3
Agricultural income tax	103.2	107.4	131.0
Tax on professions, trades, callings and employment	907.3	972.7	1,104.3
Taxes on property and capital transactions	7,419.5	9,038.9	10,860.7
Stamps and registration fees	6,267.2	7,614.6	9,118.8
Land revenue	1,073.7	1,349.0	1,656.4
Urban immovable property tax	78.6	75.3	85.5
Taxes on commodities and services	62,671.5	74,839.9	88,297.1
Sales tax	43,926.9	51,374.5	59,643.9
state excise duties	8,805.3	11,338.1	13,628.6
Taxes on vehicles	4,117.3	4,945.2	5,841.2
Taxes on passengers and goods	1,662.6	2,075.0	2,401.6
Electricity duties	2,718.3	3,390.4	4,070.0
Entertainment tax	605.8	728.4	784.6
Other taxes and duties	835.3	988.3	1,927.2
Share in Central taxes	35,037.6	40,049.0	46,701.4
income tax	13,488.6	15,503.5	18,860.5
Union excise duties	21,549.0	24,545.5	27,840.9
Non-tax revenue	46,697.3	52,039.1	56,011.7
Grants from the centre	23,154.7	27,704.1	28,306.3
states' own non-tax revenue	23,542.6	24,335.0	27,705.4
Interest	8,171.0	7,144.9	6,879.5
Dividends and profits	165.3	115.9	122.1
General services	5,328.7	6,149.0	6,908.2
Of which : state lotteries	3,639.4	3,053.6	3,764.5
Social services	1,199.6	1,410.9	1,546.3
Economic services	8,677.1	9,514.2	12,249.2
Fiscal services	0.9	0.1	0.1
Total revenue	152,836.4	177,047.0	203,106.2

Source: RBI Bulletin, Supplement, February 1999, Table 3, pp.S3-S4.

ii) Sales Tax: Problems

The problems with the present sales tax regime, namely cascading, multiplicity of rates, widespread exemptions and incentives, rate wars among states, tax exportation, and poor compliance, are well recognised in the country. In general,

⁹⁹ Includes 26 states and National Capital Territory of Delhi.

sales tax paid at an earlier stage becomes part of the tax base for the subsequent stages of tax. Without a system of set-off or tax credit for inputs, in spite of concessional treatment of inputs, the present system results in substantial input taxation and cascading.⁶⁰ Cascading not only distorts the allocation of resources, but also results in a bias towards vertical integration, an erosion of international competitiveness and tax exportation among states.

Multiplicity of rates complicates tax administration, affects compliance, distorts resource allocation, and in the absence of tax credit for inputs, leads to a non-transparent system about the final incidence of taxation across commodities. In 1994, the number of rates in most states was at least six or seven and as high as twelve or more in some (as in West Bengal and Maharashtra).⁶¹ "Conflicts arise not only over whether or not certain sales/activities should be subject to the tax, but also over which tax rate should be applicable. In most of these cases, judicial rulings generate "notes" to the law, which constitute piecemeal changes, without necessarily addressing the root cause."⁶²

Tax competition has seriously eroded the tax revenues of the states without bringing in any tangible benefits. The competition takes two forms: a rate war, and provision of incentives. Neighbouring states tax a single commodity at different rates. Tax competition in this 'beggar thy neighbour' game triggers a rate war and results in a loss of revenue to all the states put together. The states have also granted sales tax exemptions and concessions in order to attract industry. While there is little evidence that such incentives have an impact on the optimal location of industries, incentives granted by one state compel every other state to grant similar incentives.

The taxation of inter-state sale under CST was introduced in 1956 to plug the loophole of intra-state sale being declared inter-state and to avoid the producing state to issue notices to dealers in other states for taxes due on output produced in the state and sold by such dealers. The rate under CST is subject to a ceiling of 4 per cent. CST, however, acts as an impediment to the development of a common market throughout the length and breadth of the country and results in tax exportation by advanced states.⁶³ The proposed introduction of a free trade area in south Asia will create an anomalous situation where products can be brought into any part of India duty free from neighbouring countries but not from another state in India.

iii) Sales Tax: Reforms

A blueprint for reform is available since April 1994, when the NIPFP submitted its report on *Reforms of Domestic Trade Taxes in India: Issues and*

⁶⁰ Only in Haryana and Punjab, where manufacturers can buy inputs including capital goods free of tax, this problem is not there.

⁶¹ NIPFP (1994), p.13.

⁶² NIPFP (1999), p. 15.

⁶³ According to NIPFP (1994), p. xix, "Four 'high income' states with less than 20 per cent of the country's population account for 45 per cent of the total revenue from CST, while the low income states with 44 per cent of the population get 18 per cent of the CST revenue."

Options". The Union Finance Minister had commissioned the study, and the report recommended a scheme of independent dual VAT. Chief ministers, finance ministers, and top bureaucrats of all the states have been meeting since then to adopt various resolutions, but progress in terms of implementation has been tardy at best. Policy co-ordination is proving to be difficult in a federal set up with complete fiscal independence of states with regard to sales tax. With acute fiscal stress, the states are also wary of experimenting with a revenue source that constitutes two-thirds of their own tax revenue.

