REVIEW OF LITERATURE

In the late 1990’s India’s States were facing sharp fiscal deterioration. The problem was particularly serious in the poorer States. A slow deterioration in fiscal performance over the 1980s and 1990s was culminated into a State-level fiscal crisis by the late 1990’s. Almost all the States had to revise the salaries of their employees as they were under the tremendous pressure to do so after the Central government, implementing the recommendations of Fifth Central Pay Commission, hiked the salaries of its employees in 1998. Unlike the Central government, State governments’ fiscal performance did not show any improvement in the first half of 1990s, and their deterioration in the second half has been rather sharp.

In a fiscal federalism crises at one level of government are bound to spillover. So far as the fiscal imbalances are concerned, which continued till today, had appeared in the Central government’s budget in the form of deficit in its revenue account in 1979-80. States’ revenue account experienced the same in the later half of the 1980’s. Warnings about the sustainability of fiscal stance and the impending crises started appearing in academic and professional circles since around mid 1980’s (Rao SRK 1986). But the entire literature on Indian Public Finance remained focused on the fiscal crises faced by Central government. State government finances, though, started showing deterioration remained largely neglected. Even when the crises situation forced Government of India to undertake economic reforms, which included fiscal discipline, no serious beginning was made for such at the State level. The point largely missed by the government and academics alike was that reforms would not succeed unless undertaken simultaneously at both the levels. In a fiscal federalism Centre and States are not the watertight compartments and therefore the Center cannot remain insulated from the happenings at the State levels. So

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the analytical framework and the logic employed to study the Central
governments finances are equally applicable for so at the State level.

India’s fiscal federal system has served the country well, and has
brought stability over an extended period of time. But with the growing fiscal
stress, and divergence in performance, the system itself came under scrutiny if
it was responsible for the imbalances in the State finances. Therefore the
literature scanned for the purpose of present study can be classified into three
categories.

1. The theoretical framework (or in other words, the economics of deficits).
2. The theoretical and the empirical studies on fiscal federalism.
3. Analytical studies on the fiscal imbalances in the Central and in the State
government’s finances.

2.1: DEFICITS – SOME ISSUES

There are three distinct theoretical approaches, which could be found in
the existing literature on the subject.

Approach of classical economist - who were the proponent of the
minimal government – viewed the deficits as a temporary phenomenon which
could emerge as a result of some kind of emergencies like war, natural
calamity, epidemic etc. forcing the government to resort to public borrowing.
The government was required, in the wisdom of these economists, to go back
to the balance budget as soon as the conditions, which caused the deficit,
disappear. Since there was a general belief in Say’s Law of market which
suggests that economy would operate at full employment, fiscal contraction or
expansion were not viewed as tools to bring about correction in the economy as
the economy has the in-built self equilibrating mechanism. Nor was the Public
sector expected to perform redistributive role in the economy. Public debt was
not viewed as a source of capital either, for economic development. On the
other hand, there was an un-questioned faith in the market forces to generate
economic growth and macro-economic stabilisation.
Drawing an analogy between the State and the family reasonably summarises the classical notions of prudent fiscal conduct, which suggests that the public budget should be in balance if not in surplus. Therefore according to classical economist the government’s role was confined to providing basic public goods like public administration, law and order, defense and basic infrastructure like roads and bridges etc., besides putting economic system in place where people come together as buyers and sellers and to work in as much harmony as possible.

David Ricardo (1920) amongst the classical economist had different views on the question of public debt, which were summerised in what is known as “Ricardian Equivalence Theorem (RET)” this theorem suggests that the expenditure financed through the additional taxes or the public debt would have the same consequences for the economy in the long run.

“In point of economy, there is no real difference in either of three modes: for twenty million in one payment, one million per annum for ever or 1200000 for 45 years, are precisely the same value; … We are too apt to think that war is burdensome only in proportion to what we are at the moment called to pay for it in taxes, reflecting on probable duration of such taxes”.3

RET assumes considerable significance for its implications for the public policy but theory remains to be empirically tested. Buchanan and Brennan4 believed that the theorem would hold well under strict and rather unrealistic assumptions. Such condition as identified by them is listed below.

1. Public expenditure in the initial period is invariant as between two financing instruments.

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2. Public debt issued in the initial period must be serviced and/or amortized from the proceeds of taxes levied in latter period.

3. Capital markets are perfect, and persons may borrow and lend at the same rate as government.

4. Individuals are certain as to both current and future period income earning prospects.

5. Individuals as current taxpayers and as potential future taxpayer behave in terms of infinite planning horizon - they act as if they plan to live forever.

