CHAPTER 4

RECENT STATES LEVEL REFORM MEASURES

States in India are interested in devising and implementing policies to reduce poverty, promote human development and stimulate growth.

States' fiscal policies play a vital role in Indian public finance. States maintain law and order, provide economic and social infrastructure to its people. Most developmental and other normal administration functions are assigned to them, so their expenditure obligations are relatively high. They are close to the people and have a direct interface with them. They are more prone to their criticizing on grievance quantity of expenditure, resource mobilization and performance of the services provided.

Undoubtedly, fiscal reforms are necessary for bringing about macro-economic stability. The real need for fiscal reforms arises out of the adverse impact of large fiscal deficits and consequent borrowings. The preemption of budgetary resources by contractual obligations like interest payments and repayment of past loans leads to, in the face of looming threat of treasury closure by the Reserve Bank of India, the pilling up of unpaid bills and bouncing of cheques issued by the governments. This has been adversely affecting the creditability of the state governments and also their credit rating.

It must be recognized that India has twenty-nine Governments, 28 states level ones and one at the Centre. States have a large share in social expenditure. States too are major partners in the development process. Agriculture, Irrigation, rural development and social services are crucial areas that happen to be the sole responsibility of the states. Further, a large part of power development, transport and communication is also under purview, of the state governments. Thus a true reform is required in these areas.

During the last decade, the Indian economy has witnessed a number of changes in the field of economy policy. The various economic reforms measures have been undertaken by the Central government. In a federal system, the states are expected to play an important role.
4.1 Economic Reform Agenda in India

The regime of economic planning began five decades ago. It began with a glorious vision of a resurgent India marching firmly on the path of progress while ensuring an equitable distribution of the nation's wealth.

The year 1991-92 was one of the toughest years for the India economy. All the macro economic indicators became adverse. The overall growth slumped to mere 1.1 percent. The gross fiscal deficit stood at 8 percent of the GDP and revenue deficit on the current account at 3.5 percent in 1990-91.

The new government decided to adopt in June 1991 a programme of macro-economic stabilization to restore viability to fiscal balances and contain prices. At the same time it undertook a for reaching programme of structural reforms involving bold initiatives in external trade exchange rate, industrial policy, fiscal crisis, all aiming at moving the country to a higher growth.

In response to a fiscal and balance of payments crisis in 1999, India launched a programme of economic policy reforms. The programme consisting of stabilization cum structural adjustment measures was put in place with a view to attain macro-economic stability and higher rates of economic growth.

The first item on the agenda for action was removal of controls on international trade both exports and imports as well as on the domestic and foreign investment. In industrial policy, significant reform was put in place to reduce the barriers to entry in business and provide scope to private sector for participating in the growth process.

The reform has become a key word in policy discussions. The reform agenda has focused on industry, trade, banking, capital markets and policies to parent sector investment in physical infrastructure.

Fiscal reforms were also designed to restore macro economic balance. Tax reforms aimed at reducing the dependence on indirect taxes for revenue reduction in tax rates, rationalization and widening of tax has reduction in fiscal deficits and curtailing monetisation of budget deficits. Most of these steps were undertaken in the initial phase of the reforms programme. But, the whole reform agenda could not be accomplished. A large part of the economic reforms remained uncompleted. So a fresh phase of economic reforms was started in late 1996, which came to be, know as Second generation reforms.
Fiscal reforms at state level need to be considered as the foremost and top of agenda. Earlier the reforms process concentrated at the Central level but in late 1990's when Indian states experienced a sharp fiscal deterioration and a squeeze on development spending they embarked on fiscal reforms which aimed at reducing deficits and enabling effective interventions in priority areas. Reforms at state level also focused restructuring disinvestments and privatization of state owned enterprises. Actions needs to taken both at the Center and in states to increase uses charges particularly of electricity, water transport etc so that resources are generated to increase investments and also improve the quality of these services.

4.2 The State Level Fiscal Crises of the Late 1990’s

The slow secular deterioration in the fiscal performance over the 1980’s and the 1990’s was catalysed into a state level fiscal crisis by the Fifth Central Pay Commission pay awards in the late 1990’s.

