PART I

THE BROADER PICTURE

Chapter 1

Introduction and Overview

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State finances, which form the subject of this volume, comprise an extremely important and complex topic within the broader area of public finance in India. Under India's federal system, as set forth in its Constitution, the states have important functions and responsibilities in various economic and social sectors, in addition to their more narrow governmental roles. They also have access to substantial revenue flows, including both taxes they collect themselves and shares in certain taxes collected by the central government. Various transfers from the central government augment the states' own revenues.

A number of difficult issues and vexing problems are evident in India's state finances, which have suffered from adverse trends in the 1980s. State governments have been facing a worsening budgetary squeeze, which has severely affected their developmental expenditures. Inadequate, overutilized revenue sources are part of the problem, and central transfers have generally failed to grow as fast as the states' own revenues. But rapid growth of current expenditures, particularly on salaries and other establishment costs, has been a major factor behind the squeeze on state finances. Burgeoning subsidies and declining cost recovery rates for economic and social services provided by state governments have been responsible for the anemic performance of state nontax revenues and have contributed to budgetary problems in a major way. Numerous problems emerge from the structure of center-state transfers and the incentives and distortions created thereby. The proliferation of centrally-sponsored

1. Extensive assistance from Tapas Sen in preparing this chapter is gratefully acknowledged.

schemes and the increasing reliance on this source of funding by states have led to certain problems and distortions. Finally, the states have come to play an increasingly important role in the implementation of externally-aided projects, and problems concerning implementation delays, "crowding out" of other projects, possible distortion of investment programs, and slow disbursements of foreign exchange needed by the central government are of growing concern.

To set a basis for what follows in the rest of the volume, this chapter first outlines the basic structure of state finances in India and then reviews broad budgetary trends. Brief summaries of the other chapters then follow.

INTRODUCTION TO STATE FINANCES IN INDIA[2]

The Constitution of India sets forth in detail the political and governmental structure of the country, based on distinct central and state governments with specified spheres of activity, revenue-raising roles, and areas of authority.[3] Practice over the past four decades has further defined and modified the roles of central and state governments. Successive Finance Commissions, appointed normally at five-year intervals, have set parameters governing center-state flows. Some extra-Constitutional institutions and mechanisms, most notably the Planning Commission and associated center-state transfers, also have emerged and assumed great importance over the years.

The Constitution employs a three-fold classification in the division of expenditure responsibilities between the center and the states: some are exclusively subject to the jurisdiction of one or the other and others are concurrently within the jurisdiction of both. The central government is exclusively responsible for 84 categories, including defense; foreign affairs; international economic relations; atomic energy; aviation; shipping; posts and telecommunications; highways; banking and insurance; oil, petroleum, and petroleum products; certain industries that are within the jurisdiction of the center; and numerous other activities. The states are assigned exclusive juris-

2. This discussion of Constitutional aspects is based largely on P.D. Mukherji, "Centre-State Financial Relationship in India -- A Note" (in S.P. Gupta, Nicholas Stern, Athar Hussain, and William Byrd, editors, *Development Experiences in China and India: Reforms and Modernization*; Bombay, Allied Publishers, 1991).
3. Lower levels of government in both urban and rural areas have played a much more limited role than is typical in other large countries. See chapter 4.

diction over 47 items, most prominently public order, police, prisons, local governments, irrigation, agriculture and related activities, land, public health, industries other than those assigned to central jurisdiction, trade and commerce within the states, etc. Another 47 areas are under the concurrent jurisdiction of central and state governments, such as economic and social planning, forests, electricity, education, labor and others.

The Constitution also sets forth the respective taxation powers of central and state governments. Among the 13 types of taxes vested with the central government, the most important are taxes on income other than that from agriculture; corporate income tax; Customs duties; and excise duties on most goods.[4] Among the 19 taxes placed under the control of state governments are direct taxes on land and agricultural income; excise duties on alcohol and certain other goods; sales tax on all goods but newspapers; taxes on mineral rights; taxes on vehicles; taxes on sale of electricity; luxury taxes; and various others. It is generally perceived that the states' taxation powers are inadequate in relation to their expenditure responsibilities and that this imbalance has been worsening over time.

In addition to center-state transfers based on tax collections and tax sharing, the Constitution mandates resource transfers to the states through various mechanisms, determined by the Finance Commissions. These include transfers to states in need of such assistance and those for public purposes. The Finance Commissions play a key role in determination of center-state tax sharing and transfers; though their recommendations are not formally binding on the central government, in most cases they have been accepted.

The Planning Commission and the device of five year and annual plans, not originally mandated in the Constitution, have become a very important part of center-state fiscal relations. Transfers to support state plans have been determined by the "Gadgil formula"[5],

4. Sharing of proceeds of excise duties and personal income taxes collected by the central government with the states occurs, at rates mandated by successive Finance Commissions. Certain other, minor taxes are collected by the central government but are supposed to be turned over to the states in their entirety.
5. During the reference period of this volume, the factors included in the formula were population, per capita state domestic product (SDP) (for those states which had a per capita SDP below the national average), tax effort and special problems of individual states. In the recently modified formula, tax effort has been substituted by "fiscal management", and relative weights assigned to other factors have been changed.

and in addition numerous centrally sponsored plan schemes of various kinds have been established, usually involving matching contributions by the central government in response to state spending. Centrally-sponsored schemes have become an increasingly important source of funding for state government budgets, but since they are time-bound and subsequent recurrent expenditure responsibilities devolve wholly on the states, the schemes are argued to worsen the long-term fiscal situation of states.

Another problem has been emulatory behavior on the part of the states, under pressure from their employees, with respect to wage increases for central government employees. The latter have been subject to much less discipline in the 1980s than in the 1970s, and as a result of "catch-up" demands by their employees, state government salary costs have increased sharply. This factor, however, should become less important in the future, as many states have come into line with the latest central Pay Commission awards.

The revenue sources put under the direct control of the states by the Constitution have turned out to be insufficiently elastic, even when rising sharing rates for states from central excise duties and income tax are taken into account. This has led to demands on the part of the states that they be given access to more buoyant tax sources. But the respectable growth of states' own tax revenues and the failure to utilize some important taxes assigned to the states, as well as problems on the expenditure side, suggest that a more comprehensive approach to resolving the states' budgetary imbalances is called for.

Constitutionally, as long as they are indebted to the central government, states can borrow from the market only with its concurrence. Since plan transfers have had a substantial element of loans and the states have never been able to repay their debt to the central government fully, this has meant effective central control over the ability of the states to borrow; there has been nothing to prevent an arbitrary use of this power. States can borrow from foreign lenders only through the central government under the conditions stipulated by the same, perhaps with good reason; but this fact has also limited the access of states to borrowed funds. This is not to say that the states' problems would have been fewer if the institutional setup was different. Greater freedom for the states in borrowing might have resulted in further problems, as all loans have not been invested in assets yielding sufficiently high rates of return in fact. However, greater freedom in obtaining loans might have led to greater responsibility in their use. Overdrafts from the Reserve Bank of India (RBI) were intended to be short-term ways and means advances, but these were liberally resorted to by the states until 1985. The Overdraft Regulation Scheme put into practice by the RBI has hardened the soft budget constraint that the states faced earlier.

The central government has been from time to time accused of manipulating taxes to its own benefit, through a variety of means such as raising rates on taxes that it keeps in their entirety and neglecting tax sources that are shared with the states or required to be turned over to them. The use of surcharges on shared taxes is a similar phenomenon. While these and other practices may have exacerbated states' budgetary problems, it is hard to argue that they are the fundamental cause.

While center-state relations obviously comprise a critical component of state finances and raise many Constitutional and political as well as economic and financial issues, this volume focuses on state finances in their own right. To set a foundation for the rest of the book, a review of broad trends in state finances and in state plan financing follows.

BUDGETARY TRENDS AND PLAN FINANCING IN THE STATES

This section first looks at overall budgetary trends in the states. It then reviews patterns of plan financing, both aggregate and statewise. The financing of the Sixth and Seventh Five Year Plans also is touched on.

Budgetary Trends

Aggregate budgetary data of the states show that during the Sixth Plan period (1980-85), the current budgets taken together were not in the red and some surpluses were available to finance investment. The aggregate surplus was 0.4 percent of state domestic product (SDP) (as shown in Table 2.11). Shortfalls in plan outlays as compared to targets occurred mainly because the targets were unrealistic. In the Seventh Plan period (1985-90), while the outlay targets of the plan were met, state budgets showed a deficit in the aggregate (0.4 percent of SDP). There was, however, large variation in the size of surplus/deficit. In the Sixth Plan, while the fourteen states as a whole had a surplus in the current budget, West Bengal had a deficit. In the Seventh Plan, while others had a deficit, Haryana and Bihar had surpluses. Although the surpluses/deficits in revenue budgets do not correspond with those in the balance from current revenues (BCR), as the latter reflects the excess (deficit) of revenue in relation to nonplan expenditure only, it is fair to say that the BCR position depends primarily on the state of the current budget. In investigating the reasons behind the poor contribution of BCR in plan financing of the states, one has to go into the trends and factors affecting their current receipts and current expenditures.

In the Sixth Plan, for the fourteen large states, revenue receipts and expenditures comprised 15.8 and 15.2 percent of SDP, respectively. In the Seventh Plan, these proportions went up to 17.9 and 18.2 percent, respectively. This was the outcome of faster growth of current expenditures (over 13 percent) than of revenue (about 11 percent). In some states like Haryana and Uttar Pradesh, revenue expenditure grew at the rate of about 16 percent per annum, whereas their revenue grew at rates 10 to 12 percent.