6. Individuals fully anticipate future period tax behavior that is embodied in debt issue.

7. All taxes are lump sum.

In spite of serious reservations on the validity of RET (amount to its near rejection) Buchanan and Brennan suggested further analytical and empirical investigations to ascertain the relative effects of public debt and taxation. Same conclusion emerged in the survey review of literature on RET. Buchanan and Brennan’s position is largely endorsed.

RET, though evoked considerable response from academics, had never influenced the public policy, which was greatly influenced by the wisdom of classical economist as talked about earlier. It was Keynes who questioned the classical wisdom of the balanced budget. Thus Keynes was the first person to provide legitimacy to the deficits in the public budgets. Keynes argued in favour of the increased government spending to raise the level of aggregate demand, which, in turn would raise the employment level in the economy. In fact Keynes taught that government would have to undertake the new function of using its budget to run not only its own activities, but also to maintain the entire economic system in full employment with budgetary expansion or

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contraction serving as the counter cyclical mechanism. Keynes’ advocacy might have remained unheeded had the great depression in the capitalist economies of Europe and United States not occurred in 1930s. Before the onset of depression there were not very many takers for the Keynesian line of argument. Faith in Keynesian argument continued beyond the period of depression, as its usefulness during the periods of World War II and the post war recovery vindicated it all the more.

Though the Keynesian prescription was probably to serve the capitalist economies to successfully face the cyclical swings, its usefulness was promptly recognised by the economies of the developing countries, which had very low saving potentials and structural unemployment. These economies found a justification for deficit financing their development programs.

In India deficit financing received overwhelming support as it could provide the much-needed capital required for the ambitious developmental goals through the Five Year Plans with public sector playing a dominant role, although there were few skeptics as well;

Rao V.K.R.V. (1952) expressed the same by pointing towards the supply constraints, which result in limiting the role of government expenditure.6

Shenoy B.R. (1955) dissented with the joint memorandum entitled “The Second Five Year Plan: Basic Considerations Relating to the Plan Framework” on the preposition of large scale deficit financing in order to provide ‘big push’ to the economy7.

Dasgupta A.K. (1987) did not join the issue when it was hotly debated at the time of the launching of Second Five Year Plan but he expressed his views in a paper in 1987. According to him the reason for unemployment in

7 Shenoy BR was the member of a group of economists constituted to study the ‘framework’ for the Indias Second Five Year Plan (1957-1962).
underdeveloped countries was not the demand deficiency (as Keynesian prescription seeks to remove) but the resource constraints. He refused to call Indian unemployment to be the Keynesian unemployment as in India unemployment existed along with the underutilisation of productive capacity. Such excess capacity was not because of the demand deficiency but was brought about by market imperfections underscores the fact that most of the industries were functioning as either monopolistic or oligopolistic entities and therefore enjoying sellers market. So the creation of additional demand through deficit financing could not be the remedy, which lies in the release of competitive forces in the economy.\(^8\)

By 1970s Keynesian approach began to be widely questioned. In fact large public expenditure could have been useful to tide over the crises generated by the deficiency of aggregate demand in the economy but the capacity augmentation in the producing sector would surely create problem in the long run. This is what had actually happened in the industrialised economies. United States experienced large fiscal deficit together with unemployment. The main criticism was that the deficit financed public expenditure couldn’t be sustained on the long-term basis. Other macroeconomic variables too would be adversely affected such as price, rate of interest and balance of payment (BOP) etc. The neoclassical approach that remained somewhat over shadowed by the Keynesian economics gained the ground again. So much so that the world financial institutions such as International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (The World Bank) had incorporated neoclassical approach as the guiding principle.

2.2: STUDIES ON FISCAL FEDERALISM IN INDIA

Since the publication of the monumental work of Musgrave in 1959 where he explained the fiscal functions of allocation, distribution and

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stabilization to be performed by the government in accordance with the objectives of the economic efficiency and social optimality, a plenty of literature has been produced on the question how these functions are best performed in a federal country. How should the various layers of government be assigned various responsibilities and tax jurisdictions? What principles should govern the formation of federalism and how such federalism should be geared to realise social, economic and political objectives, is the subject matter such studies.

There appears to be a consensus on the preposition that the primary responsibility for macroeconomic stabilisation policies and for the redistribution of income and wealth must be of the Central government, while the sub-national governments can be entrusted with the large part of allocation as the decentralised provision of public goods can cater to the local demands more efficiently.