The sharp increase in expenditures in the latter half of the 1990’s, alongside declining revenues could only be supported by greater borrowing by state governments. The deterioration in the states finances in the late 1990’s was coupled with a worsening of Central government finances. The combined effect significantly weakened India’s overall macro-economic performance. The overall impact of fiscal crisis of states was that it weakened the developmental and poverty impact of state governments especially in the poorer states.

The fiscal stress of the late 1990’s gave rise to an intense state level reform effort. The sharp deterioration in the fiscal performance generated sense that business as usual was not an option and gave an enormous level. Many states started adopting medium term fiscal reform programmes to differing degrees of strength and credibility. GOI also moved swiftly to help states undertake fiscal and sectoral reforms. The demand from several stressed states for extraordinary Central financing led to the birth of MOUs between GOI and many state governments in 1999-00.

4.3 Spread of State Level Reform in India

One of the striking features of Indian states prior to the 1990s is the relative uniformity of policies across states. The role of the states was to implement Central government policies. The India Constitution following the Government of India Act (1935) is famous for dividing the responsibilities of government into three lists: a
State lists, a Central list and a Concurrent list. Many important subjects, such as electricity and education are on the concurrent list and with dominant Centre, uniformity prevailed in this but even subjects which were on the state lists such as irrigation where we have to see variation from state to state. The situation by the end of the nineties was quite different. Individual states took a lead in introducing reforms in different areas. E. g. Orissa privatized its power sector, Andhra Pradesh had setup user groups across the states to manage the distribution of canal irrigation. According to Stephen (2000) following are the factors, which gave rise to growth of state reforms.

(a) First, was the strong contagion effect at work India states are not countries. Movement between them is new spreads and innovations successful in one state quickly become the option for adoption in others. The reforms and innovations spread from state to state is a healthy process of competitive developmentalism driving out competitive populism.

(b) Second, a number of political factors have led to increased levels of state autonomy over the nineties. The political authority of the Central government has weakened over the nineties, providing more political space for states. The average tenure of government has fallen at the Central level and there has been a shift to coalition governments as no single party has been able to claim a majority in its own right.

(c) Third, economic development has also favored the growth of reforms at the Centre in the early nineties, set the stage, and made reforms at the state level necessary. Liberalization has made state reforms more important.

(d) Finally, the state level fiscal arises of the second half of the nineties had much the same impact as the balance of payment crises generated a sense of systemic crisis and gave enormous movement to the reform project at the state level.

4.4 India’s State Level Fiscal Crises-Causes

The fiscal deterioration in both the Central and states fiscal position in the second half of the 1990’s and prevailing still now were due to the out come of many causes: -

1. The first and the fore most culprit as stressed by Acharya (2001, 2002) is the Fifth Pay Commission Award, the decision of the Government of India in 1997 under the United Front (Gujaral) Government to implement large (40 to 60 percent) pay
increases for Central employees. Under employee pressure, most state governments followed suit in the next couple of years starting in 1998-99 resulting in a massive ballooning of the salary at the state level. The Fifth Pay Commission has been called the single largest adverse shock India’s strained public finances in the last decade and an act of fiscal profligacy without parallel (Godbole, 1997, Acharya, 2001). There is a wide range of criticism against the pay commission. State governments are autonomous body and they have the right to decide salaries of their employees. State governments had their pay commission till 1972. But after 1972 they are following the same salary pattern of the Central government employees. So it a wrong policy of state governments which had given rise to such fiscal crises.

2. The second factor one can point to after public sector salary increase is a secular deterioration in the finances of the states over the last twenty years.

3. The third factor is that the states were hit over the nineties by high interest rates. Even at the start of the nineties, the states faced high interest rates than the Centre but the gap increased over the course of the nineties from 2.5 percent in 1990-91 to as much as 5.1 percent ten years later in 2001-01.

4. The fourth contributing factor to the state level fiscal crises was the inability or unwillingness of the Central government to limit the borrowing of state governments.

