CONCLUSIONS AND POLICY IMPERATIVES

Findings of the study that emerge from the examination of States finances could be presented in three broad categories, though the categories themselves are not mutually exclusive. Therefore, certain amount of overstepping is possible. These areas are:

- Dynamics of fiscal correction in States finances (14 major States)
- Mechanism of federal transfer system and its role in States’ fiscal affairs.
- Fiscal imbalances in Uttar Pradesh and their management.

Analyses of States’ finances in the present study reveal the significant correction in the States fiscal performance during 2000 to 2006. Such improvement looks further impressive if compared with the situation prevailed during nineties. The decade can be characterised as that of serious deterioration in States’ fiscal health and reaching by 1998-99 to a crises situation. This time amount of the debt reached the unsustainable level resulting in squeeze on resources for social and economic infrastructure and other services which is States’ constitutional responsibility.

The reason for this kind of fiscal trend during the period 1991 to 2000 was the delay in the initiation of State level reforms. Worsening of fiscal situation from 1997-98 onward could be attributed a great deal to the substantial pay hike of the government employees by the States after the same was done by Central government.

Fiscal corrections during 2000-06 have been the result of the following factors;

1. States’ fiscal correction efforts.
2. Increase in the share of Central resources under the award if Eleventh and Twelfth Finance Commission including the debt relief package.

3. Overall growth of the economy specially its acceleration since 2003-04.

The fiscal correction can be achieved through three means with each pointing to different levels of correction quality are following:

- Achievement and maintenance of balance in revenue account.
- Arresting the further growth of debt through maintaining primary surplus.
- States’ own fiscal efforts.

These methods primarily measure the strength of fiscal correction with the last one being superior to others.

The majority of States have relied more on enhancing their own revenue to reduced deficit as compared to the cuts in expenditure. Orissa has achieved significant reduction in its primary deficit through its revenue effort relatively greater measure than the enhanced Central resource transfers. Bihar on the other hand could achieve only moderate improvement in primary deficit despite a significant increase in Central transfers.

Greater amount of fiscal profligacy was committed by relatively richer State like Punjab. Poor states that have significantly improved their own revenue include are Orissa, Uttar Pradesh, Rajasthan and Madhya Pradesh. The States’ that have consistently performed badly in terms of revenue efforts are Bihar and West Bengal. Those that have slipped in the relative performance are Gujrat, Kerala, Maharashtra and Punjab.

States’ revenue position have also been augmented by the Twelfth Finance Commission through raising the States’ share from 29.5 per cent to 30.5 per cent with poorer States getting relatively larger share. Poorer States have also been benefited by higher special purpose grants.

In brief it can be said that the substantial increase in States own revenue could become possible through reforms in tax policy and administration which
would expand the tax base and reduce evasion. Otherwise the fiscal correction so achieved will be washed away as considerable portion of correction could be because of debt relief measure, a phenomenon that can not be repeated frequently.

Analyses of federal finance reveal the following trends, which have far reaching implications for the federal financial structure itself.

Role of political economic factors in determining the shape of fiscal transfers, especially with the growing influence of regional political parties is evidenced from the fact that there were two occasions when major concession were conceded to the States, and on both the occasions political situation in the country facilitated the same. First time, when Seventh Finance Commission raised the States share in the divisible Union Excise Duty from 20 per cent to 40 per cent, there was first non congress government at the Centre with many State leaders were having considerable say in that political formation.

Another major event was the 80th Amendment of Constitution which made all the Central taxes to be sharable. This too was the result of the States growing influence in the national politics. It appears that the era of coalition government at the Centre is going to stay in at least in foreseeable future, with regional political parties occupying a considerable political space at the Centre. States are going to demand more and more concessions. The States now may not simply follow the principle of sound fiscal management if it curbs their flexibility in running the administration and expending the political influence of the political party in power.

Some time political expediency also induced the government to abandon the precautions the sound fiscal management might demands. Such development resulted in the increase in the size of State governments which has been faster than that of Central government. During nineties, State governments’ expenditure as a percentage of GDP had shown a remarkable rigidity downward.
In spite of such development States remained critically dependent on Central transfers. Vertical imbalance that are the result of Constitutional provisions themselves could only worsened over the years. During nineties States revenue balance suffered considerably due to the decline in the transfers from the Centre. Such decline was the result of the Centre’s fiscal reforms. The devolution gap so occurred had to be financed through borrowing by the States, resulting in the increase in interest payment obligations and hence the revenue expenditure growth.