Over the decade of the 1980s, tax receipts, which account for about two-thirds of states' total revenue receipts, grew at 15.1 percent per annum, while total revenue receipts grew at 14.9 percent. Own tax revenue showed a slightly faster growth (15.7 percent per annum) while the states' share of central taxes grew at 13.7 percent per year. Overall growth of own tax revenue seems to have been at a similar rate in all states, but that of individual taxes varied. Agricultural taxes and entertainment tax are on the decline (although in some states the growth in agricultural taxes was high, as the base was small). The significance of entertainment taxes is declining because of videos and resistance to increases in the tax rates. Sales tax, the most important tax source for the states, showed fairly high growth varying between 13.7 percent and 18 percent.

In all states, buoyancy of total revenue receipts and tax revenue was greater than unity during the decade. Sales tax shows high buoyancy in most states (the highest being in Andhra Pradesh, 1.51). In Punjab, buoyancies are relatively low for almost all taxes except electricity duty. Gujarat is not doing well in stamp duties and registration fees; in Tamil Nadu and West Bengal motor vehicles taxes seem to be sluggish.

The per capita tax burden varies considerably across the states (in the Sixth Plan, from Rs. 126 in Bihar to Rs. 331 in Punjab). In the Seventh Plan, the spread came down somewhat: Rs. 231 in Bihar to Rs. 552 in Punjab. Per capita taxation seems to be related to per capita SDP. But there is little evidence to show that per capita plan expenditure is determined by per capita tax burden.

Of non-tax revenues, which comprise 33 percent of the total revenue receipts of the states, 16.4 percent and 18.4 percent came from the central government as grants in the two plan periods respectively.

The contribution of states' own nontax revenue to total revenue receipts has been declining (15.4 percent in the Seventh Plan against 17.6 percent in the Sixth). The prospects for a substantial increase in any of the heads in this category do not seem to be bright.

By and large, revenue receipts of the states seem to have grown fairly uniformly at about 15 percent per annum in the 1980s. It was the faster growth of expenditure which resulted in the poor BCR position. The shares of selected categories of revenue expenditure in total revenue expenditure of the states in the Sixth and Seventh Plans are indicated below.

	General Adminis-tration	*Interest payment & appropria-tion to revenue against debt*	*Compensa-tion and assignment to local bodies*	*Social services*	*Economic services*
Sixth Plan	18.0	9.7	1.4	41.1	29.9
Seventh Plan	16.4	11.7	1.3	41.3	29.6

Over the two Plans, the share of interest payments has gone up, while that of general administration has declined and that of other heads has remained more or less the same (with a small increase under social services). The fastest growth was recorded by debt servicing in most states (there was a decline only in Punjab and Orissa). In Punjab, the share of general administration registered an increase. The obvious cause of the rapid growth of debt servicing is the increase in the debt burden (at over 15 percent per annum between 1985 and 1990). The ratio of outstanding debt to SDP increased from 20.9 percent in March 1980 to 23.7 percent in March 1985. This has been the trend in all the states except Tamil Nadu. The share of loans from the central government in the total debt has declined from about 72 to 69 percent, reflecting greater reliance on market and other borrowings. The ratio of repayments of principal to fresh loans seems to be declining and may be expected to decline further with the reliefs recommended by the Ninth Finance Commission, provided that the states manage to eliminate deficits in their current budgets.

The economic and functional classification of state budgets (available up to 1987-88) also shows that it is interest payments (not included in these data) which show the largest increase in the growth rate in the 1980s as compared to that in the 1970s. Compensation to employees grew at 17.1 percent per annum in 1980s, as against 14.8 percent in the 1970s, with considerable variation across states (Tamil Nadu, Madhya Pradesh and Maharashtra recorded a sharp increase in the growth rate in the 1980s under this head (see Table 2.18), while in Andhra Pradesh, Bihar and Karnataka there was a deceleration).

The detailed analysis of state finances presented in chapter 2 brings out the fact that the genesis of the resource constraint of the states lies in the growth of current expenditures outpacing that of revenues. Arguably, more rapid growth of revenue might have helped to avert this situation. While there is scope for better exploiting some of the revenue sources of the states, such as urban property tax and agricultural taxes, more attention needs to be paid to rationalization of existing taxes. Even more urgent is the need for cutting down wasteful expenditures and recovering costs of providing public services from those who can pay. The low buoyancy of states' shares in Central taxes also calls for some attention. With better management on the expenditure side and a little more effort on the revenue side, the states should be able to restore the balance in their budgets and undertake their vital tasks vigorously once again.

Plan Outlays and Financing

In the strategy of planning adopted by India in the post-independence era, a large role was assigned to the public sector. During the forty years spanning seven Five Year Plans, roughly 45 percent of gross domestic capital formation took place in the public sector. This was perhaps to be expected, as the initiative for laying the foundations for growth in the form of infrastructure and development of key industries was supposed to come from the public sector.While the lead for drawing up the blueprints for development -- the "Plans" -- was taken by the central government, as is to be expected in a federal polity, the states were involved in the task of promoting development almost in equal partnership. Until about the Seventh Five Year Plan (1985-90) nearly 50 percent of the total public sector plan outlay was undertaken by the states. In recent years, however, the states' share in the public sector plan outlay has declined. In the Seventh Plan, it fell to 41 percent (Table 1.1). The decline appears to have been even more pronounced in the capital component of plan outlay. The states seem to be experiencing difficulty in fulfilling even relatively modest targets. This is a matter for concern as planning needs to be decentralised if it is to serve the objectives of balanced growth and bring into full play local aspirations, potential and

Table 1.1

Public Sector Outlay Under Five Year Plans (Actuals at current prices)

(Rs Crore)

	Center	*States and Union Territories*	*Total*
First Five Year Plan (1951-52 to 1955-56)	706 (36.02)	1294 (63.98)	1960 (100.00)
Second Five Year Plan (1956-57 to 1960-61)	2534 (54.24)	2138 (45.76)	4672 (100.00)
Third Five Year Plan (1961-62 to 1965-66)	4212 (49.11)	4365 (50.89)	8577 (100.00)
Annual Plans (66-67, 67-68, 68-69)	3379 (51.17)	3224 (48.83)	6603 (100.00)
Fourth Five Year Plan (1969-70 to 1973-74)	7826 (49.60)	7952 (50.40)	15778 (100.00)
Fifth Five Year Plan (1974-75 to 1978-79)	13893 (48.21)	14986 (51.79)	28819 (100.00)
Annual Plan (1979-80)	10558 (46.02)	12383 (53.98)	22941 (100.00)
Sixth Five Year Plan (1980-81 to 1984-85)	57825 (52.91)	51467 (47.09)	109292 (100.00)
Seventh Five Year Plan (1985-86 to 1989-90)	129764 (58.77)	91009 (41.23)	220773 (100.00)

Note: 1. Figures for 1989-90 are revised estimates.
2. Figures within parentheses are percent to total.

Source: 1. CSO, *Statistical Abstract of India* (various issues).
2. Planning Commission, *Annual Plan* (various issues).

initiatives.

Difficulties in meeting the plan targets on the part of the states have been evident even in the Sixth Plan period. As Table 1.2 shows, the states' outlay under the Sixth Plan fell short of estimates by nearly 26 percent, as compared with a shortfall of 12 percent at the center. In the Seventh Plan too, the states' outlay registered a shortfall of about 11 percent from the original estimates, while the central government's outlay exceeded targets by about 12 percent. The

Table 1.2

Estimates and Actuals of Plan Outlay (Sixth and Seventh Plans)

(Rs Crore)

	Sixth Plan			*Seventh Plan*		
	Original estimates	*Actuals**	*Shortfall (-)*	*Original estimates*	*Actuals**	*Excess (+) Shortfall(-)*
Center	47,250	41,444	(-) 5,806 (-12.3)	95,534	1,06,817	(+) 11,277 (11.80)
States	48,600	36,022	(-) 12,578 (-25.9)	80,698	71,857	(-) 8,841 (-10.96)
Total	95,850	77,466	(-)18,384 (-19.9)	1,76,232	1,78,674	(+) 2,442 (1.38)

Note: * At prices of base year.
(Figures in parentheses indicate percentages of respective original estimates.)

Source: Planning Commission, Annual Plan, various issues and the two plan documents.

shortfall in the Seventh Plan outlay occurred despite only a modest increase in targets for 1985-90.In some crucial sectors (irrigation and power, in particular) the shortfalls were much larger in the Sixth Plan, both at the center and in the states. In the Seventh Plan, while the targets at the center were overfulfilled under most heads, large shortfalls occurred in the states, again in irrigation and flood control, power, and water supply and sanitation (25 percent or more), although the targets were modest. In contrast, general economic services and general services recorded an excess of 40 percent over targets (Table 1.3).