5. The fifth and the final factor behind the state level fiscal deterioration of the late nineties is the rise of off-budget liabilities particularly the acute financial weakening of the power sectors and the rise of off-budget borrowing.

4.5 Factors that will Help State Reforms to Succeed

1. First, is the role of government of India. If state reforms are to succeed, the Central government needs to take the lead, both through example (tackling its over fiscal problems) and through facilitation, by implementing changes which can only be done Centrally, but which affect all states.

2. Second India’s external official funding agencies have a role to play in promoting reforms at state level. Several agencies have already started working with Government of India to support reforms at state level. The funds of these agencies can help in financing the reforms.
3. Third, a special support is needed for the poorest states. Regional inequality is increasing in India and the North-South divide appears to be on the increase. It is the poorest states that stand most in need of reforms.

4. Fourth, there is a real need for sharing of reform experience both across states and internationally.

5. Fifth and finally, reforms needed to be widely and successfully communicated. The reform agenda remains a contentious one.

4.6 The Fiscal Reforms Agenda: Stabilization and Fiscal Empowerment

As Quoted by World Bank "The agenda backed by the Government of India for fiscal crises of both Centre and state receives support from the both the Central and State governments in India. States must reduce deficits to sustainable levels. But simply averting bankruptcy will not be enough. Striving for fiscal empowerment that is shifting to a fiscal instance that makes states more effective an agents of development also requires expenditure restructuring for reaching expenditure management reforms and comprehensive revenue reforms and mobilization."

The ultimate responsibility for fiscal adjustment at the state level lies with India’s states, fiscal reforms cannot be carried out by the states alone. The GOI has the critical role to play in not only promoting expenditure and tax reforms but also strengthening the federal fiscal framework.

A continuation and intensification of reforms is needed to achieve both fiscal stabilization and what it is referred as "Fiscal Empowerment". To achieve these objectives states must free up resources for spending in priority areas, improve the quality of government expenditure and carry out tax reforms.

4.7 Components of Reforms

4.7.1 Revenue Reforms

Restructuring the tax system constituted a major component of fiscal reforms with the aim of augmenting revenues and removing anomalies in the tax structure. The main focus of reforms was on simplification and rationalization of both direct and indirect taxes drawing mainly from the recommendations of the Tax Reforms Committee, 1991 (Chairman: Raja J Chelliah)

One of the causes of the fiscal crises was the declining states revenue to GDP ratio over the second half of the 1990’s. States in India derive revenues from own
sources and Central transfers (shared taxes and grants). States collect about 65 percent of the revenue themselves the remaining 35 percent is transferred to them by the Central Government. Strong growth in revenues is essential to ensure that fiscal indicators are sustainable and developmental spending sufficient to achieve the desired developmental outcomes. For this many states have adopted tax reform programmes. The Government of India also moved swiftly to help states undertake tax reforms and the idea of intensively reforms has taken root.

4.7.1.1 Tax Reforms

It is very difficult term to define tax reform. The assessment of whether something should be termed a reform is highly political in itself. It is expedient in some contexts to dress up as reform a mere transient trimming of a system. Because of this deliberate obfuscation, no definition is attempted that is related to what has been regarded as reform domestically. According to some, "New taxes should be a major sign of reform although the purist has rightly pointed out that an innovation is not a reform" (Burke).

Tax reforms have figured prominently in the agenda of governments in recent years in both developing as well as advanced countries. Mexico, Bolivia and Columbia in Latin America, Korea and Indonesia in Asia, Zimbabwe, Morocco and Kenya in Africa carried out major reforms in their tax system during 1980’s.

The motivation of tax reform, which has taken, place across the world over the last decade or so has been essentially similar among all countries. In USA and the industrially countries, the urge for tax reforms came primarily from the widely shared perception that the new tax system was unfair, unduly complex and detrimental to growth and welfare.

India’s tax rates are high Stamp duties on property transactions highest in the world, as combined Centre and states indirect taxes. One of the key challenges that the India face is to broaden the tax base. Another is to simplify India’s tax system and reduce corruption and evasion. India’s indirect tax system is the most complex in the world and surveys has show state tax offices to be most corrupt government agencies in the country.

