ABSTRACT

Sound fiscal health of the economy not only ensures its uninterrupted growth it also makes the fiscal instruments effective in managing the economy vis-à-vis macroeconomic stabilisation, allocation of productive resources along the desired line, and redistribution of income in accordance with the social and political philosophy. Imbalance in government finances not only hampers the growth momentum of the economy but also affects adversely the quality of public goods. In a federal country the issue becomes complicated as the fall out of fiscal imbalance does not remain confined to the level of government where it occurs but affects other layers of the government as well. Since responsibilities and the sources of revenue are constitutionally assigned to different levels of government they are independent in matters of taxes and expenditures in their area of jurisdictions. Thus even if imbalance at one level affect the other one it is not possible for the government whether at Centre or at the State to transcend the jurisdictional boundaries in attempting fiscal corrections.

India is federation with three layers of government namely the Central government, the State government and the Local government, the last one created through 73rd and 74th amendment to the constitution as late as in 1992 but the local bodies so created largely function as subsidiary bodies or the decentralised entities of States.

Structure of Indian federation is said to be asymmetric in nature where States have been assigned less elastic and relatively insignificant sources of revenue while they shoulder greater responsibilities of providing public goods and economic services. Constitution provides for the devolution of resources from Centre to States to make up for the inadequacy of their revenue. States in turn have to devolve revenue to local governments both Urban and Rural as these local bodies have been assigned a negligible source of revenue specially the later which hardly has any dependable source of revenue. Besides the
constitutional transfers, Central government provides assistance to the States for their development plans. These resources are routed through Planning Commission a body that was created to carry out India’s development plans.

In India fiscal situation became worse in the early 1990s and reforms were initiated at the Central government level. But as has been stated earlier, what happens at one level of government affect the other one, soon it became clear that fiscal reforms at the Central level alone would not be sufficient as the fiscal situation at the State level continued to deteriorate.

Present study attempts to analyse the imbalances at the State level. It examines the time profile of imbalances as reflected in various fiscal parameters like fiscal deficit, revenue deficit, primary deficit and public debt over the years. The inter State comparison has been carried out to find if the States exhibit the uniform pattern in terms of fiscal imbalances or their pattern differs in accordance with the difference in their respective fiscal capacity, per capita State domestic product and growth potentials.

Chapter One broadly explains the plan of the study. It begins with the explanation as to why the study on States’ fiscal imbalances is necessary and timely. It defines various measures of fiscal imbalance like fiscal deficit, revenue deficit, primary deficits etc. and their implication for the economy and fiscal management. In Indian federalism there exists a formal relationship between different layers of governments. Therefore what happens at one level affects the others too. Any amount of fiscal prudence at one level will be insufficient if the other one indulges in fiscal profligacy. By late nineties it became clear that fiscal reforms at State level were inevitable as the States’ imbalances were threatening to become unsustainable. Following issues have been identified for the Study:

- Growth profile of States’ fiscal imbalances over the years.
- The comparison across States of the imbalances in their budgets.
- Asymmetric fiscal federalism and its role in States’ fiscal imbalances.
• Mechanism of fiscal transfers and its contribution to States’ imbalances.
• Relative merits and demerits of revenue equalization approach of fiscal transfers.

Objective of the study is to find the genesis of States’ fiscal imbalance and to see to it if the States exhibit some uniform pattern or the problems are unique to individual State. Further, it is also intended to examine the role of federal financial arrangements in reducing / increasing the imbalances of States.

The hypothesis proposed to be tested in this study is;

“Indian States’ current endeavor to bring about fiscal discipline did not remove structural weaknesses in the financial system itself.”

Fiscal profile of fourteen general category States has been analysed that provides the inter-State comparisons. Among the general category States newly created States of Jharkhand and Chattisgarh, are excluded as they are newly created one and therefore not comparable with the rest of the States selected for the study. Goa and Delhi have been left out as they differ almost in every respect from rest of the general category States. To carry out the detailed Study Uttar Pradesh has been chosen because in spite of its vast agriculture, diversified economic activities and its distinct position in national politics the State is one of the poor States in India.

Most of the fiscal indicators are shown in relation to Gross State Domestic Product. Changes over time have been measured through ratios and percentages. Broad fiscal indicators have been presented graphically as well. The time series analyses by applying econometric tools can said to be the major limitation of this study.