In August 1995, a *Committee of State Finance Ministers* had recommended the expansion of the tax base by keeping the exemptions to a minimum, rationalisation of the rate structure by reducing the number of applicable tax rates, and horizontal harmonisation of the rates. For horizontal harmonisation, goods were divided into four general categories: zero floor rate or exempted goods (25 goods), goods with 4 per cent floor rate (41 goods), goods with 8 per cent floor rate (74 goods), and goods with 12 per cent floor rates (57 goods). Apart from the four general categories, two special categories — consisting of a 20 per cent floor rate category (for liquor, molasses, petroleum products, rectified spirit and narcotics) and a 1 per cent floor rate category (for bullion, gold and silver articles, and precious stones) were also provided. Adoption of these floor rates was expected to bring in some degree of harmonisation and contain the problem of tax competition.

The floor rates had not been enforced and tax concessions had not been withdrawn until November 1999. In a significant move, after a meeting of the chief ministers on November 16, 1999, there was an announcement that floor rates will be implemented in every state and sales tax incentives abolished by January 1, 2000.⁶⁴ Furthermore, according to the announcement, the states have also agreed to replace the sales tax by the value added tax from April 1, 2001.

iv) Other tax issues

Apart from sales tax, the other important sources of tax revenues for the states are state excise duties on liquor, stamp duty and registration fees, and motor vehicles tax. Excise duties on liquor account for about 13 per cent of own tax revenues in the states, some states continue to have a stop-go policy regarding prohibition. While Gujarat has had prohibition continuously for a long period, the states of Andhra Pradesh and Haryana imposed prohibition a few years ago, only to withdraw it after severe revenue losses and enforcement problems. There is considerable scope for improvement of the tax regime and administration in the areas of stamp and registration fees and of motor vehicles tax. High stamp duty rates are leading to evasion, both directly as well as through undervaluation of property.⁶⁵ Motor vehicles tax administration continues to suffer because of lack of computerisation.⁶⁶

⁶⁴ See Business Standard, November 17, 1999, p. 1.

⁶⁵ See Mathur(1999), and Sen (1999).

⁶⁶ See Sen (1999).

Agricultural income tax, which is under the jurisdiction of the states, is a potential source of revenue. While not all states levy this tax, the present revenues from this source in the states are estimated at around Rs. 100-150 crore, which is insignificant. The question of mobilising more tax revenues from agricultural income, however, is a highly charged political issue.

VI. Concluding Observations

Federalism in India has served the country well in political terms. Even in economic terms, apart from the area of tax harmonisation and tax reforms, the states do not appear to have fared badly. Both revenue and fiscal deficits of the states have been smaller than those of the centre. The fiscal prudence exercised by the states in the past may have been partly because of the 'hard' budget constraints that they faced.

All governments in India are under fiscal stress because of increasing interest burdens from debt contracted in the past, and increasing wage bills. There are signs of the states catching up with the centre in terms of fiscal deficit. Rapid increases in interest and wage payments are crowding out capital and other developmental expenditures. It is imperative to effect a fiscal correction and safeguard developmental expenditure at the state level. Subsidies that do not benefit the poor and that do not generate much positive externalities is one area that offers a large scope for fiscal consolidation.

The centre needs to provide a leadership role in fiscal consolidation, particularly in an era of intensely competitive politics and coalition governments. While the 'hard' budget constraint at the state level will continue to provide some safeguard at the state level, such a safeguard can be bolstered by a *Fiscal Responsibility Act* at the central level which has been proposed by some.⁶⁷ The issue of fixing borrowing limits of the central government by parliament is not new. It came up in the discussions of the *Estimates Committee on Budgetary Reforms* in 1957-58, in the *Public Accounts Committee* in 1962, and again in the *Estimates Committee*, 1991-92.⁶⁸ The RBI has repeatedly raised the issue in its annual reports for 1991-92, 1995-96, 1996-97 and 1998-99.⁶⁹ It may be useful for states to also enact *Fiscal Responsibility Acts* to have a medium term framework for containing debt and interest payments, and to impose ceilings on guarantees. The states should

⁶⁷ Articles 292 and 293 of the Indian constitution provide the enabling provisions for fixing limits on Government debt. Article 292 states "The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed." Article 293 has similar provision for the state legislatures as far as states are concerned.

⁶⁸ A comprehensive discussion of this issue is available in Kanagasabhapaty, Pattnaik and Jayanthi (1997), pp. 983-1008.

⁶⁹ Quite a few countries have already imposed such limits on public debt. Countries of the European Union, according to the Maastricht Treaty signed in 1991, have a limit of 60 per cent for the ratio between Public Debt and GDP at market prices. Many observers have commended New Zealand's *Fiscal Responsibility Act* of June 1994.

also have a closer look at their strategy of using their share of small savings for financing the deficit, and at the cost of such funds. It is also essential to move away from the 'gap filling' approach in fiscal devolution and devise stronger incentives for states to mobilise additional resources, reprioritise expenditure, and reduce deficits.

Tax reform is an area where progress has been tardy at the state level. While states may have been wary of taking any reform initiative in an atmosphere of acute fiscal stress, there seems to have been a coordination failure as well. Given the tax assignment, surveillance and enforcement of mutually agreed reform programmes in the area of sales tax have been problematic. This is an area where rapid progress is expected in the next couple of years. But, given the past record, 'cautious optimism' may be all that can be recommended.

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