Signification reforms had been made in strengthening revenue performance in the recent years. The sales tax is the most important state level tax. The replacement of sales tax by VAT is the key reform, which look effective in April, 2005 in all states
of India except Uttar Pradesh. With the view to harmonize inter state taxes and ultimately switch over to state level value added tax (VAT). States introduced uniform floor rate during the year 2000.

There is rich agenda for reforms in other taxes of states, which require wide-ranging actions by the Centre, and the states. Eliminating tax on inter state exports is also critical and should proceed with or without VAT. Moreover states should be allowed to integrate the taxation of services into their sales tax VAT.

The professions tax, which is levied, is very low and needs to be raised. The reform of stamp duties and registration fees requires a multi pronged approach including cutting stamp duties on property transaction from there current high levels as well as improving compliance and reducing corruption by a number of business reforms like computerization and banning on stamp paper.

Liberalizing the public transport sector would help to grow the revenue base and reduce reliance on public sector utilities. Increase in electricity tax on household is warranted to compensate for low tariffs.

State excise duties are be levied on the production of alcohol and other narcotics substance. They are the second most important source of revenue for the state governments. The liquor in India is fragmented into Indian made foreign liquor and country liqueur. The country liqueur can be traded across state borders whereas the latter cannot. Country liquor vending licenses are cautioned in many states where country liquor is not banned leading to less buoyancy in this segment. But IMFL is less buoyant to adopt modern distillery monitoring technology and outdated information systems, large state tax rates had lead to cross state smuggling. Thus is there is much scope to improve the performance of state excise duties.

4.7.1.2 Non-Tax Revenue Reforms

Significant deterioration in the performance of the own-tax revenue of state is seen the late 1990s.

Unlike tax revenue where many problems are common across taxes and their administrations, different non-tax revenue sources have very distinct problems. A key objective of the reforms process was the augmentation of non-tax revenue by way of enhancement of user charges and returns through government investment through restructure of PSUs. States have also undertaken measures to enhance non-tax revenues by reviewing and rationalizing the royalties payable to then, including those
on major and minor minerals, forestry and wild life, revision of tuition fees, medical fees, irrigation water rates. The issue of raising user changes with the cost of public services rendered, has not been given serious consideration yet. Recognizing this aspect, the Medium term fiscal Reform Programmes finalized by several states have emphasis the cost effectiveness and raising of user charges of services rendered by them.

Revenue from mineral royalties is already the fifth important source of own-non-tax revenue. Measures may further increase the importance of this source of revenue which include rule based setting of royalties of states by the Centre and also states, including revision at least once in three years with reference to market prices, streamlining of the clearance process for grant of mineral prospecting licenses with the help of automation strengthening of administration and introduction of self assessment and risk based scrutiny of royalty returns to reduce litigation. Revenue from sale of forest produce is next important to mineral royalties. The problem with the many forest departments is their limited attention to the sale of forest produce, since they perceive their role in terms of conservation and protection of forests and wildlife. One major reform in this area is formation of Forest Corporation to enable focused exploitation of forest resources on commercial lines. A second major reform with great revenue potential is strengthening the infrastructure for eco-tourism, with the participation of private sector.

The performance of user charges has been poor. A key reason, for his is the deteriorating Recovery of costs in case of irrigation of water supply, transport etc restoring commercial discipline and improving cost recovery in public sector is difficult when beneficiaries are politically powerful.

In the case of state level enterprises, which are partially or wholly aimed by government of India, affect the fiscal position of the government through their operations. It is a major source of revenue imbalances rooted in the poor profitability of the PSUs.

4.7.1.3 Reforms to Tax administration

Tax administration performance probably more important than tax policy reforms but have received less attention to date. Tax reforms in India require not only just policy changes but also institutional reforms to improve policy making, weed out corruption and increase incentives for compliance and collections. The institutional
structure of major revenue raising department is weak. Many do not have visions, missions transparent performance most it monitoring is often absent. Tax departments have limited budgetary flexibility and anti corruption institutions are often in effective. Within tax administrations, absence of performance indicators and poor record structures for functional units and individual staff makes performance difficult.