Oates, Wallace E., (1977) provided an overview of economics of fiscal federalism. He tried to workout the implications of the basic principle for the efficient functioning of a multilevel public sector. Such approach seems to generate an insight which is useful for the analysis of budgetary policy of the government. But he cautions that it is difficult for such analytical tools to capture all the aspects of fiscal programs like revenue sharing. Moreover the economic logic often militates against social objectives. But despite all its limitations it often reveals certain basic tendencies in the system with which public policy must come to terms irrespective of its goals.

Dikshit Ashutosh, Viswanathan Renuka, T R Raghunandan (2007) pointed out one of the significant issues in the system of fiscal transfers. The practice of the Central Ministries releasing the grants under Centrally Sponsored Scheme (CSS) directly to the district level bypassing the State

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governments is a matter of dispute between Central and States’ government. Authors feel such practice has severely affected the adoption of sound accounting and monitoring practices. It is essential to restore them in an amicable and acceptable manner. In this they examine various issues concerning the accounting mechanism and attempt to develop a comprehensive system of solution to the problems.\textsuperscript{11}

Rao C Bhujanga, Manish Gupta, Pratap Ranjan Jena (2007) undertook the case of CSS transfer to the Panchayati Raj Institutions (PRIs) to the State of Madhya Pradesh. The CSS are of two types, one routed through State government budgets, and the other that bypass them. Study identifies some of the major CSS reaching the PRIs. An inverse relationship was found to exist between per capita CSS release and per capita GSDP for Madhya Pradesh and other major States. But for the poorest States whose per capita GSDP lie within a very narrow range, such relationship does not hold good, as there is huge variation in per capita releases.\textsuperscript{12}

Singh Nirvikar, T.N. Srinivasan (2006) examines India’s federal system in the context of prospects for India’s future economic growth and development. The analysis focuses on the major issues with respect to India’s federal system in terms of their developmental consequences. The impacts of tax assignments, expenditure authority and the intergovernmental transfer system on the following aspects of India’s economy and economic performance: the quality of governance and government expenditure, the efficiency of the tax system, the fiscal health of different tiers of government, and the impacts on growth and on regional inequality. The comparison has been made with China’s federal system, as China is a commonly used benchmark for analysing the Indian case. In there opinion the transfer system in


India is complex one with different channels of transfers because of which no firm conclusion can be drawn empirically on equalizing and growth promoting impact of transfers. Another important suggestion they made is to reconstitute the Planning Commission into a Fund for Public Investment.13

Garg Subhash Chandra (2006) found that the ever increasing financing of State sector’s subject which has proliferated over the years, affect the autonomy and the responsibility as it has generally transcended the States’ jurisdiction. Such instrument of financing is used by the Centre to influence States’ policies. Bypassing the States’ budget in some of the transfer, meant for local bodies has been found to be a significant irritant. He suggested major procedural changes in the disbursement of grants under Centrally Sponsored Schemes to minimise the element of discretion.14

Eunice Heredia and Mark Rider (2005) found that the high transfer dependency of the States has weakened accountability and fiscal discipline. The transfer system is also found to be complex and less transparent. Further, the lack of coordination among the institutions responsible for the transfers, produce distorting incentives. To address the problem of perverse incentives structural changes in the system of transfers are required. In the absence of changes the disturbing fiscal trends observed by the study are likely to persist. Although the Twelfth Finance Commission (TFC) has addressed some of the issues related to the intergovernmental fiscal system and soft budget constraint, there is still an urgent need to tackle other issues in the intergovernmental fiscal system that create perverse incentives and soften budget constraints.15

Singh Nirvikar (2004) argued that reducing the channels of intergovernmental transfers, would help in achieving objectives of horizontal

15 Eunice Heredia, Mark Rider (2005) “India’s Intergovernmental Transfer System and the Fiscal Condition of the States”, Andrew Young School of Policy Studies research paper series no.06-47.
equity as well as managing political challenges arising from increased regional inequality within the federation. Effective decentralisation seems critical, in his opinion, to improve the efficiency of government delivery of local public goods and services, particularly those that improve human capabilities. Thus, improvements in India’s inter governmental transfer system must include reforming the system of tax and expenditure assignments.\textsuperscript{16}