Chapter Two undertakes the review of literature. The literature available on the subject can be classified into following three categories:

1. Theoretical frame work
2. Theoretical and empirical studies on fiscal federalism.
3. Analytical studies on fiscal imbalances in the Central and / or in the State government’s finances.

As far as theoretical approach is concerned three distinct approaches could be found. One, classical approach that favours balanced budget would suggest the borrowing in only extreme emergency situations. Two, Ricardian Equivalence Theorem (RET) which believes that the expenditure financed through the additional taxes or the public debt would have the same consequences for the economy in the long run. Three, Keynesian approach, that favours deficit budgets to facilitate increased government spending which would raise aggregate demand which in turn would increase employment level in the economy, was the first attempt to provide theoretical legitimacy to deficit financing.

In a multilevel financial arrangements there seems to be the consensus over the division of fiscal functions in accordance with the general framework suggested by Musgrave in 1959. Such framework assigns “distribution” and “stabilization” functions to the Central government while “allocation” to be the responsibility of State government. In India federal fiscal arrangements are largely based on such principle. Latter studies however sound caution that the analytical tools derived from such principles might not capture all the aspects of fiscal matters in a federation, for instance the revenue sharing and the resolution of conflict between economic reasoning and social objectives require institutional mechanism.

There is considerable amount of asymmetry in India’s federal fiscal arrangements which could be unavoidable to hold together the federation itself. So long as the asymmetry is transparent and rule based it works well but the discrimination of States based on political consideration weakens the system. Besides, high transfer dependence, multiplicity of channels of transfers and lack of coordination among them often produce distorting incentives. Central ministries transferring (in certain cases) to the third tier of the government
bypassing the State governments have been found to be the problem area for the federation.

Deficits started appearing in Central government budget since 1979-80 and became the regular feature. Since 1986, academicians and professionals have been expressing concern for the growing debt which was threatening to become unsustainable. States have been facing fiscal distress since 1987-88. Increase in non developmental expenditure, competitive populism of the political parties leading to unjustifiable subsidies, tax war among States to attract private investment have been some of the factors found to be responsible for the States fiscal imbalances.

**Chapter Three** undertakes the analysis of the system of federal finance and transfers mechanism in India. Constitution of India assigns responsibilities and revenue sources to Centre as well as States. Such division is asymmetric as States are assigned greater responsibilities considering their revenue jurisdiction. The constitutional scheme seems to be based on the principle of dominant Centre with the inbuilt flexibility. Therefore constitution provides for the financial devolution from Centre to States to make up for the inadequacy of States’ own revenue. Such devolutions are in the form of tax sharing and grants-in-aid from the Centre. The constitutionally created institution, the Finance Commission, appointed with a regular interval, is entrusted with the task of recommending the States’ share in the Central taxes and how such share is to be distributed among the States. It also recommends the quantum of grant to the States that, in the judgment of Finance Commission, are in need even after the tax sharing.

There are non statutory channels of transfers as well. They are in the form of the Centre’s support to States’ Five Year Plans which is routed through Planning Commission and administered by Revised Gadgil Formula. These transfers are in the form of grants and loans in the ratio 30:70 respectively for general category States (Corresponding ratio for special category States is
Yet another source of federal transfer is the grant provided by the Central ministries to their counterparts at State level.

Beginning with the First Finance Commission, a clearly discernable trend is the increase in the share of States in the sharable Central taxes. States’ share in Personal Income Tax increased from 55 per-cent under the award of First Finance Commission to 85 per-cent by Ninth Finance Commission. In case of sharable Union Excise Duty States have been receiving the greater Share in the award of every successive Finance Commission. States that got only 40 per-cent share in the Excise Duty coming from only three items by the First Commission were getting 45 per-cent share in the same from all the items under the award of the Tenth Finance Commission. Devolution to States went up further when through eightieth amendment to the Indian Constitution all the Central taxes were made sharable and States received 29.5 per-cent and 30.5 per-cent share respectively Eleventh and Twelfth Finance Commissions.

As far as the distribution of sharable proceeds among the States is concerned the criteria adopted by the earlier Finance Commission was mainly the population and to some extant the contribution of the State with respect to sharable tax particularly the Excise Duty. Latter on more items were included in the criteria especially the income distance of the State from the national average. In short this channel of transfer can be said to be fairly progressive.