The World Bank Report presents a large number of proposals to improve tax administration these include:

1. Strengthening departmental accountability through better articulation of department goals and more budgetary flexibility and increasing individual accountability through the provisions of incentives to staff.

2. Attacking corruption by strengthening anti-corruption institutions and to functional organization for tax departments in place of current systems where a single officer is responsible for group of taxpayers.

3. Promoting the user friendliness of and citizen feedback to tax departments.

4. Modernizing field enforcement and check posts, mobile squads and particularly border check posts.

5. Involving the private sector in tax collection through well-structured public private partnerships.

4.7.2 Expenditure Reforms

State governments consumption and investment spending constitute an important part of aggregate demand in the economy. It influences growth through several channels. Thus it is important to plan expenditure reduction while improving the quality of public spending to aim simultaneously at supporting growth with equity and improving fiscal balances.

The major contributing factor imparting a downward rigidity to the revenue expenditure relates to items of committed expenditure on wages and salaries. The rising wage bill has been considered as important element in fiscal deterioration in recent years. One view is that the rise in spending on wages and salaries and pension was the prime factor for the abnormal rise in revenue expenditure during the 1990s. (Acharya 2001, Rao 2000). The Eleventh Finance Commission on the other hand notes that the increase in revenue expenditure towards the late 1990s cannot be attributed only to salaries and pension revision, through it led to immediate and acute fiscal stress all round (Government of India 2000). A similar view is expressed by
Mohan (2000) who notes that the Central government spending on salaries and pensions as proportion of GDP during the 1990's was much lower than in the 1980s.

Taking the expenditure of state governments about 90% of the expenditure of states is on the current revenue account and the remaining 10 percent on the capital account. The larger current expenditures are salaries (37 percent), interest payments (18 percent) and pensions (9 percent). The fastest growing item of expenditure over the 1990's was pensions followed by interest payments.

Given the low levels and the working recent trends in both the quantity of expenditure and the quality of expenditure, there is an urgent need for expenditure restructuring to free up fiscal resources and improve the quality of spending. To address this issue, the states governments have come up with expenditure reforms in four major areas like salaries and pensions, subsidies, public sector enterprises reforms and interest payments but much more reforms remains incomplete.

4.7.2.1 Salaries and Pensions

Salaries are such large part of government spending that they must be at the core of any expenditure restructuring effort. Salaries make up 30 percent of state governments spending. India’s public private wage differentials are in fact among the highest in the world. In India about 40% of the state government employees are teachers.

"Pensions are increasing at a faster rate due to the longevity of life".

However, no major reform has been taken so far by state governments towards increase expenditure of salaries and pensions. As suggested by World Bank, for maintaining a policy of wage restraint will be avoidance of another pay commission leading to significant increase in real wages.

New hiring is needed in the civil service in priority areas; overall hiring restraint is justified because there are large areas of overstaffing as well as understaffing. Targeted retrenchment programmes would be the best way to free up space for new hiring but have not been success in India. A second set option through which much can be achieved is attrition based restructuring.

Pensions also forms a mounting liability and as a source of fiscal vulnerability. Pensions payments at the state governments level have also risen sharply during the last 10 years. Pensions expenditure of states are proposition of revenue receipts rose from 5.4 percent in 1990-91 to more than 10 percent in 2000-01.
In the budget 2002-03, Government announced the introduction of new restructured defined contribution pension system applicable in the first stage to new entrants to government service, except armed forces. Accordingly, the new pension system (NPS) was introduced from Jan 1, 2004 for Central Government employees recruited on or after that date. The NPS will be available on the voluntary basis to all persons including self-employment, professional and other in the organized sector. However mandatory programmes under the employee’s provident fund Organization and other special provident funds contrive to operate as per the existing system. The Union cabinet recently approved a proposal to introduce legislative framework for NPS. An ordinance was promulgated on December 29, 2004 for the establishment of Pension fund Statutory Regulatory and Development Authority (PFRDA) to undertake promotional, developmental and regulatory functions in the respect of pension sector. However no abroad measure has been taken place in case of reforming the pensions sector of state governments.