Rao M.Govinda and Nirvikar Singh (2004) are of the opinion that the asymmetry in administrative, political and economic spheres in federal systems is unavoidable and in fact, may be necessary not only to ‘come together’ but also to ‘hold together’. They argue that the rule based and transparent asymmetry (the special treatment to certain States accorded in the constitution and special treatment accorded to some of the states in evolving intergovernmental transfer system) has contributed to the health of the federation. The discretionary treatment of States arising from changing configuration of political power structure (real politicking by regional parties and the coalition politics) weaken the institutions of intergovernmental finance and can be harmful to the stability of Indian federation in the long term.\textsuperscript{17}

Nirmal Amit (2004) analysed the trend in transfer of resources from Centre to States from the data of 25 years i.e. from 1978-79 to 2002-03. The study reveals a steady growth in all the components of transfer of resources (Finance Commission, Planning Commission and various Ministries and Departments of Govt. of India) State’s share in central taxes, grants from Centre under various Plan and Non-Plan schemes, gross loans from Centre contributed around 37 per cent, 29 per cent and 33 per cent of the gross transfer respectively. It also indicates that in total devolution of resources the statutory


devolution is always on the higher side. It also becomes evident from this study that although the quantum of transfer of resources from Centre to State has increased in every five-year period, the rate of increase has shown a decline in subsequent five-year period. While five yearly growth rate decreases marginally in States’ share in Central taxes, it has decreased significantly in Grants from Centre. Thus it shows that Centre is withdrawing its hands from giving Grants to States.18

Bagchi Amaresh (2003) examined the working of India’s fiscal system in the light of the sound principles of fiscal federalism. He found the following weakness in it.

1. Over-centralisation of economic policies and attempt by the centre to take on too much, and micro-manage the economy by intruding into areas assigned to the States in the constitution, stifling local initiatives and weakening accountability of lower level governments.

2. Failure to ensure the development and smooth functioning of a common market in the country and prevent its segmentation through fiscal and quasi-fiscal actions of governments at both levels.

3. Faulty design of intergovernmental transfers creating perverse incentives for fiscal behavior of recipient governments.

4. Inadequate Central oversight over States' borrowing resulting in the problem of sub national debt and deficit.

He is of the opinion that the assignment of tax powers needs a fresh look especially after the constitutional recognition of the third tier governments. For sub-national governments to be accountable and fiscally prudent it is desirable that as far as possible they can meet their expenditures out of revenues they can

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raise on their own at least at the margin as most of them lack any substantial revenue sources of their own.\textsuperscript{19}

Chakraborty. P. (2003) found that the fiscal transfers are regressive in nature as the aggregate tax transfers per capita is positively related to the per capita income of the states. He also found that though, the fiscal autonomy was found to be negatively related to the grants transfers (both total grants and fiscal equalization grants) implying progression in the transfer of grants, it failed to eliminate horizontal inequality as the relative share of grants, especially fiscal equalisation grants are much less than the tax transfers.\textsuperscript{20}

Rao M. Govinda (2003) concludes incentive-linked transfers are too small to make any difference to fiscal performances.\textsuperscript{21}

Chakraborty. P. (1998) analysed the relative importance of the various components of resource transfers from the Center to the States and came out with the conclusion that Center-State financial relations as they have evolved over the years have failed to reduce the vertical imbalance. The continuous decline of own revenue as a percentage of States’ revenue expenditure could be another indicator of vertical imbalance.\textsuperscript{22}

\textbf{2.3: EMPIRICAL STUDIES ON THE CENTRAL AND STATES’ FISCAL IMBALANCES}

The deterioration in the finances of Central government started appearing since 1979 when the Union budget had shown a deficit in the revenue account. It was not considered then that this was going to become a serious problem in perpetuity. Though the then Union Finance Minister,

\begin{itemize}
\item \textsuperscript{19} Amresh Bagchi (2003): “Fifty years of Fiscal Federalism in India” Working Paper 2, NIPFP, New Delhi.
\end{itemize}
Chaudry Charn Singh expressed the confidence that the balance would be restored in the next year’s budget, but such optimism could not materialise. Every subsequent Union budget had shown even larger revenue deficit and even after Fiscal Responsibility Act, revenue deficit could not be wiped out. Seriousness of the fiscal deterioration was overshadowed by the continuous and impressive growth of the economy since the beginning of 1980s. Slumbering of the managers of the economy might have been because of the belief in Domer’s sustainability condition that the debt is sustainable if the growth in real income is higher than the interest on the public debt. State governments did not have such deficit, but by the mid 1980s most of the States were having the same. It was Rao S.R.K. who rang the alarm bell on the fiscal situation.