The probable reasons underlying these trends include relatively large contributions by the central government to the anti-poverty programmes, growing involvement of the central government in the power sector for technological and other reasons, and public resistance to large multipurpose irrigation projects due to apprehensions of environmental degradation and preference for less capital intensive dry farming techniques. Failure to meet even modest investment targets in vital areas like irrigation and power during the Seventh

Table 1.3

Plan Performance by Major Heads of Development : Center and States (Sixth and Seventh Plan)

(Rs. crore)

Heads	Center (Sixth Plan)			States (Sixth Plan)			Center (Seventh Plan)			States (Seventh Plan)		
	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)
I. Agriculture*	2450.1	2213.6	9.7	3119.0	2493.2	20.1	3556.7	4040.9	-13.6	5732.1	6477.2	13.0
a. Animal Husbandry and Dairies	398.0	250.9	37.0	430.6	318.9	25.9	410.0	278.8	32.0	622.6	591.2	5.1
b. Forestry	105.0	69.5	33.8	559.5	486.9	13.0	446.7	295.2	33.9	1340.1	1306.0	2.5
c. Investment in Agricultural Financial Institutions	664.4	972.9	-46.4	156.7	82.3	47.5	195.0	743.6	-281.3	158.6	134.2	15.4
II. Rural Development*	2314.9	2222.7	4.0	3020.0	2809.8	7.0	5401.6	7809.6	-44.6	4491.0	5689.1	-26.7
a. Cooperation	330.1	260.4	21.1	566.0	458.0	19.1	500.0	443.7	11.3	870 2	828.3	4.8
III. Special Area Programmes	0.0	0.0		1480.0	1145.0	22.6	0.0	0.0		2803.6	2938.3	-4.8
IV. Irrigation & Flood Control	635.0	353.3	44.4	11395.5	7524.0	34.0	834.9	701.6	16.0	15949.8	11868.3	25.3
V. Energy	11995.0	12358.8	-3.0	14293.6	9436.9	34.0	31492.1	33718.9	-7.1	22786.2	17284.3	24.2
a. Power	4725.0	3517.3	25.6	14293.6	9429.8	34.0	11051.5	13639.8	-23.4	22686.8	17213.3	24.1
VI. Industry and Minerals	12771.5	10247.6	19.8	2185.9	1881.0	13.9	18553.0	20642.3	-11.3	3785.9	3897.8	-3.0
a. Village & Small Industries	923.4	690.8	25.2	815.1	668.3	18.0	1284.8	1302.7	-1.4	1378.5	1343.2	2.6

Heads	Center (Sixth Plan)			States (Sixth Plan)			Center (Seventh Plan)			States (Seventh Plan)		
	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)	Plan Outlay	Actual Expen-@ diture	Shortfall (%)
VII. Transport#	8418.6	7076.6	15.9	3707.3	2967.2	20.0	16459.4	18878.5	-14.7	5772.5	5322.9	7.8
VIII. Communications, Information and Broadcasting#	3102.0	2440.8	21.3	28.6	36.1	-26.3	6365.8	8042.1	-26.3	99.3	91.9	7.5
IX. Science and Technology	848.2	699.5	17.5	17.1	23.7	-38.8	2303.4	2293.8	-0.4	157.3	133.9	14.8
X. Social Services#	4453.4	3700.5	16.9	8830.9	7086.6	19.8	10350.9	9897.3	4.4	17692.1	16146.4	8.7
a. Education	734.8	474.2	35.5	1624.1	1444.9	11.0	2388.6	2756.5	-15.4	3488.7	3862.0	-10.7
b. Health (incl. Medical)	601.0	445.0	26.0	1091.2	937.4	14.1	897.3	816.0	9.1	2240.3	2032.4	9.3
c. Housing	300.0	247.3	17.6	1065.9	979.5	8.1	457.9	152.9	44.8	1928.9	1905.0	1.2
d. Urban Development	110.0	69.9	36.5	780.8	562.4	28.0	*	99.7	*	1352.2	1374.4	-1.6
e. Water Supply & Sanitation	614.2	654.6	-6.6	3123.6	2057.0	34.2	1236.8	1566.3	-26.6	4848.1	4012.3	17.2
XI. Others	261.3	130.6	50.0	522.2	464.1	11.1	216.1	786.3	-263.8	1428.3	2006.7	-40.5
XII. Total	47250.0	41444.1	12.3	48600.0	36022.3	25.9	95534.0	106811.2	-11.8	80698.0	71856.7	11.0

Note: Negative signs under "shortfall" signify excess over the estimates.

Data for the Seventh plan period have been adjusted to roughly correspond those for the Sixth plan period.

@ Total of the values for five years, each converted to values at prices comparable to the original estimates.

* Included in housing.

Source: Planning Commission, *Annual Plan*, various issues, and the two plan documents.

Table 1.4

Financing Pattern of Plan (Sixth and Seventh) - Center and States

(Rs Crore)

	Item	CENTER						ALL STATES					
		Sixth Plan			Seventh Plan			Sixth Plan			Seventh Plan		
		Esti-mates	Actuals[1]	Short-fall (per cent)	Esti-mates	Actu-als[2]	Short-fall (per cent)	Esti-mates	Actuals[1]	Short-fall (per cent)	Esti-mates	Actuals[2]	Short-fall (per cent)
1.	Balance from current revenue	9568	6427	32.83	10479	3807	63.67	22312	14826	33.55	28974	17368	40.06
2.	Contribution of PSEs	13811	12815	7.21	37454	26872	28.25	-516	-4620	795.42	-1969	-3757	90.81
3.	Market borrowing including those by PSEs.	15000	12626	15.83	20620	34026	-65.01	4500	3406	24.30	9942	9242	7.04
4.	Small Savings and Provident Funds	3772	4049	-7.34	8677	8751	-0.85	6393	5901	7.70	16566	19070	-15.12
5.	Drawing down of foreign exchange reserves	1000	-	-	-	-	-	-	-	-	-	-	-
6.	Term loans from financial institutions		-	-	-	-	-	2722	1887	30.67	4639	4445	4.18

Item	CENTER						ALL STATES					
	Sixth Plan			Seventh Plan			Sixth Plan			Seventh Plan		
	Esti-mates	*Actuals*[1]	*Short-fall (per cent)*	*Esti-mates*	*Actu-als*[2]	*Short-fall (per cent)*	*Esti-mates*	*Actuals*[1]	*Short-fall (per cent)*	*Esti-mates*	*Actuals*[2]	*Short-fall (per cent)*
7. Miscellaneous capital receipts (net)	6170	6988	-13.26	19809	29039	-46.59	-2161	-2012	-6.91	-7191	-5113	-28.90
8. Budgetary deficit	5000	7955	-59.10	14000	28381	-102.72	0	3497	-	-	-	-
9. Net inflow from abroad	9929	6239	37.17	18000	16348	9.18	-	-	-	-	-	-
10. Total resources	64250	57098	11.13	129039	147224	-14.09	33250	22885	31.17	50961	41255	19.05
11. Central assistance to States	-15350	-13619	-11.28	-29737	-33554	12.84	15350	13690	10.82	29737	33264	-11.86
12. Resources available for the Plan	48900	43479	11.09	99302	113670	-14.47	48600	36575	24.74	80698	74519	7.66

Notes: 1. Calculated by adding up the annual latest estimates, deflated to 1979-80 prices using the wholesale price index.
2. Calculated by adding up the annual latest estimates, deflated to 1984-85 prices using the wholesale price index.

Caution: Figures given in this table may not tally with those in Table 1.3 as the present table is concerned with "resources" while 1.3 shows the "expenditures", the difference arising from a convention followed in the Planning Commission whereby actual expenditures are determined after taking note of diversions.

Source: 1. Ministry of Finance (1988), *Indian Economic Statistics (Public Finance).*
2. Reserve Bank of India (1991), *Annual Report.*

Plan, however, resulted mainly from acute constraints on funds available for development, as reflected in shortfalls in resources available for the plans compared to estimates. This was partly due to a larger proportion of plan funds being allocated to the revenue component of the plan. Rural development, which has a large component of revenue expenditure on anti-poverty programmes, did better.

Table 1.4 shows the actual pattern of plan financing as compared with plan estimates for the center and the states. While the constraints faced by the central government in financing the plans are not the same as those operating in the states, at both levels of government shortfalls in resources available for the plan are accounted for largely by the inadequacy of the balance from current revenue (BCR) and the contribution of public sector enterprises (PSEs), leading to heavy reliance on market borrowings and miscellaneous capital receipts. In the Seventh Plan, the central government was able to exceed its overall resource target, but mainly through market borrowings, miscellaneous capital receipts and budgetary deficits.

Shortfalls in the case of the states stemmed mainly from failure to generate surpluses from current revenues to the extent stipulated in plans. Massive losses of PSEs were also a major contributory factor. In the Seventh Plan, the aggregate losses of state PSEs turned out to be Rs. 3,757 crore, as against an estimate of Rs. 1,969 crore. Receipts from small savings and provident funds and miscellaneous capital receipts were appreciably higher than the estimates. Even so, there was a shortfall of about 19 percent. Central assistance to states brought down this deficiency by about 12 percentage points, leaving a resource gap of about 8 percent. Actual outlays, however, fell short of the original estimates by a larger margin, presumably because of diversion to other uses. Evidently, large surpluses would have to be generated especially by the states if they were to undertake development through planning on any significant scale.

Chapter 2 presents a detailed review of state finances and plan financing in the states during the Sixth and Seventh Plans, in an attempt to identify the factors underlying their increasing resource problem, so that remedial measures could be proposed. This is a matter of some importance, as the persistence of regional inequalities and the slow absorption of assistance from external agencies are attributable at least partly to the weakening of the states' ability to undertake investment for development.