However, two types of reforms are underway-structural reforms to enable shifting to a cheaper and less fiscally risky defined contribution (DC) scheme and parametric reforms to contain the cost of the current pay, as you go system. GOI has announced DC scheme for new civil servants a scheme that will also be open to interested state governments and the unorganized sector on a voluntary basis. Several state governments have indicated their willingness to shift to a DC scheme and some have already announced that new employees will no longer be eligible for the old defined benefit scheme (Maharashtra, Tamil Nadu and H. P.)

Parametric pensions reforms aim to bring about savings by tinkering with the existing pay as you go pension system and can deliver large fiscal savings when needed. Several states have brought in parametric pension reforms in the last year (2004) especially by Tamil Nadu and Andhra Pradesh have developed pension projection models and GOI is now encouraging other states to follows the suit.

Some of the reforms in field of pension as suggested by World Bank are:

a. Use of longer averaging periods for the calculation of benefits Some state governments use the last month’s or last day’s basic pay to determine pensions levels. A shift from 10 months to 36-month period as recommended by the Bhattacharya committee. (RBI 2003)

b. Use of a lower limit for the maximum amount of pension, which can be taken as a lump sum at retirement.
c. Use of high discount rates and more realistic set of life tables to calculate the value of the lump sum pension.

d. Reduction in leave encashment limits reduces the payout required from government at the time of retirement to employees who have saved up their leave.

4.7.2.2 Subsidies

Details on the state governments subsidies are not available in their budget documents but the indicators are that the trend is similar to that of the Central government, as reflected through the quantum of subsidies extended to some SEBs by state governments. The largest explicit state subsidy is for the power sector and large implicit subsidies are provided for the irrigation and higher-education sectors. The smaller explicit subsidies are provided by many states for public transport, housing and food.

In case of power sector there are various causes for the higher level of financial losses in the power sector including in efficient operations, theft of power and rapid increase in generation unit costs. Also important are high levels of subsidies of two consumers groups who pay below cost tariffs households and farmers. Indian industry pays world record prices for low quality electricity. Indian farmers get very cheap power but at very poor quality. The rationale regime that governs the supply of power to agriculture is an enormous source of fiscal pressures and in discipline. The agricultural supply to farmers is unlettered and often free. Even if payments are required for electricity, they are lump sum and so the marginal cost to the consumer of are additional unit of consumption is zero. The biggest problem facing the power sector is the lack of commercial discipline in three areas that is, in the utility customer relationship, non-paying customers are frequently not disconnected and bills are often not paid. Second, is government utility relationship. Governments typically fail to compensate utilities for the losses incurred by them due to supply of power at non-remunerative rates, Third, on the utility supplier relationship utility lacking cash in part as a resent of the payments defaults.

There are some recent reforms that are carried out in reducing power losses but not in agriculture.
4.6.3 Public Sector Undertaking Reforms

A major source of revenue imbalances reflected in dissaving of the public sector is rooted in the poor profitability of the PSUs. The returns on capital invested by the Government in case of SEBs, and SRTC have been low.

Efforts to phase out inefficient PSUs were also made at state level. The leaders states include Andhra Pradesh and Orissa. According to the available information from the ministry of disinvestments, 19 states have identified 290 state level public enterprises for disinvestments out of which AP, Karnataka, Kerela and West Bengal account for nearly half of the PEs. Restructuring or closure has been initiated in 221 of these enterprises. So for 69 units have been closed down, 33 units have been privatized.