“… a situation is fast approaching even without raising the interest rates on government securities and treasury bills when the centre would have to borrow money just to pay for amortization of debt and interest on borrowing. Unless the government controls its level of borrowing, it would enter into debt trap situation”.23

Debt trap situation is defined to be the one when the amount borrowed might be just sufficient to meet with the debt servicing burden with situation further worsening where borrowing would not be sufficient enough to meet even the debt servicing charges.

Subsequent to this, appeared plenty of literature, both theoretical and empirical, on fiscal imbalances, initially on Union finances and latter, on States finances.

Seshan A. (1987) was perhaps the first study in this sequence to have attracted the wide attention. It not only endorsed the warning handed out by Rao (1986) but also analysed the growth of public debt over fairly longer period. It found that until 1973-74 the interest receipt of the Centre exceeded its payments. It traces that this negative interest payments had emerged in 1963-64

when the Centre received Rs.32.6 crore more by way of interest than it paid. After 1973-74 net interest payment (NIP) became positive and grew faster especially after 1978-79. The annual compound growth rate of NIP was 52.1 per cent during the period 1978-79 – 1985-86. As a result the interest payment accounted for 62.7 per cent of net market borrowing. Calculations on the basis of this trend suggest that borrowings may not be sufficient to pay even interest on market borrowing.24

Rakishit Mihir (1989) did not seem to buy the arguments regarding consequences of public debt, which in his opinion had been blown out of proportion without undertaking a serious analysis. He emphasised that the debt indices be re-looked at before arriving at any conclusion. On the debt figure as stood on 31, March, 1987 gross interest figure for 1986-87 and net interest payment, he argued that

(1) Interest should be netted not only for interest receipts but also for dividend receipts as borrowing is undertaken not only for advancing loans but for investments also.

(2) Out of total internal debt more than two third was held by Reserve Bank of India, Commercial Banks, Life Insurance Corporation etc. therefore a major part of interest payment is transfer to financial organisations owned and controlled by government itself.

(3) The practice of calculating public debt without taking into account the asset liability figure of public enterprises, which would probably create positive balance in net wealth of the public sector, is also responsible for enlarging the debt figure.

Further, most of the government investments are in infrastructure, which augment productive capabilities of the whole economy and therefore the private sector too is benefited. If the tax- GDP ratio did not increase in the

same correspondence it is the failure of the tax administration. Therefore instead of public debt it is the use of such debt, which matters.\textsuperscript{25}

Rangarajan C, Anupam Basu and Narendra Jadhav (1989) voiced the concern about the growing government deficits and the resultant rapid expansion of domestic debt in India. They attempted to devise analytically more meaningful measures of domestic debt. Starting from the inter-temporal budget constraint, analytical expressions in the form of differential equation were derived so as to establish the dynamic inter-linkages between government deficits and different modes of financing. This framework was used for financing in Indian scenario.

- Debt financing scenario (DFS)
- Monetary financing scenario (MFS)

MFS lead to vicious circle of large deficit and higher level of inflation. DFS lead to increase in overall debt-GDP ratio rising from 44.6 per cent of GDP in 1987-88. The overall debt-GDP ratio was anticipated to cross the 100 per cent mark in 1995-96.\textsuperscript{26}

Mundle and Rao (1992) while examining the fiscal crises of the Central government had glossed over the States finances and expressed concerned for the same. States’ finances, which were found to be in critical state resulting in the mounting public debt with strong possibilities for some States that they would perpetuate. They also examined the nature of the crises for the Central government and found the problems both at revenue as well as at expenditure level. Revenues have been found to be narrow based with multiple exemptions. On expenditure side subsidies were the cause for concern as they were not only increasing over time but were poorly targeted.\textsuperscript{27}

Bhattacharya, Barman and Nag (1994) prepared a stabilisation policy model for India using annual time series data for the period 1970-1991 for

\textsuperscript{26} Rangarajan, C., Basu, Anupam and Jadhav Narendra (1989): “Dynamics of Interaction Between Government Deficit and Domestic Debt in India”.
estimating the parameters of the model. Ordinary least square technique also has been employed to estimate the stochastic equation because the number of parameters exceeded the number of observations.