Statewise Patterns

While the aggregate data indicate the worsening of the finances of the states as a whole in relation to the plan, there are wide variations among states in the scale of planning undertaken by them (Table 1.5). Indeed, the level of plan expenditures per capita varies widely across States. Despite thirty years of planning, it appears that per capita plan outlays in states are related closely and not inversely to their per capita SDP, contrary to what one might expect under planning aiming at balanced growth for all regions. In the Sixth Plan, the highest per capita plan outlay was that of Haryana (Rs. 235) and the lowest (Rs. 81) that of Bihar. In the Seventh Plan, the highest was Rs. 356 (Punjab) and the lowest Rs. 137 in West Bengal, followed closely by Bihar (Rs. 148). It is not surprising that planning has not been able to make much of a dent on regional disparities. While for the states taken together, the shortfall in aggregate outlay in the Sixth Plan was 26 percent, West Bengal could meet only about 52 percent of the target. Other states with less than average performance were Haryana (36 percent shortfall) and Bihar (33 percent shortfall). Karnataka, Tamil Nadu, Assam, Himachal Pradesh and Tripura had done better than the average.

In the Seventh Plan, shortfalls of varying magnitudes also occurred in all states (except Orissa), though the extent was smaller, thanks partly to the modest targets set. Some states did remarkably well in the Seventh Plan, however (Bihar for instance). This, coupled with the impressive performance of Orissa and the fact that the poor states had an above average growth rate in plan expenditure, helped to achieve a slightly more equitable distribution of plan outlay in the Seventh Plan.

Sectorwise shortfalls and overfulfillments in plan performance also varied considerably across states both in the Sixth and in the Seventh Plans. For instance, in the Sixth Plan the target for agriculture was exceeded in Bihar, Orissa, Tamil Nadu and Uttar Pradesh, while West Bengal and Haryana fell short by 30 percent. Among the major sectors, fairly large shortfalls occurred in energy in almost all states (the largest, 44 percent, in Haryana). Interestingly, large excesses of actual expenditure over targets occured under the heads communication, information and publicity, and "others". "District planning" accounted for the bulk of the excess under the last head. In the case of some states, shortfalls could be attributed to overambitious targets (e.g. in Tamil Nadu, Uttar Pradesh and Maharashtra) but that could not be said of West Bengal and Kerala. In the Seventh Plan, shortfalls do not seem to be attributable to enlargement of the targets, though in some instances (e.g. in Madhya Pradesh), the plan was clearly too large.

Table 1.5

Shortfalls and Average Annual Growth in Real Plan Expenditure During Sixth and Seventh Plans

(Per cent)

	Agriculture and Allied Services		Rural development		Irrigation and Flood Control		Power		Industry and Minerals		Transport		Social and community Services		TOTAL	
	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan
1. Andhra Pradesh																
Shortfall	16.7	19.7	27.9	-41.8	22.1	18.9	9.6	24.1	22.5	17.96	26.4	-54.0	13.5	-0.6	24.8	6.3
Average growth	18.5	3.9	29.3	9.2	13.2	-2.2	0.5	2.4	19.9	-10.6	2.5	-6.7	14.1	4.2	8.2	0.9
2. Bihar																
Shortfall	34.8	-30.3	20.6	-5.0	36.6	12.2	44.2	20.1	19.6	-17.0	12.5	3.7	26.2	4.6	33.1	2.3
Average growth	9.2	8.5	20.9	9.1	7.9	-3.9	-3.8	9.7	4.3	2.6	1.9	-2.8	3.6	6.9	4.1	2.6
3. Gujarat																
Shortfall	4.4	9.5	36.8	-19.1	33.2	44.2	27.8	26.5	0.1	-38.2	12.8	18.1	9.6	32.1	23.1	28.5
Average growth	7.0	1.4	0.7	6.7	5.9	5.3	10.9	2.7	5.2	3.0	-9.0	-1.9	6.2	4.0	5.0	2.7
4. Haryana																
Shortfall	25.7	30.5	14.2	-24.0	44.6	13.6	35.8	43.9	25.3	31.2	41.5	33.5	28.6	4.0	36.2	28.3
Average growth	19.5	-1.2	12.8	7.8	2.7	-20.6	3.1	0.4	-4.2	-4.4	-5.2	-2.8	12.9	28.3	3.8	0.9
5. Karnataka																
Shortfall	11.8	15.9	-40.4	-50.6	28.8	12.0	13.2	16.7	-14.8	7.6	3.3	24.6	22.5	11.2	14.5	11.0
Average growth	12.1	4.7	16.5	15.2	2.5	4.5	1.9	-1.3	9.3	0.1	6.3	-11.5	17.4	4.8	7.5	1.0
6. Kerala																
Shortfall	42.2	23.8	5.0	13.0	30.8	25.3	22.3	21.0	24.9	13.6	23.2	-13.9	6.5	9.9	22.0	15.5
Average growth	5.7	-2.4	-0.4	-0.3	2.3	-6.0	1.1	9.5	-2.6	1.2	4.8	1.6	1.7	2.5	0.4	0.2

	Agriculture and Allied Services		Rural development		Irrigation and Flood Control		Power		Industry and Minerals		Transport		Social and community Services		TOTAL	
	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan	Sixth Plan	Seventh Plan
7. Madhya Pradesh																
Shortfall	12.6	1.1	23.1	5.0	34.6	28.3	32.3	31.6	-11.0	-25.2	11.4	26.8	4.1	-5.5	26.0	18.4
Average growth	16.0	12.0	10.0	9.4	5.1	1.6	2.1	9.4	27.6	5.2	-4.9	2.6	19.9	10.1	6.6	8.5
8. Maharashtra																
Shortfall	-2.0	20.3	-206.4	-146.2	21.3	3.9	40.4	32.2	15.3	10.3	29.6	37.3	20.6	33.5	23.2	15.3
Average growth	28.4	3.0	128.7	-7.5	6.1	-0.5	-5.5	1.4	14.7	7.8	3.1	-2.6	11.9	7.4	8.6	0.8
9. Orissa																
Shortfall	16.4	-22.9	26.7	-12.3	30.5	3.5	27.6	34.2	-15.6	-43.8	24.6	1.0	14.1	-31.2	24.0	-0.6
Average growth	7.9	18.0	31.3	6.1	-0.7	5.3	-2.2	14.8	22.5	1.6	21.4	-1.0	11.4	11.8	5.8	9.1
10. Punjab																
Shortfall	32.5	27.1	16.6	29.8	46.7	21.0	15.4	6.0	33.7	0.9	24.8	33.4	38.7	33.4	29.2	13.2
Average growth	3.2	8.4	3.4	-3.5	-4.4	-0.5	11.7	4.5	11.4	5.2	-8.3	0.6	-1.4	13.1	2.3	7.9
11. Rajasthan																
Shortfall	15.9	9.4	16.8	1.7	22.4	29.7	37.6	13.3	26.1	39.1	-37.4	25.6	20.0	6.6	22.4	15.0
Average growth	-0.4	13.3	15.0	12.4	1.5	-2.5	-6.0	7.9	3.6	13.5	11.6	5.2	11.4	20.7	0.3	9.1
12. Tamil Nadu																
Shortfall	16.6	-30.5	-35.1	18.6	24.2	11.6	31.5	26.2	-11.0	-32.9	12.7	-2.8	19.8	13.6	17.4	11.8
Average growth	23.1	5.9	13.3	2.0	29.9	-9.5	3.4	-0.3	28.5	10.6	8.5	3.6	18.5	2.5	12.0	1.6
13. Uttar Pradesh																
Shortfall	-4.2	-12.9	-59.5	-27.9	33.6	23.9	35.8	35.5	4.3	8.9	-11.7	15.1	2.6	-6.0	19.0	14.0
Average growth	11.4	15.4	21.5	13.6	-2.6	-0.2	6.5	-7.8	33.3	-5.3	14.7	-4.4	19.8	15.0	9.1	1.5
14. West Bengal																
Shortfall	49.3	30.6	37.3	22.9	61.6	5.2	49.9	17.8	59.1	2.2	44.9	-8.1	40.1	5.0	48.9	14.0
Average growth	5.9	2.6	9.2	-2.8	-6.0	4.2	-2.1	12.7	5.6	9.2	7.7	2.8	1.3	2.6	0.0	5.0

Note: Figures for Sixth Plan are in 1979-80 prices and figures for Seventh Plan are in 1984-85 prices.

Table 1.6

Shortfall in Resources for the States : Sixth and Seventh Plans

(Percentages)

State		*Balance from current revenue*	*Contribution of public enterprises*	*Small savings*	*Provident Funds*	*Miscellaneous capital receipts*	*Adjustment of overdrafts etc.*	*Market borrowings and negotiatiable loans*	*Total State resources*	*Central assistance*	*Total resources*
Andhra Pradesh	6th Plan	37.9	118.8	-8.7	6.3	2.6	-280.3	42.5	37.4	13.2	30.3
	7th Plan	24.6	-10.5	1.2	-11.5	-47.3	-247.3	N.A	N.A	N.A	N.A
Bihar	6th Plan	40.9	719.1	3.0	32.6	46.7	27.4	23.1	62.6	15.4	44.1
	7th Plan	6.1	98.6	-1.6	-50.6	13.4	-131.0	N.A	N.A	N.A	N.A
Gujarat	6th Plan	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A
	7th Plan	51.4	214.4	-31.0	-15.6	-295.7	-934.7	N.A	N.A	N.A	N.A
Haryana	6th Plan	48.0	472.9	7.5	17.1	-173.0	-580.7	24.3	41.9	-1.2	36.3
	7th Plan	64.0	819.1	-90.5	-73.6	40.2	-184.2	N.A	N.A	N.A	N.A
Karnataka	6th Plan	23.9	-9.3	-0.3	18.1	20.1	-42.2	35.1	24.1	22.8	23.8
	7th Plan	54.3	-60.6	-46.5	-27.4	-52.6	-200.8	N.A	N.A	N A	N.A
Kerala	6th Plan	46.1	-59.2	-1.3	-4.7	38.6	21.5	42.3	30.3	24.0	51.1