The non statutory transfers that consist of Planning Commission transfers and the Central Ministries’ transfers despite their contributions to the States’ economic and social development add to latter’s dependence on Centre. Besides, mechanism of Planning Commission transfers is such that States automatically become entitled to loans which keep flowing to them as a matter of routine. Such mechanism has been identified by the Twelfth Finance Commission to be one of the principal causes for States’ growing public debt.

Central Ministries provide resources to the States to finance various schemes sponsored by them. These transfers are largely the grants but often requiring the States to provide matching allocations. That means though such
transfers do not add to States’ debt but certainly takes away, to certain degree, the States’ independence with regard to plan their expenditures. Further, in certain cases, Central government transfers fund to the local governments to implement the formers schemes totally bypassing the States. Such practice creates some accounting difficulties for the States.

In spite of such a large devolution which is roughly one third of the States’ own revenue, significant amount of post devolution gap is still left. Moreover the devolution through other than statutory source is not the insignificant one. These are the receipt that States can not claim as a matter of right. Though States receive their respective Share of plan grants according to Revised Gadgill Formula planning priorities of States are not necessarily reflected in it. Same can be said about the grants for the centrally sponsored schemes where discretion of Central government plays a significant role. Thus there are few structural problems with regard to federal transfers. Principal among them is the existence of multiple channels of transfers and near absence of any coordination between them.

Chapter Four presents the macro view of the imbalances in major States in India. For the purpose fourteen general category States have been chosen. The States belonging to this category but omitted are the one that would not fit well for the purpose of comparative analyses. The chapter presents the aggregate picture of the States’ finances as well as inter-State comparison.

States’ finances did not exhibit any serious imbalance till 1987-88 while Central government was experiencing the same since the beginning of the same decade. Central government’s experience amply demonstrated that even robust growth of the economy during eighties did not automatically correct the financial imbalances. When the things went wrong for the economy in 1990-91 its fiscal correction could not have been ignored any longer. Thus began the fiscal reforms by the Central government.
Significant thing to be noticed in this regard is that despite smaller tax resources and greater responsibilities assigned to them by the Constitution, Indian States were doing remarkably well till 1987-88 when deficit appeared for the first time in the revenue account of States taken together. This is in contrast with the Central government’s finances that have been experiencing revenue deficit continuously since 1979-80. Fiscal reforms at the Centre aggravated the fiscal difficulties of the States as the reforms adversely affected the devolution of resources to them which did not initiate any reform process as yet.

States thus continued with the imbalances which were worsened by 1998-99 when all the fiscal parameters, i.e. gross fiscal deficit, revenue deficit and primary deficit were at their worst. Seriousness of the matter can be gauged from the fact that interest payment which used to constitute less than sixteen percent of the revenue expenditure was consuming more than twenty percent of the same by 1999-00 and continued to increase till 2004-05 when as a result of debt relief measures of the Twelfth Finance Commission the downward movement began to take place.

The pattern of imbalances has not been found to be uniform across States. So much so that exceptions could be observed within the sub groups of States made on the basis of per capita gross State domestic product. For example the fiscal deficit level of richer States has, as expected, been lower than the average of fourteen States but Punjab has been the exception here. So is the case with fiscal corrections which has been sharper for such States and the exception was again Punjab. Similarly the steady increase in fiscal deficit observed in case of poor States has not been found in case of Bihar, the poorest of all.

Revenue deficit of these major States has risen faster during nineties but again the correspondence could not be found between such deficit and economic status of the States. Variation among States could also be observed in terms of fiscal discipline as there are few States that could swiftly get on to the
correction path. Punjab and West Bengal have been found to be the fiscally profligate States. Revenue deficit increased sharply till 1999-00 and then started declining but did not disappear completely. Existence of revenue deficit means the utilisation of capital receipts, largely the borrowings, to finance revenue expenditure. The major worry has been the existence of primary deficit (fiscal deficit minus interest payment). It is this deficit that represents the annual addition to the public debt. Though consolidated public debt of the fourteen major States have not been computed, the same for all the States taken together as stood on March 31, 2007 was Rs. 665866.00 crores which was a little less than six times higher than what it was in 1991. This, together with the fact that the primary deficit for the category of States under discussion during the period has been positive, provides sufficient evidence for the existence of States’ large public debt. This obviously resulted in the increasing portion of revenue receipts to be consumed by interest payments.

Significant relief provided by the Twelfth Finance Commission, though provided considerable amount of relief may not be a lasting solution to the States’ fiscal imbalances. The real solution therefore lies in enhancing the revenue receipts of the States on sustainable basis and bringing austerity in revenue expenditure.