The model seeks to distinguish between differential effects of public consumption and investment expenditure on output. It does not directly link fiscal deficit to current account deficit, which is found to be through output and price. The model has been designed to evaluate the effect of various policy changes adopted in 1991 such as fiscal, monetary and exchange rate, etc. on output, inflation, fiscal imbalances and debt. The parameters of the model are also used to make various projections about the economy under alternative policy option. It found that the demand driven growth of 1980s would not be sustained and a fiscal and monetary contraction would result in trade off between inflation and growth. It has also been found that even without heavy inflow of foreign capital external sector stabilisation would have been achieved through devaluation itself.\(^\text{28}\)

Chelliah Raja J., K.K Atri., Rangmannar (1996) discussed some conceptual issues regarding deficit and stressed the significance of revenue deficit with which it will be difficult to maintain the productivity of public investment as several states are paying salaries to employees out of borrowing, and the contribution of their electricity boards, and irrigation work to the revenue receipt is negative. He argued that a moderate increase in revenue ratio would not be sufficient to reduce the burden of interest payment unless it is accompanied by the reduction not only in fiscal deficit but revenue and monetized deficits as well.\(^\text{29}\)

Nirupam Bajpai and Jeffrey D. Sachs (1999) examined the deteriorating fiscal position of the State government in India. The fundamental weaknesses


of State governments are; increase in non-developmental expenditure, structural imbalances in the form of large revenue deficit, rising interest burden, increasing distortion in the pattern of expenditure, and very slow growing non-tax revenues. The three different methods of intergovernmental fiscal transfers have resulted in de-linking the plan requirements of States from actual transfers. Similarly, better fiscal performance is not rewarded with higher transfers; instead the gap filling approach of the Finance Commission discourages fiscal discipline in the States. In the area of expenditure reduction, they favoured the increase in user charges on irrigation and a freeze on government employment.30

Kurian, N.J. (1999) focused on the deteriorating trend in State finances. The study highlighted a serious phenomenon of tax war among State governments to attract private investment. He also analysed the Center-State financing pattern and States own tax and own non-tax revenues, which are found to be insufficient. The increasing expenditure on non-developmental purpose is also a cause for concern as it resulted in increasing the borrowing of the States.31

Ambirajan, S. (1999) highlighted the competitive populism of political parties by taking up the State of Tamil Nadu, which leads to a distortion of the subsidy system in India. He examined the nature, causes and the consequences of the growth of subsidies in the State and found a qualitative evidence to show that the subsidy system in Tamil Nadu is wasteful, corrupt, and regressive and therefore counter productive.

“Subsidy is a system of inter connected institutions and when the inner mechanism decay due to the subversion


of norms and rules, the system is bound to fail to deliver the original objectives”.32

Schiovo, Campo Salvotore and Daniel Tomamasi, (1999) provided an overview on the two objectives. First, it places public expenditure management in the broader context of the role of the States, good governance, macroeconomic policy and the changing global environment. Secondly, they provide a quick run through of the entire expenditure management cycle. They also discuss about the corruption, because it is equally troublesome in management of tax administration, debt management, customs, and ill designed privatization of trade and exchange controls etc.33

Lahiri, Ashok. K. (2000) discussed the developmental problems of States’ macroeconomic problems, and the tax war among the States. Acute fiscal stress has been found at all level because of the implementation of Fifth Pay Commission’s recommendations, which is one of the major factors responsible for the fiscal imbalance in the States. 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. Resources endowments and levels of economic development differ across regions; this regional disparity may be reflected in the ability of sub-national governments to provide public goods to the residents under their jurisdiction. Increasing imbalance in the State finances is because of increasing interest bill, which is due to the large borrowing by the State governments, and Central government does not have full control over the borrowing through Small Saving Schemes.34

Ahluwalia, Montek. S. (2000) analysed the economic performance of States in post-reform period. After liberalisation, the control exercised by the

Center in many areas has been diluted somewhat, which enabled the States to attract larger amount of investment, both domestic and foreign but the growth performance of States remained different from each other. Inter-State inequality is quite wide spread. Some States have done exceptionally well; several other put up strong performance while some are doing very poorly. The reasons for this difference may be economical, institutional, social-economic or even socio-political.35

Shenggen Fan, Peter Hazell, and Sukhadeo Thorat (2000) developed a simultaneous equations model using the State level data for 1970 to 1993 to estimate the direct and indirect effects of different types of government expenditure on rural poverty and productivity growth of India. The results show that government spending on productivity enhancing investments such as agriculture R&D and irrigation, rural infrastructure (including roads and electricity) and rural development targeted directly to the rural poor, have all contributed to reductions in rural poverty and most have also contributed to growth in agriculture productivity.36