State		Balance from current revenue	Contribution of public enterprises	Small savings	Provident Funds	Miscellaneous capital receipts	Adjustment of overdrafts etc.	Market borrowings and negotiable loans	Total State resources	Central assistance	Total resources
	7th Plan	229.5	-101.3	-127.1	-30.4	-21.3	-186.2	N.A	N.A	N.A	N.A
Madhya Pradesh.	6th Plan	14.1	747.2	24.8	60.1	-257.8	-388.8	34.4	36.9	22.4	33.0
	7th Plan	8.8	51.9	-33.1	28.6	56.7	-548.2	N.A	N.A	N.A	N.A
Maharashtra	6th Plan	N.A.	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A
	7th Plan	31.4	-183.4	-10.7	16.8	16.3	-	N.A	N.A	N.A	N.A
Orissa	6th Plan	24.9	-108.3	36.4	3.6	32.4	60.2	48.5	44.8	20.4	27.6
	7th Plan	56.6	203.2	-17.6	-87.6	-64.1	-41.4	N.A	N.A	N.A	N.A
Punjab	6th Plan	50.2	1124.3	24.3	23.4	309.3	-62.7	12.8	32.1	16.7	29.8
	7th Plan	107.6	8.5	-144.1	-252.6	294.1	-329.7	N.A	N.A	N.A	N.A
Rajasthan	6th Plan	51.0	49.7	-26.2	10.0	-61.8	-160.2	13.6	37.2	-9.9	22.7
	7th Plan	100.8	-97.8	-1.5	-45.6	150.9	-	N.A	N.A	N.A	N.A
Tamil Nadu	6th Plan	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A
	7th Plan	39.4	81.3	-11.7	-175.7	14.1	43.5	N.A	N.A	N.A	N.A
Uttar Pradesh	6th Plan	28.5	-1359.4	8.7	31.8	117.8	18.8	37.4	33.8	15.9	27.9
	7th Plan	84.0	3267.0	-57.1	-310.1	-78.4	-187.7	N.A	N.A	N.A	N.A
West Bengal	6th Plan	92.8	72.6	20.5	-9.3	-203.8	2473.7	30.6	81.4	7.5	67.0
	7th Plan	83.5	1.3	6.2	21.9	25.3	-243.7	N.A	N.A	N.A	N.A

While there were inter-state variations, five sectors (agriculture, irrigation and flood control, energy, transport, sanitation and water supply), which accounted for 75 percent of total plan outlay, experienced heavy shortfalls in the Sixth Plan in many states and also in the Seventh Plan (though the shortfalls were smaller). In social services, on the other hand, shortfalls were relatively small in general in the Seventh Plan. In some states as much was laid out on social services as on energy. It is thus not surprising that the share of revenue expenditure in total plan expenditure financed through the budget went up from 42 percent in the Sixth Plan to 51 percent in the Seventh. Punjab, however, deployed 70 percent of the plan for investment expenditure while Tamil Nadu spent only 27 percent. While the shrinking of the states' investment in the power sector could be due to the greater involvement of the center, stagnation of investment in heads like irrigation was due presumably to resource constraints.

Financing Pattern of State Plans

The financing pattern of the Sixth and Seventh Plans for the central government and for the states as a whole was depicted in Table 1.4. The main factor underlying the resource shortfall is the inadequate generation of public saving, which consists of surpluses of current revenues over current expenditure in the budget and the contribution of PSEs (Table 1.6). In the Sixth Plan, the shortfall in BCR was the main factor underlying the resource shortage in most states; in fact, in Haryana, Punjab and Rajasthan, the overall shortfall was almost equal to that in BCR, while in some states (Uttar Pradesh) PSE contributions also fell far short of the estimates. Surprisingly, variations from estimates occurred also in central assistance, ranging from a shortfall of 24 percent in Kerala to an excess of nine percent in Rajasthan. In the Seventh Plan, although the full picture of the financing pattern that emerged is not available, it is evident that deficiencies in BCR and PSEs' contribution were again at the root of the resource problem of the states. Large shortfalls in BCR occurred in Punjab, Bihar, Haryana, Karnataka, Uttar Pradesh and West Bengal; Punjab and Kerala actually had a negative BCR. Problems were compounded by the heavy losses of PSEs. These deficiencies were made up largely with accruals to small savings, state provident funds and in some cases (West Bengal) large overdrafts, accentuating the already heavy burden of state government debt.

OVERVIEW OF THE VOLUME

Brief summaries of the eight papers presented at the Seminar on State Finances and included in this volume, as well as two shorter papers circulated but not discussed at the seminar, are presented below. The summary of the seminar proceedings (Chapter 10) is not discussed here.

Chapter 2

This paper, written by Amaresh Bagchi and Tapas Sen, examines overall budgetary trends and plan outlays and financing in the states. It seeks in particular to ascertain the determinants of plan spending in the states and the reasons for shortfalls in relation to plan targets as well as slow growth of plan expenditure in real terms. There is also some analysis of trends on both revenue and expenditure sides, providing a foundation for the topical and state-specific analysis in subsequent chapters.

The paper starts out by looking at statewise and sectorwise patterns of plan expenditure, in terms of real growth as well as in relation to original plan projections. Performance in relation to targets was considerably better on the whole in the Seventh Plan period than during the Sixth Plan, in part due to more modest targets in the Seventh Plan. There was, however, great variation across states and sectors. Heavy shortfalls occurred in crucial sectors like power and irrigation under both Plans, although in the case of power this, to some extent, reflected a trend of increasing centralization of investment. Among the states, West Bengal, Haryana, and Bihar exhibited the largest shortfalls during the Sixth Plan, whereas Gujarat and Haryana suffered from relatively large shortfalls during the Seventh Plan.

States have exhibited an increasing tendency to allocate plan resources to "current" or "revenue" expenditure, especially in direct poverty alleviation and employment schemes, as opposed to capital investments in various kinds of infrastructure. Hence shortfalls of plan spending in relation to targets were relatively small in the social sectors. The shift toward current expenditure within the plan has been encouraged by the availability of central funding of various kinds for such schemes.

The paper then turns to an analysis of the pattern of financing the plan. Balance from Current Revenue (BCR) and contributions from state public enterprises have suffered from severe shortfalls as compared with plan targets. By and large, revenue receipts of state governments have grown at least as fast as state domestic product (SDP), although the growth of nontax revenue has not been satisfactory. This means that declining BCRs have been due primarily to rapid growth of nonplan expenditure, particularly subsidies and interest payments, the latter resulting from the burgeoning of state debt outstanding. Compensation of state government employees also recorded rapid growth (14.8 percent p.a. in the 1970s and 17.1 percent p.a. in the 1980s). Declining BCRs and weak contributions from public enterprises have meant that states have increasingly relied on borrowings of various kinds to finance their plans, including assistance related to externally-aided projects (see chapter 5).

The pattern of plan financing that emerged in the 1980s is argued to be unsustainable. One of the main conclusions of the paper is that without better control over expenditures, states' plans will be further squeezed, and planning at the state level will cease to be a meaningful activity.

In looking at the buoyancy of different revenue sources, the paper finds that indirect taxes have been relatively buoyant, whereas agricultural direct taxes and entertainment taxes have largely lost their significance. Nontax revenues also have declined in importance. A harmful tendency noted in the paper is that of states on the one hand trying to "export" their tax burdens, in a distortionary manner that goes against the principles of sound taxation, and on the other hand losing revenues through competitive "rate wars".

The paper undertakes an econometric analysis of the determinants of plan spending at the state level as a ratio to SDP, leading to some interesting findings. First, the dependent variable is negatively related to per-capita income, other things equal, suggesting that plan spending to some extent has had an equalizing influence. Interest expenditure not surprisingly is negatively related to lagged plan spending, as the former appropriates funds that would presumably otherwise be available for the latter. Political variables turned out to be a significant determinant of plan spending, as was ability to raise own resources (proxied by the share of manufacturing in SDP).

Chapter 3

In their paper, M. Govinda Rao and Sudipto Mundle undertake a detailed analysis of subsidies at the state government level, building on their earlier work on fiscal subsidies more generally. The paper covers budgetary subsidies for the fourteen major states at two points of time: 1977-78 and 1987-88. The aggregate level of subsidies and the sectoral composition are calculated, and differences across states and sectors as well as trends over time are documented.

The first part of the paper examines revenue trends and shows that nontax revenue has accounted for a small and declining share of total revenue and has made only a negligible contribution to ameliorating the fiscal problems of state governments. This provides a strong indication of inadequate cost recovery for services provided by state governments. The next section puts forward a definition of subsidy for use in the analysis and outlines how levels of subsidies are calculated for different activities. Subsidies as defined in the paper include imputed interest and depreciation costs, as well as current (or "revenue") expenditures.

The paper finds that levels of subsidies grew phenomenally over the decade between 1977-78 and 1987-88, with growth of recoveries lagging far behind the increase in costs. This pattern is common to all states. It is interesting to note, however, that both aggregate and per-capita subsidies went disproportionately to the better-off states. Relative shares of states in total subsidies remained remarkably stable between the 1970s and the 1980s.

The authors then examine subsidies in major functional categories. Social services claimed a predominant share of subsidies in all of the major states, with education accounting for the largest share within social services, followed by health. Per-capita subsidies tend to be higher in states where levels of provision of education and health services also are higher. The paper documents the extremely low rates of cost recovery prevalent in social services, even in sectors like higher education where distributional and other justifications for subsidies are weak.