**Chapter Five** examined the revenue and expenditure of the major States belonging to general category. Faced with the problem of fiscal difficulties and forced to cut expenditure, governments find it convenient to cut developmental expenditure as greater part of the revenue expenditure consists of the committed expenditure like interest payments, wages and salaries etc. Subsidies are difficult to cut as political expediency would dictate it otherwise. Taking into consideration these difficulties it can be said the capital expenditure of States did not suffer badly. The gap between two did not increase to any significant extent except in 2000-01 when it was maximum but from the subsequent year it kept on narrowing down.
At an average the revenue expenditure of the States was a little more than fifteen percent which after increasing to little less than eighteen percent by 2001-01 declined eventually and reached almost at the level where it was in 1993-94. But the States deviated significantly from the average. Taking into account the extent of variation among States in terms of per capita income it can be believed that few States might be providing the poor quality of public goods, basically the governance.

The increase in the interest payments over the years during nineties has been very much in evidence which means that even without reduction in revenue expenditure the share of public goods in such expenditure has declined during the period between 1990-91 and 2002-03. Ratio of social sector expenditure to total expenditure has also declined for the States under reference with a couple of exceptions.

Receipts of the States, consists of own revenue (both tax and non-tax) and devolutions from Centre, did not show any increase (as percentage of GSDP) since early nineties. Cause of particular concern is the non-tax revenue. Ratio of non-tax revenue receipts to non-plan revenue expenditure during current century (the period otherwise witnessed fiscal consolidation) shows a near stagnancy in case of social services. In case of economic services such ratio improved considerably, but still insufficient to eliminate under recoveries of investment on them. In case of roads the ratio has in fact declined after peaking in 2003-04. In short it can be said that the cost recovery has been extremely low.

The realization of own tax revenue of States is not satisfactory either. The tax-GSDP ratio which though improved after 1999-00 is still quite low which is evident from States’ average tax-GSDP ratio being 8.4 per-cents in 2005-06. Further, even this is not uniform across States. Divergence among States is large with West Bengal and Karnataka representing the extremes at four per-cents and twelve per-cents respectively.
In view of the inadequacy of own revenue of the States the dependence is inevitably on Central transfers. Thus the transfers constitute significant part of revenue receipts of the States. In case of few poor States such transfers even exceed the own revenue. Central transfers as percentage of own revenue was 152.6 per-cents and 132.4 per-cents for Bihar and Orissa respectively during 1995-00. The corresponding figure for these States during 2000-05 was 281.6 and 120.6 per-cents. The other extreme is represented by Haryana and Punjab in whose case central transfers constitute only 17.3 and 18.5 per-cents respectively. The difference of such a large magnitude reflects only the difference in fiscal capacity of these States rather than the difference in the quantum of the transfers. But one thing becomes clear that the non performing States are drag on the system and capable of proliferating the fiscal imbalances to Centre and other States.

Beside Finance Commission transfers which are the statutory one there are non-statutory sources of transfers as well. Planning Commission and Central Ministries are the agencies that facilitate such transfers. Share of these agencies may not be greater than the statutory transfers but is not insignificant either. The share for various States in such transfers in 2005-06 ranged between 47.1 per-cents in case of Haryana and 17.9 per-cents for Bihar. In the preceding ten years period the share of non-statutory transfers as per-cent of total Central transfers has gone up for the richer States while the same has gone down for the poor States.

Over all picture that emerges is that of fiscal corrections, improvement in Tax-GSDP ratio and containment of the growth of revenue expenditure. Twelfth finance Commission’s debt relief measures helped the States a great deal in getting them shed off some debt burden. But the continued dependence of States on fiscal devolutions from Central government, given the inadequacy of their own revenue, may not enable them to have fiscal consolidation on sustainable bases.
Chapter Six is devoted to the analysis of the fiscal scenario of Uttar Pradesh, most populous, most diversified in terms of economic activity, politically most active and yet one of the most economically backward States in India. Uttar Pradesh experienced almost the same pattern of fiscal deterioration as did the other States. In the beginning of the nineties all the fiscal parameters were showing the deficit of significant magnitude. As there was no effort on the part of the State such imbalances were enlarged further and reached the peak by 1998-99. Around this time fiscal discipline began to be focused resulting in the marked improvement in all the fiscal parameters.