On debt relief front too the Finance Commission (both Eleventh and Twelfth) did not take into account the fiscal capacity of the respective States. Debt relief was tied to conditions of reducing the fiscal deficit, which States were to make themselves committing them legislatively. In order to fulfill the legislative commitment States cut the expenditures that were politically and administratively expedient rather than the economic one.

In brief it can be said that the transfer system failed to reduce the vertical imbalance. Conditional grants largely through Central Sponsored Schemes have only proliferated over the years and the fiscal decentralisation has hardly occurred. Such things leave question mark on the future of federal transfer system which in view of the changing political scenario is likely to be challenged with greater intensity.

As far as Uttar Pradesh’s fiscal deterioration is concerned a turnaround occurred in 1988-89 with the revenue deficit appearing for the first time in its budget. Downslide thus set in motion continued unabated in the nineties as was the case with other States as well as the Centre. The small correction notwithstanding it was at its worst in 1998-99. The new century witnessed correction again initially but before it could be consolidated it worsened again and in 2003-04 all the indicators of fiscal imbalance were at their worst ever level. Worst thing was the fact that revenue deficit was higher than the fiscal deficit which means the borrowing was insufficient even to cover the revenue gap. Definitely this fiscal instance was unsustainable but the State could quickly
get over the crises and a sustained process of steady correction had begun which is continuing till date.

But bringing about fiscal balance per se may not be the objective if it is not accompanied by provision of social and economic services. The present study found that the revenue expenditure has been around 17 per cent of GSDP throughout nineties and thereafter except for year 2003-04. The quality of revenue expenditure could be gauged from the fact that about 30 per cent of it is consumed by the interest payment and pensions alone. Furthermore, it has been rising steadily. State could somehow manage to devote around 23 per cent of revenue expenditure to the social services which include health and education. This level is certainly unsatisfactory especially when viewed in the context of poor and deteriorating service delivery system. Though present study did not go into examining the quality of delivery system but such thing is well documented. The real casualty has been the economic service expenditure as it has been continuously declining. In the year 2005-06 there was merely 13.05 per cent of revenue expenditure which was less than half if compared with the same in 1993-94 when it was 26.45. It can therefore be said that while taking a correction path the State took recourse to the soft option of curtailing the expenditure on economic services which has serious implications for future revenue receipts and economic growth.

State of capital expenditure is not different either. It has, for most part, of nineties remained in the range of 3.5-4.0 per cent of GSDP occasionally breaching this range on either side. After the late nineties capital expenditure increased a bit reaching to 6 per cent and more. But the problem with capital expenditure has been that of substantially low returns on it. Interest received on loans and advances has seldom been one per cent or more in nineties and less in the current century. That means the recovery rate on loans and advances are not only low but have also fallen over time. Similar pattern can be observed in the case of State government investments. The quantum of investment has doubled between 1987-88 and 1999-00. Even after bifurcation it continued to increase
rapidly. However the extremely low rate of dividend renders such investments meaningless. The rates of return on the equity invested, even in the best year (1999-00) less than 0.2 per cent, for all other years in the decade it has been less than 0.1 per cent.

Receipts of the States, so far as tax revenue is concerned, continued to remain critically dependent on trade tax (now value added tax). The other sources did not show any promise. The reason for this narrow tax base has been the mere 20 per cent contribution the industries were making to the GSDP. Unimpressive growth of agriculture in recent years could also be the reason for poor tax receipts as enhanced agricultural income (though not taxed) results in the increased amount of value added tax.

Inadequacy of revenue is made up by the federal transfers. Different sources of transfers have different implications for the States’ finances. Significant change in the composition of such transfers has occurred over the years. The share of Uttar Pradesh in total transfers to States in 1998-99 was 12.30 per cent as compared to the peak in 1992-93 when it was 16.56 per cent. Disaggregation into the components of central transfer reveals that the share in central taxes has increased while that of grants has declined. It is also found that while both shares in central taxes and grants declined as percentage of GSDP, the fall in grants was steeper.

The broad conclusion of the study therefore is that given the kind of responsibilities and the assignment of revenue resources to the States the imbalances are bound to remain in their finances. Centre’s endeavor to induce financial discipline through transfers could provide temporary relief. Moreover often such measures fail to augment the fiscal capacity of the States. States have been increasingly becoming assertive and often succeeding in getting the Centre conceding to their demand. Another finding of the study is the relatively better off States are fiscally more profligate.
In view of these findings it may be desirable the studies are undertaken to find if there could be lasting solution to the problem of imbalances in the States’ finances i.e. the solutions that simultaneously provide strength and functional harmony in transfer system so that structural vulnerability of States’ finance could be reduced. It is hoped the future studies, especially at the level where team of experts work together so that it is free from various constraints present study has been subjected to, would undertake this task.