Turning to economic services, the authors note that irrigation and agriculture subsidy costs account for more than half of the total, while power and transport also involve substantial subsidies. Analysis of trends suggests that distortions induced by subsidized provision of various economic services have been increasing over time. As in the case of total subsidies and those on social services, subsidies on economic services are skewed in favor of the more developed states. Inefficiency in state public undertakings as well as inadequate tariff increases, resulting in worsening rates of return, have been major factors contributing to the rise of subsidies.

The paper concludes by reiterating that the total volume of subsidies in fourteen major states amounted to a staggering 8.3 percent of GDP in 1987-88. Rapid growth of expenditures on social services (which carry low cost recovery rates) and declining rates of cost recovery for economic services both have contributed to the rapid growth of subsidies. Moreover, the volume of budgetary subsidies to state public enterprises has been increasing. Subsidies have been maldistributed across states and across income groups within states, indicating that the federal transfer mechanism has failed to achieve fiscal equalization objectives. The authors argue that redistributional objectives would in some cases be better served by pure income transfers.

Chapter 4

This paper, by Abhijit Datta, surveys the crucial area of local government finances (both urban and rural). It highlights the colonial legacy of local government in India, onto which was grafted a Soviet-style system of local government in the rural areas. By international standards, India is well below the norm in terms of the share of total government expenditures handled by local bodies (about six percent in 1986-87). Moreover, local government functions have increasingly been usurped by higher levels of government, and in many cases local bodies have actually been superseded for periods of time.

There are great dissimilarities between rural and urban local government in terms of the structure of revenues. For rural local governments, as much as 88 percent of total revenue flows from state governments, whereas for urban local governments, less than a quarter of revenue consists of assistance from outside. This pattern reflects the dearth of meaningful tax sources for rural governments. There are major differences across states in local revenue mobilization. Three states, Maharashtra, Gujarat, and West Bengal, account for about two-thirds of total rural government revenue. Constrained by their limited tax powers, urban local governments are also experiencing increasing state intrusions into their tax domains. The productivity of local taxes is generally low. One promising potential revenue source would be local professions taxes, which have been increasingly taken over by the states. Datta also makes a number of suggestions for improving property taxes, which are argued to have considerable revenue mobilization potential.

Octroi has been a primary revenue source for urban local governments in many states. There have been widespread calls for its abolition, because of its distortionary effects on internal trade and high costs in terms of delays and corruption. Datta points out that the pattern is actually quite mixed: while some states have abolished octroi, sometimes with adverse consequences for local revenue, some non-octroi states have imposed octroi or are considering doing so. Unless certain preconditions are met, argues Datta, abolition of octroi will not have beneficial result, and readily available alternatives may be worse.

Despite very low physical levels of various local services, many local governments are nominally in surplus year after year. This is argued to be not a healthy phenomenon, reflecting in part the lack of stable revenue sources and consequent conservatism in incurring expenditure liabilities.

Considerable attention is devoted in the paper to cost recovery for local government services. In general, Datta argues that the potential for enhanced cost recovery will not be very good until basic community needs have been met. Alternative private provision is a possibility in many cases, however.

Transfers and grants to local government need to be revamped and consolidated, in a manner that will enhance local autonomy, argues the author. Local governments have virtually no independent role in plan development, although they are often forced to bear the burden of implementing or continuing plan schemes. Datta also argues that local authorities should be given more access to borrowing to finance projects.

The paper closes with some policy recommendations. Datta asserts that major reforms are needed, starting from political decentralization and moving to a more market-based economy. Local fiscal autonomy needs to be promoted judiciously. Reforms in the environment faced by local government, it is asserted, will be more important than internal local government reforms in the immediate future.

Chapter 5

Bajaj's paper on externally aided projects in the state sector is of particular relevance in the light of recent concerns about the utilization of aid commitments and their effectiveness. External financing assumed an increasing role in the financing of development spending in the 1980s, a trend which is likely to continue over the medium term. The bulk of Official Development Assistance (ODA) flows have been linked to pre-identified, project-specific investments in the governmental sector; a significant (and increasing) proportion of ODA transfers are on the basis of activities by the states. With the emergence of newer sectors in which the states have primary implementation responsibilities, the role of states in utilizing external assistance has increased. At the same time, the search for additional funds to finance investments (and liberalization of transfer provisions from the central government) has led many state governments to actively seek external assistance.

Disbursements in the state sector have been slower than in the central or autonomous sectors. This can partly be attributed to the sectoral characteristics of projects undertaken at the state level, which typically have a longer implementation span, are multi-component, and entail complex and interlinked investments in infrastructure and staff. On the other hand, there is evidence of limitations in planning, design, financing and implementation capabilities in the states, which have tended to constrain disbursement performance. In sectors where comparisons are possible (for instance energy), SEB performance has lagged behind that of NTPC. Nevertheless, given India's federal structure and the Constitutional assignment of developmental responsibilities, it would not be possible to exclude the state sector from the sphere of external financing.

Bajaj traces the evolution of current policies on transfer of external resources to the states. These have undergone significant changes in less than a decade and a half. Before 1975 the states derived no additional resource benefits from externally aided projects; the funds flowing from external agencies were fully retained by GOI and "internalized". At present such resources are transferred, to the extent of 100 percent in most sectors, and substantially in the remaining few, as identifiable additionality. External flows are therefore no longer neutral in their inter-regional and inter-sectoral impacts; implementing states and sectors have gained at the expense of others.

External aid (and therefore additionality) was concentrated in a few states in the Fifth and Sixth Plans. In the Seventh Plan there has been relatively greater dispersion of projects; despite this, 71 percent of additionality flows in 1989-90 were disbursed to only five states (Maharashtra, Gujarat, Tamil Nadu, Madhya Pradesh and Uttar Pradesh). The pattern of external transfers to the states in this period has diverged increasingly from the principles of the Gadgil Formula which governs the allocation of "normal" plan assistance among states. Special Category States (for whom the Plans are effectively centrally funded) have little incentive to seek additional resources; their share of external transfers has been less than two percent in the 1980s (as against their access to 1/3 of the "divisible" pool of plan resources). The major gainers from external flows have been Gujarat and Maharashtra, along with other largely better placed states.

There have been reservations in India about the possible distortionary impact of external funding on inter-sectoral allocations. (The direct impact would be expected to be confined to the state sector, since additionality provisions do not formally operate in the central sector). In the aggregate such a problem is not immediately apparent, since external transfers have been small in comparison with the overall Plan outlays. The displacement or "crowding out" effect of externally aided projects is, however, clearly visible in sub-sectoral allocations. External assistance is not only significantly availed of by only a few states; it has been concentrated in a few sectors in these states. This has been a factor in the inability and at times the reluctance of states to assign counterpart funds for such projects.

Within the planning framework, the states have tended to overestimate, ex-ante, additionality flows, resulting in implementation slippages and utilization delays. Reinforcing this have been the design and other characteristics of externally aided projects: they tend to be relatively expensive, their costs are under-projected, and they are started with inadequate attention to project detail.

Chapter 6

The paper by S. Guhan reviews Tamil Nadu state finances in the period 1960-1990, with particular emphasis on developments in the 1980s. It highlights the dramatic growth (more than 13-fold) of receipts and outlays, which now represent 20 percent of net state domestic product (NSDP). The state has assumed important functions in many spheres; adequate funding for these activities in the future is, however, contingent on the containment of current outlays. Tamil Nadu has one of the most impressive records of resource mobilization among the states, a fact recognized by successive Finance Commissions; this will be difficult to sustain in the future, however. Tamil Nadu has been relatively disadvantaged in its access to central transfers. The paper also examines issues of cost recovery for publicly provided services and returns from investment in state enterprises.

The decline in outlays for capital formation since the mid-1970s provides grounds for concern in the context of capital formation; 75 percent of total outlays are now devoted to current consumption. At the same time, there has been, in the 1980s, an increase in direct subsidies, even as the state government is increasingly burdened with a high-cost administration.

Tamil Nadu's tax revenues almost doubled as a proportion of NSDP from less than 6 percent to 11.5 percent between 1960 and 1985; among major states, Tamil Nadu is one of the most heavily taxed. In the tax structure, sales taxes predominate (67 percent); along with excise and stamp duties, motor vehicle and entertainment taxes, they represented 97 percent of total tax receipts in 1985. Other direct taxes, including electricity duties, constituted two percent and direct taxes on income and property only 1.4 percent. Sales taxes have also shown the fastest rate of growth, rising from 48 percent in 1960-70 to 66 percent in 1980-90. The adverse impact of sales taxes arises from their regressiveness, possible inflationary effects, and from the taxation of both final goods and intermediates. Tax rates are high and have been largely stable in recent years. Additional taxation is unlikely to realize major dividends in the future, as are other taxes, including motor vehicle and entertainment taxes and stamp duties. Excise duties, currently significant at around 11 percent, have been volatile as a result of repeated changes in prohibition policy. Agricultural taxation is low (and politically difficult to enhance), not progressive, and unresponsive to the growth of incomes in the sector. Nontax revenues have steadily lost relative share, including recoveries of outlays on the social services.

Guhan highlights the problem of access to central transfers of a middle income, low-deficit state like Tamil Nadu. The state's status has limited its access to Finance Commission transfers -- its overall share of the divisible pool has dropped with successive Finance Commissions; at the same time per-capita plan assistance has been below the average for major states. Not being a post-devolution deficit state, Tamil Nadu has not qualified for "gap" grants, either.