The improvement in fiscal situation realised in the new century may turn out to be instable because of the following facts. Though there was the continuous increase in tax-GSDP ratio since 1999-00 but the rate of such increase was slow. Share of own tax revenue could not reach the level attained in 1998-99 and has been continuously declining since then. Therefore whatever increase in tax-GSDP is observed has been largely due to increase in the share in Central taxes. State's narrow tax base is evident from the fact that its dependence on sales tax (renamed as value added tax since) increased over time. State continued to receive more than fifty per-cent of its revenue from this source. More worrisome aspect of revenue receipts has been awfully inadequate and declining non-tax revenue continuously since 1993-94. Non-tax revenue as per-cent of total revenue receipts in 2005-06 was 18.50 in comparison to the 36.66 in 1993-94.

Yet another area of concern could be the injudicious capital expenditure reflected in the abysmally low interest receipts which as per-cent of loans and advances, for most part since early nineties, has been less than one per-cent. Dividend on equity too was low till 1997-98 but thereafter it increased significantly.

Of late State has succeeded in bringing about fiscal correction. Twelfth Finance Commission’s debt relief package played a key role in such corrections. Besides consolidating all its outstanding loans, contracted at higher
interest rates, and swapping them with the low interest one Commission offered a debt write-off as well. Of these the former was subject to State enacting a Fiscal Responsibility Act which makes the State committed to achieving certain targets by the year 2008-09. However the latter was conditional upon State’s fiscal correction actually achieved every year.

So the present comfortable fiscal situation of the State has been obtained through debt relief measures and the greater financial devolution. States own revenue structure no fundamental change could be observed. This generates apprehensions that present fiscal discipline can be short lived or alternatively it can continue at the cost of depriving the population the necessary social and economic services.

**Conclusion:** Findings of the study are presented in this chapter can be presented in the following three broad categories.

- Dynamics of fiscal corrections in the fourteen general category States.
- Mechanism of fiscal transfers and its role in States’ fiscal matters.
- Fiscal imbalances in Uttar Pradesh and their management.

The deterioration of States’ fiscal situation which began in the closing years of eighties reached the crises situation by 1997-98 prompting the reforms at the State level. Visible improvement in the fiscal situation of States observed after 1999-00 was the result of such reforms. There was marked improvement in almost every fiscal parameter which was consolidated further by the debt relief measures of the Twelfth Finance Commission. Overall growth of the economy too might have contributed to the fiscal correction.

There were three means through which States sought to achieve fiscal correction.

- Maintaining the balance in revenue account.
- Arresting the further growth of debt through maintaining the primary surplus.
- States’ fiscal efforts.
Majority of States have relied more on enhancing the revenue rather than cutting down the expenditure. There was no uniformity among the States with regard to approach towards measures to achieve reduction in deficits. Consequently the degree of success varied too. Orissa achieved significant reduction in primary deficit mainly through revenue efforts while Bihar could achieve only moderate improvement in the same despite a significant increase in Central transfers. States’ performance with regard to fiscal efforts can be summarised as follow:

1. Poor States like Orissa, Uttar Pradesh, Rajasthan and Madhya Pradesh that have significantly improved their own revenue.

2. States that have consistently performed badly in terms of revenue efforts include Bihar and West Bengal.

3. States that have slipped in the relative performance are Gujrat, Kerala, Maharashta and Punjab.

The greater part of fiscal improvement could be attributed to the increase in the States’ share in Central taxes facilitated by the eightieth amendment to the Indian Constitution as per which all the Central taxes were made sharable. This, together with the debt relief measures of Twelfth Finance Commission have been found to be the major instruments in bringing about fiscal correction in States’ finances.

The major cause of worry is the States’ failure in managing their expenditures as the major adjustments have been done by cutting down the development expenditure. Substantial decline in non-tax revenue is also a major problem. Under recoveries on capital expenditure and under realisation of cost on economic services are the contributory factors for such maladies.

The broad conclusion of the study therefore is that the fiscal discipline observed currently is induced by the Centre through Finance Commission and no other structural change has taken place which could have enhanced States’ own revenue in any significant manner. States continued to depend, rather increasingly on federal transfers as their own revenues have been quite
inadequate. Whatever changes in federal structure have been effected so far were more because of political factors rather than the economic one. In view of such findings it would be desirable to conduct further studies, by such researchers or by the official agencies that do not face the constraints a research student does, to explore long term solution to the problem of fiscal imbalances of States in general and for poor States like Uttar Pradesh in particular.