Rao M.Govinda (2000) questioned the rationale of the directives given by the Central government to the Eleventh Finance Commission to design a transfer system linking transfers to revenue deficits as the reality is not that simple. Transfers alone cannot solve the problem of the growing revenue deficits of the States as there are other problems affecting the States’ finances.37

Rakshit Mihir (2000) examines the nature of on-going budgetary imbalances in the Indian economy. Rakshit considered the fiscal deficits and the debt of the government sector as a whole and has treated the problem relating to them in the realm of ‘internal’ debt involving transfers with in a

jurisdiction. They expressed concern with the role of debt finance in promoting government capital formation and its expenditure on human resource development. Rakshit also examines how the use of loan finance could be optimised within the limit of fiscal sustainability over time with fiscal sustainability judged in terms of acceptable or manageable ratios of debt to interest payments, GDP and revenue receipts. The main concern is with the long term aspects of the consequences arising from continuing fiscal deficits. It would like to minimise the cost of government borrowing so that the ratio of interest payments to GDP may be correspondingly kept down. Rakshit recommends a higher monetised deficit, i.e. borrowing from the RBI than the permitted seignorage.\(^{38}\)

Bhargava P.K. (2000) discussed the deteriorating situation of States’ finance and need for resource mobilisation. The implementation of Fifth Pay Commission further deteriorated the fiscal situation of the Center as well as States. The interest payments gradually increased from 13 per cent of the States receipt on revenue account in 1990-91 to 17.9 per cent in 1998-99. During this period the quantum of fiscal deficit became slightly more than three times (from Rs 18,787.0 crores to Rs 59,276.6 crores). If State governments cannot reduce their day-to-day expenditures they ought to make extra efforts to mobilise additional resources and avoid wasteful expenditure. The measures recommended, besides reform in tax structure, include the State governments’ withdrawal from the loss making public sector undertakings. As the State governments have been incurring substantial losses on electricity schemes; irrigation works and road transport, the beneficiary of these facilities should be made to pay at least the user charges that cover the running cost.\(^{39}\)

Lahiri, Ashok.K. and R Kannan,. (2001) sought to draw a distinction between sustainability of public debt and its solvency. The debt is sustainable so long as the government is able to discharge its debt obligations in foreseeable future. But this can be done by playing what is known as ponzi


game (repaying through further borrowing). Therefore what is important is the ability to repay on the long-term bases. To achieve this, primary deficit as ratio to GDP should be zero. This may be a qualification to the Domer’s sustainability condition, which on its own does not generate primary surplus, making government to continue to borrow for debt servicing.40

Chelliah (2001) worked out appropriate fiscal stance and the optimum size of fiscal deficit, emphasising that deficit and debt of Union and State governments have to be considered separately. The State governments’ debt to external creditors and their capacity to borrow and repay must be considered in that light. The State governments should have been advised and guided to follow a more prudent financial path and not to imitate the Central government in the reckless use of borrowed funds for financing consumption and subsidies.

He advocated loan financing exclusively for capital expenditure, because the savings are contributed mainly by household sector. Public sector’s excessive claim over it through borrowing is likely to lead to sub optimal allocation of savings for capital formation. He also did not agree with Rikshit’s proposal of raising tax ratio as such rise might be accomplished only through steep rise in tax rate, which may not be advisable.41

Rao M Govinda (2002) discussed the trends in fiscal imbalances and the sources of such imbalances in States. The reforms should be focused on imparting efficiency and improve revenue productivity besides prioritisation and compression of unproductive expenditures.42

Dev, S. Mahendra, Jos Mooij (2002) brought out that social sector expenditure by both Center and States did not increase in the 1990s.

Expenditure of Center and States taken together as a proportion of GDP did not increase during the reform period except in 1999-2000.43

Joshi B.M. (2003) discussed the reform process initiated by Uttar Pradesh government in late 1990s. The white paper tabled in March 1998 along with the budget for the year 1998-99 acknowledged that the State was facing a near debt trap situation. The white paper, thus, became the beginning of the comprehensive reform process. The disquietening facts were the reaching of revenue expenditure to the level of 146 per cent of revenue receipts and the capital expenditure dropped to almost half of what it was 1987-88. The paper highlighted the factual account of the fiscal reforms specially the emphasis that the State government has placed on targeting minimum levels of social sector spending and improving overall expenditure composition. The impact of the fiscal correction and the efforts of the government in this direction and observed some encouraging trends over the period from 1998-99 to 2000-01. It is also suggested that better financial management and accountability have created an improved environment for measuring the State’s fiscal progress.44

Rao M.Govinda (2003) evaluated the measures introduced to incentivise the fiscal system of the States with a view to improve their fiscal discipline. He also examined the deterioration in the States’ finances, particularly during the last decade, and traced the possible reasons for the sharp decline in fiscal discipline among States.