On the expenditure front, consumption outlays increased from 66 percent of the total in 1960-70 to 75 percent in 1985-90, with a corresponding reduction in capital outlays. There has, however, been relative stability in sectoral shares: currently social services receive about 40 percent, economic services 35 percent, and general services 25 percent. Guhan confirms that in relation to other states, the ratio of plan spending to total expenditure has been higher in Tamil Nadu. There is a trend of declining plan outlays for agricultural activity matched by an increase in spending on social and community services. The power sector, despite a dip in the early 1980s, has maintained a share of 35 percent. Tamil Nadu has opted for larger current outlays at the expense of capital outlays, reflecting the state's commitment to basic needs and welfare programmes.

Excluding current transfers and committed liabilities, salaries and establishment costs consumed more than 72 percent of the state's direct revenue expenditures, showing the heavy burden of employee compensation. In fact, this figure may be an underestimate, since a large part of grant-in-aid transfers actually goes to meet salary liabilities. The average employee cost has risen appreciably, as has the level of staffing, and most areas of governmental activity tend to be overstaffed.

Recoveries constitute about 12 percent of net state expenditures, that is, direct unrecovered costs comprise about 88 percent. Guhan's paper incorporates a detailed analysis of unrecovered costs. Recoveries varied from 2.3 percent in the social services (1.5 percent in education) to 18 percent in administrative services (mainly representing recovery for roads, with less than one percent recovery in irrigation and power). In particular, power subsidies to the agricultural sector have been significant. Food and nutrition comprise almost 35 percent of total direct subsidies, followed by power (through TNEB, 16 percent) and agriculture (14 percent). More than half of the direct unrecovered costs consist of untargeted or undifferentiated subsidies.

Among the state enterprises, TNEB has been the largest recipient of state government loans. Its financial position has deteriorated sharply in the 1980s. Government subsidies for power rose from negligible levels in 1960-70 to Rs. 181 crores in 1970-80 and to Rs. 523 crores in 1989-90 alone. TNEB's large losses are attributable to high costs (inputs, wages, debt servicing); inefficiency (transmission and distribution losses and a plant load factor, which though high in comparison with many other states, is still too low); and tariff policies which have not kept pace with cost escalation. Cross-subsidization is heavy and has shown an increasing trend in favor of agricultural and domestic consumers at the expense of industry. For the other state enterprises, the aggregate net loss in the period 1986-89 (after depreciation, interest, and taxes) was 7.2 percent; only two corporations (out of a total of 62) paid nominal dividends.

Tamil Nadu's reliance on the central government for borrowing has been less than the average for major states, but it is still sizeable at 96.5 percent of outstanding debt in 1988-89. The growth of borrowing in the 1980s has been rapid, though significantly slower than the growth of revenue receipts. There has been a perceptible shift in borrowing from the Government of India to other sources. In the case of borrowings from the central government, it appears that 40 percent of fresh loans are used to repay past borrowings. Tamil Nadu is one of the relatively less indebted states, possibly due to availability of current account surpluses and the lack of major capital projects (especially in irrigation).

Chapter 7

The paper by J.L. Bajaj and O.P. Aggarwal on Uttar Pradesh state finances also highlights the major expansion in the scope and scale of budgetary operations, following from and sustaining the expanding dimensions of state activity. In the 25-year period covered (1965-90), aggregate receipts increased 28-fold to Rs. 9213 crores, with current revenues as the most significant resource. There has, however, been a decline in the contribution of state taxes to total receipts, and also of nontax revenues. At the same time there has been greater recourse to borrowing to finance increasing expenditures (and deficits). Uttar Pradesh's tax effort, despite major absolute increases, has not been at the same level as that of many in other states, including comparably backward ones.

In terms of tax structure the importance of direct taxes has secularly declined, whereas among indirect taxes, sales taxes have become increasingly dominant, their share rising from 38 percent in 1965-70 to 53 percent in 1985-90. Excise duties have oscillated and were 19 percent in 1985-90. These trends are similar to those in other states. The scope for further increases in sales taxes is circumscribed by the high existing prevalent rates (and by the incidence of central taxes), as well as by the fear of trade diversion to neighboring states. Sales and indirect taxes, which have been shown to be inherently regressive, have been even more so in rural areas.

Among direct taxes, there appears to be a strong case for restoration of the professions tax (abolished in 1971). The only significant direct tax in agriculture is land revenue, which has been declining in importance. But other levies collected from the agricultural sector have been buoyant, including purchase taxes on foodgrains and sugarcase and mandi (agricultural market) fees. The contribution of the agricultural sector increased, as a result, from Rs. 78 crores in 1980 to Rs. 250 crores in 1990.

The relative contribution of nontax revenue to total receipts has sharply declined. Dividends from state enterprises are insignificant; the major sources are interest receipts, followed by departmental receipts. Interest receipts represented only 30 percent of interest outpayment in 1989-90, however, and over 95 percent of such receipts represented only accounting adjustments from departmental budgets (mainly irrigation projects).

The Uttar Pradesh State Electricity Board (UPSEB) is the largest state public sector undertaking, with capital and current assets at the end of 1987-88 of over Rs. 5000 crores. UPSEB showed gross operating surpluses until 1987-88; taking into account depreciation and interest payments, however, losses have averaged Rs. 400 crores annually since 1980. The causes of poor financial performance have been in part systemic (increases in thermal generation and of purchased power) and in part due to increased costs, low efficiency and productivity, low tariffs, and overstaffing. Subsidies on power supply to agriculture are extremely heavy; currently rural areas consume 40 percent of power but contribute only 15 percent of revenue from power. The Uttar Pradesh State Road Transport Corporation (UPSRTC) has also been incurring major losses, including Rs. 68 crore in the Seventh Plan alone. There has been a proliferation of state public enterprises (increasing in number from 11 in 1970 to 56 in 1984), to which the state's financial commitment was Rs. 975 crores in 1984. The returns from this investment have been negligible. Excluding UPSEB and UPSRTC, state public enterprises incurred an average annual loss of Rs. 25 crores in 1980-83. Their negative contribution has further eroded the resource base of the state. Among the contributory factors to poor performance are poor management, overstaffing, subsidized pricing of output, outdated technology, and lack of clarity of institutional objectives.

Irrigation works have represented a major area of state investment. However, even on "commercial" work, receipts contributed only 17 percent of maintenance costs. (If maintenance were to be carried out according to the norms, this figure would be even lower.) The subsidy on commercial irrigation in the period 1983-88 averaged Rs. 456 per irrigated hectare (Rs. 1145 per hectare for state tubewells). In addition, the irrigation potential has been seriously underutilized; of the 18 lakh hectares of potential created in the 1980s, only 5 lakh hectares were utilized.

On the expenditure front, consumption outlays have shown a rising trend as compared to capital outlays. As in other states, the social sectors dominate current spending, and economic services receive the bulk of capital outlays. Annual average per-capita budgetary outlays were about the lowest among major states, though the capital component of budgetary spending was higher than the major-states average. In current outlays, establishment costs represent the major portion; if grant-in-aid transfers for salaries are taken into account, this could be as high as 65 percent.

Direct subsidies have increased in importance to Rs. 2600 crores in 1985-90, particularly in agriculture and allied activities where they are concentrated. Indirect and largely untargeted subsidies are also provided in the social sectors, for which cost recovery is insignificant. In the education sector, per-capita expenditures (almost entirely subsidy) ranged from Rs. 440 at the primary level to Rs. 1815 in higher education.

Per-capita plan expenditures in Uttar Pradesh have risen at rates approximating the major states average; the increasing constraint to larger plan outlays is the limitations on the state's own resources.

Plan spending now represents over a third of Uttar Pradesh's total expenditures; over 40 percent of plan expenditures consist of revenue expenditures. The longer-term impact of centrally sponsored schemes is a cause of concern, in the context of the burden that they place on state finances. Expenditures in the Seventh Plan on centrally sponsored schemes averaged Rs. 825 crores annually; clearly, in the Eighth Plan, Uttar Pradesh will have to meet substantial nonplan liabilities on this account.

Central government loans were the main source of borrowing for the state (52 percent) in 1987-88, followed by market loans (17 percent) and small savings loans (15 percent); the balance represented Provident Fund and other deposits and institutional loans. Uttar Pradesh's indebtedness is low relative to that of many other major states, possibly explained by low per capita plan assistance and lack of access to market borrowing. At the end of 1989-90, assets, in the form of cumulative capital expenditures, loans advanced by government, and other investments, amounted to over Rs. 15,500 crores, well in excess of "liabilities" in the form of outstanding debt (Rs. 11,600 crores). This does not, however, give an accurate picture, since part of loans was specifically intended for consumption, while the other assets created have not resulted in cash flows to amortize investment.

Current revenues, excluding tax transfers from the Government of India, have been inadequate to finance current outlays, resulting in a trend of increasing deficits over time. Tax transfers from the central government have doubled in each five-year period. In the 1980s the current deficit increased sharply, and as a result incremental capital formation stagnated.

Chapter 8

This paper by Nizar Jetha reviews the structure and trends of Gujarat's finances in the period 1973-87. In particular, budgetary transactions in 1986-87 and 1987-88 have been analyzed. The paper highlights the emergence of current account deficits in the mid-1980s, in part a consequence of rapid growth of expenditures. The paper also reviews trends in the structure and composition of receipts and expenditures and examines in detail the state's own revenue efforts, their sustainability, and their potential for growth.