The important conclusions are;

- Incentive-linked transfers are too small to make any difference to fiscal performances.

- Multiplicity of Centrally Sponsored Schemes creates segmented incentives.

- There is serious problem of design also.

- The schemes do not address the basic causes of deterioration in the States fiscal performance.

Stephen Howes, Lahiri Ashok K., Nicholas Stern (2003) argued that the system is not in the process of absorbing a fiscal shock, as it was five years ago, when the impact of the fifth pay commission pay awards was being felt. He says that revenue performance is better at both the States and Central government level than it was in the late nineties. Revenue/GDP ratios appear to be on an upward trend, and the award of Twelfth Finance Commission will give a significant boost to State revenues. Poor States face a particularly difficult fiscal situation. In addition to fiscal reforms, they need faster growth and additional Central government transfers.45

Rao M. Govinda and Nirvikar Singh (2004) attempted to analyse asymmetry in administrative, political and economic spheres of the federal systems. It is unavoidable, rather advisable to have such asymmetry not only to ‘come together’ but also to ‘hold together’. They argued that the rule based and transparent asymmetry - the special treatment to certain States accorded in the constitution and special treatment accorded to some of the States in evolving intergovernmental transfer system - has contributed to the health of the federation. However the discretionary treatment of States arising from changing configuration of political power structure, vagaries of coalition and regional party politics, weaken the institutions of intergovernmental finance and can be harmful to the stability of Indian federation in the long term.

Mukesh Anand and Rajeev Ahuja (2004) found that the Central government’ expenditure on pensions increased six fold between 1990-91 and

1999-2000. Therefore, a case is made for pension reform as it has considerable bearing on the Central government fiscal deficit that is already a matter of much concern.46

Pinto Brian and Farah Zahir (2004) found that the deterioration in fiscal parameters after 1997-98 appeared to be sharper when compared to the period that produced the 1991 fiscal and Balance of Payment crisis. Even the decline in interest rates to a record low level in recent time did not softened this deterioration because of the fact that the public debt dynamics is driven by the average cost of the whole stock of debt and not just the marginal cost of new borrowings. At the same time, power sector losses and guarantees extended by the State governments for bonds issued by loss-making public enterprises have become a significant threat to State government’s finances.47

Rao M.Govinda (2004) found evidence for the deterioration in State finances, in terms of sharp increases in revenue, fiscal and primary deficits, increase in their indebtedness and contingent liabilities, and decline in capital and maintenance expenditures. Further, the low buoyancy of Central transfers and spillover of Central Pay Revisions had the most adverse impact on States’ finances. He also recommended that States should focus on imparting efficiency in revenue productivity and prioritisation and compression of unproductive expenditures. However a strong political will, efficiency in administration, and involvement of the public in the reform process would be required to accomplish this.48

Acharya, Shankar (2005) surveyed the thirty years of tax reforms in India and found that enormous progress has been made in the last 30 years. He identified the key issues for the future reforms that include simplification of the complex system of customs tariff with multiple exemptions, low buoyancy of

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excise, integration of CENVAT with States’ VAT and the broad basing of direct taxes.\textsuperscript{49}

Adarsh Kishore and A Prasad. (2007) discussed fiscal performance of the States in India, which he found to be a cause for concern. He found that the Twelfth Finance Commission’s a three-pronged strategy to alleviate States’ fiscal distress, built around greater orientation toward market discipline, incentives for fiscal consolidation targets, and commitment to fiscal correction seems to have produced the desired results. States have created fiscal space through raising revenues and reducing and reprioritising expenditures. This expansion of fiscal space is essential to meet the States’ large infrastructure and social needs in order to alleviate bottlenecks to growth and should be accomplished without compromising fiscal prudence.\textsuperscript{50}

In view of theoretical approaches towards fiscal imbalances as well as their consequences for the economy and various issues involved in fiscal management ranging from asymmetric federalism itself to the fiscal profligacy on the part of States, found in the literature, it is worthwhile to examine fiscal health of the States along these lines. The same is attempted for major States in India in general and Uttar Pradesh in particular in the subsequent chapters.