The bulk of Gujarat's current account receipts are derived from its own tax and nontax revenues; only about a quarter originate from central grants and transfers. State taxes predominate in own revenues (about four-fifths) and sales taxes in turn comprise about two-thirds of total tax receipts. Central loans, on the other hand, cover a significant proportion of capital receipts, financing about 50 percent of the overall deficit. The balance is met by domestic borrowing, and from recoveries and net contributions from provident funds. Interest receipts, dividends, and oil and mineral royalties constitute the major part of nontax revenues. User charges, particularly in the social sectors, are relatively less important as sources of revenue.

Within current expenditure, the social services predominate (42 percent), with education alone accounting for 20 percent. A further 35 percent is expended on economic services; general administration and debt servicing make up the rest. In capital expenditure, however, economic services dominate -- spending on irrigation alone represents 46 percent of total capital spending. Because of the importance of loans and advances made to state enterprises, budgetary transactions provide only a partial picture of the composition of investment. The Annual Plans provide a clearer picture, with irrigation and energy together garnering 54 percent, and social services 22 percent of plan resources.

Between 1973 and 1984, state expenditures rose by five times, while per-capita real expenditures rose by two-thirds. Capital expenditures rose rapidly initially, then slowed down in relative terms, reflecting resource constraints, while current expenditures increased rapidly and continuously. The growth of the latter is a consequence of ambitious development plans, the rising interest burden, expansion of poverty alleviation programmes, and "indexing" of state government salaries.

To finance rising expenditures, Gujarat increased its tax efforts substantially, without altering basic tax structure. State taxes as a proportion of SDP grew steadily. Electricity duties and sales taxes showed considerable buoyancy, while land revenue, motor vehicle and other taxes were less buoyant. There was also a moderate increase in central transfers, reflecting the growth of central loans for capital expenditures. The increase in the Government of India's contribution to the state did not result in a slowdown of Gujarat's own resource mobilization efforts.

In the context of emerging deficits and an increasingly inflexible pattern of state expenditures, Jetha examines in detail the structure of state revenues, specifically their potential for further expansion, without increased reliance on user charges or better performance on the part of public enterprises. The paper examines the distortionary impact of state and central sales tax on the allocation of resources (through changes in the relative prices of goods); at the same time input taxation affects the costs of production of user industries. The paper reviews land revenue, professions tax, stamp duties, and other taxes; it shows that there is scope for more efficient tax administration and collection.

Among Jetha's findings are the non-sustainability of recent trends of a 20 percent annual rate of growth of current expenditures (to which poverty alleviation, centrally sponsored schemes, and the state's own welfare schemes have contributed). He suggests that beneficiary targeting and greater cost effectiveness are required. The paper also suggests that maintaining Gujarat's impressive record in growth of tax collections may be difficult, due to concentration on a narrow range of taxes and the need to coordinate/compete with neighboring states. Continued and increased taxation of inputs would be anomalous, and even deleterious to economic efficiency. A significant suggestion in the context of coordinating state sales taxes is to abolish the central sales tax and adopt a destination principle. Among possible growth areas identified are professions tax and motor vehicle taxes. User charges represent a potentially important and at present greatly under-utilized source of revenue, including charges for publicly provided energy and irrigation services, as well as transportation and access to higher education. The agricultural sector, which is distinctly undertaxed, is another area of potential growth for future resource mobilization.

Chapter 9

This paper, by R. Ramalingom Aiyer and K.N. Kurup, looks at state finances in Kerala. Kerala is most interesting because of its paradoxical pattern of development -- slow growth of economic activity and per-capita income juxtaposed with high achievements in terms of social indicators of development, which in some cases match developed country standards. The paper explains this paradox in terms of the fiscal position and choices of the state. It also engages in extensive comparative analysis of Kerala and other southern states as well as aggregates for all states.

A central theme of the paper is that Kerala has suffered as a result of its emphasis, ahead of time, on social development (especially in education and health) and resulting inability to provide adequate funds for economic infrastructure or manufacturing development. Kerala's social achievements in certain respects themselves have worsened the fiscal picture, e.g. through increased pension costs or health expenditures. But most important, the slow rate of economic growth has squeezed the budget and weakened development prospects.

Despite its success in social development, Kerala's achievements are argued to be precarious and unsustainable. In education, for example, the government has taken over the bulk of institutional funding, even though the private sector had played the major role in earlier development of education. Such a pattern of financing cannot be maintained. Fees for education are minimal and are in urgent need of major revisions (the same is true of health). The budgetary situation overall is argued to be substantially worse than that of neighboring states.

The paper points out some interesting innovations by the state in various areas of tax and expenditure, which have resulted in improvements in the fiscal situation and may be worthy of emulation by other states. In education, for example, the spread of higher education in the 1980s occurred mainly through private "parallel" colleges, attended by students who subsequently passed state university exams and earned degrees in this manner, avoiding massive additional expenditures by the state government. On the tax side, Kerala has achieved substantial increases in agricultural income taxation and has rationalized sales tax rates to some extent.

An argument reiterated several times in the paper is that Kerala has suffered unjustifiably due to neglect on the part of the central government in terms of transfers. In effect, not only has the state not been helped fiscally as a result of its social achievements, but it has been penalized. Central investment funding at least in the same proportion as Kerala's share in the national population is strongly recommended.

Chapter 11

In his short paper, B.P.R. Vithal examines three critically important aspects of public expenditures at the state level: grants-in-aid, emoluments of government employees, and state subsidized services.

Grants-in-aid were a device inherited from the British, which involved partial government support to private entities providing social and other public services deemed important by the government, primarily education. The objective was to enhance provision of the services concerned while limiting government expenditure and gaining the efficiency advantages of private sector management. However, under the "net deficit" approach adopted several decades ago, the state government prescribed the fees that could be charged for the services and the pay scales for the employees concerned and then committed itself to cover through grants-in-aid the difference between receipts and expenditures of private providers. This is argued to have been very damaging both to expenditure control and to incentives. The state government took over additional expenditure liabilities from the private sector and at the same time removed incentives for enhanced cost recovery and efficient management.

Trends related to emoluments of state government employees are of concern, most importantly the rapid growth of real incomes. One factor leading to this result has been the increasing tendency for civil servants at different levels of government to demand parity with the best-paid group, culminating in pay scales identical with those of the Government of India. Moreover, the demand for parity in terms and conditions of employment has increasingly permeated lower levels of government and even government-assisted private institutions, regardless of ability to pay on the part of the employer. Thus state governments and ultimately the central government have become in a sense "responsible" for the remuneration of the host of lower-level government employees and those attached to quasi-governmental and even many private organizations, a burden which cannot continue to be borne.

Concerning state subsidized services, Vithal points out that many schemes intended to benefit the poor have been "hijacked" by the nonpoor and in fact mainly serve the latter's interests. Better targeting of services is often difficult and in any case is strongly resisted by the nonpoor, who have great political clout. Providing services to the poor and nonpoor at the same facility, the former free or highly subsidized and the latter on a fee basis, does not seem to work; the poor simply lose access to the services concerned. The only solution would seem to be reserving government facilities only for the poor and forcing the nonpoor to rely on the private sector, recognizing that this may result in further decline in the quality of government services.

Chapter 12

Oberoi's paper on the education sector focusses on a perspective often underplayed in India in the context of sectoral policy -- financial resources. Despite impressive increases in infrastructure, in enrollments, and in investment, the attainment of basic sectoral objectives has lagged. In fact, India's performance in literacy and related endeavours has been poorer than that of several comparably placed countries. Oberoi attributes the mixed success of initiatives in education, at least to an extent, to the failure to adequately integrate resource perspectives in the evolution of education policy. According to him, issues of financing of investments in education and their sustainability have tended to be dealt with as a residual.

Increases in public investment in the sector have supported, since independence, a manifold expansion of systems and infrastructure. This has rendered the sector, which already absorbs a large part of current government expenditures, increasingly dependent on budgetary support. In the 1990s, in the face of a relatively constrained resource environment, it may not be possible to continue these trends. Expenditure on education currently averages over four percent of GNP. This estimate is, however, based largely on institutional spending; if private direct costs for education are added, as well as subsidies on transportation, text books etc., the figure is likely to be considerably higher.

Education expenditures currently represent over a fifth of all developmental expenditures, comprising the largest single block of spending in governmental budgets. Spending on education is also the fastest growing segment of social service expenditures. A large (and increasing) proportion of sectoral expenditure is met from budgetary sources. Public spending has tended to substitute for community and private spending, a cause for concern. This trend is unlikely to afford a sustainable path for future growth; at the same time it has led to the entrenchment of expensive delivery systems.

The essential characteristic of education spending is a state sector orientation. Despite increased central efforts, the primary spending, financing and management roles are with the states. The central government's effective role would therefore appear to be catalytic and complementary, not over-riding. In the Seventh Plan, enhanced central provisioning of resources for education has partially succeeded in arresting a trend of declining Plan allocations for education. Despite this, the bulk of educational expenditure continues to reflect committed non-plan liabilities. As a result, resources available for incremental investments and quality improvement have declined over time.

The education sector relies almost entirely on exogenously derived resources (increasingly perceived as entitlements). This has inhibited the development of perspectives for financial management in the sector. The education sector has the lowest cost recovery rates, even among the social services. Significantly, unit subsidization is much greater in higher education than in basic education. This intra-sectoral inequity shows the potential for cross subsidization and increased internal resource generation. Other intra-sectoral trends also indicate a relatively disadvantaged primary education component, in terms of per-capita outlays, and the almost total domination by regular recurrent costs.

All of these trends raise important issues for the future content and directions of education policy.