4.6.4 Reforms to Improve the Quality of Spending

Another major reform that is needed in the expenditure management of state governments is the improving the quality of spending in case health, education and infrastructure. As suggested by World Bank there are some key reforms to open to Government to improve the quality of spending, which includes:

a. Agency specific reforms including an increased role for the private sector can improve service delivery.

b. Encouraging citizens demand for better services. Encouraging circuit society actively monitor government performance and promises at both the micro and macro levels. Examples may be cited of Bangalore and Himachal Pradesh in case pf a case of education and infrastructure sector.

c. Increasing Transparency –Some states have adopted legislation to make procurement process more transparent Eg. Karnataka, Tamil Nadu and to provide a legislative basis for the public's right to information (Delhi, Rajasthan, Tamil Nadu Karnataka Maharashtra and Goa).

d. Breaking down on circuit service transfers and leaving reforms champions in place. Several states have shown that both the volume and the discretionary nature of mass transfers can be reduced through the introduction of strict rule based systems especially if they are computerized (Andhra Pradesh, Karnataka, Tamil Nadu).
e. Establishment of strong and independent corruption agencies but very few of them have strong and independent. Only Karnataka has the strong and independent corruption agency.

f. Budget realistically and implement the budget as passed.

4.6.5 Fiscal Federation and the Incentive From Work for State Reforms

India's complex system of fiscal federation is important to analyze the states reforms. Centre plays a dominant role in Indian federation. First it transfers revenue resources to the states in the form tax sharing and grants. Second, GOI plays a leadership role with respect to many national policies for example Central Pay Commissions in theory set salaries only for Central government employees but in practice influence salaries paid in the public sector. Third, GOI lends to the states and under the constitution sets the borrowing framework within which states operates. Further, there are Central pools of senior circuit servants that operate at both the Central and state government levels.

With the growing fiscal stress in the recent years, the Indian fiscal federal system has become the subject of increasing controversy. Central transfers have been falling over time, with no increase being provided to the states through increased tax base. Reforming India's fiscal federalism frame work is a difficult task because different Central actors particularly, the Finance Commission, the Planning Commission, the Ministry of Finance determine different components of the Central fiscal frame work. Proper coordination is required among them for the possible reforms for the poorer states, fewer loans but more transfers for all states and tighter control over total borrowings. As suggested by World Bank there are institutional reforms that would help the functioning of fiscal federalism in India:-

i. The first would be if the finance commissions were made a permanent body as it is in Australia.

ii. The Second would be it the responsibility for compiling timely state level fiscal data was entrusted to a single agency.

iii. The third suggested institutional reform is an over have of the role of the planning commission.

Finally, the Central government can back the states own reform efforts especially by encouraging the passage of and subsequent compliance with fiscal responsibility legislation at the state level.
4.7 • Recent Reforms

The states level Fiscal Reforms undertaken by states can be divided into following categories:-

4.7.1 Fiscal

Fiscal Reforms at states covered tax reforms, expenditure pruning restructuring of public sector undertakings.

Restructuring of tax system constituted a major component of fiscal reforms with an aim of augmenting revenues and removing anomalies in the tax structures. The main focus of the reforms was on simplification and rationalization of both direct and indirect taxes drawn mainly from the recommendations of the tax reforms committee 1991. (Chairman: Raja J. Chelliah)

Recognizing the need for strengthening their finances, states have initiated measures towards enhancement of various taxes such as land revenue, vehicle tax, entertainment tax, betting tax, luxury tax, sales tax etc. One of the important components of tax reforms initiated since liberalization relate to the introduction of value added tax (VAT). At a meeting of the empowered committee held on June 18, 2004, the state value added tax was implemented from April 1st 2005. The empowered committee of state has also come up with a White Paper on the state level value added tax on January 17, 2005.

States have also undertaken measures to enhance non-tax revenue by rationalization the royalties including those on major and minor minerals, forestry and wild life, revision of tuition fees and medical fees.

The state governments has also taken measures to contain expenditure that includes restrictions on fresh recruitment and creation of new posts, review of manpower requirement and reduction non-merit subsides through better targeting. Detailed lists of fiscal measures taken by 14 major states are presented in Appendix Table 4.1.

4.7.2 Institutional

States have also taken institutional measures aimed at facilitating the fiscal consolidation process. The need for fiscal adjustment has been well recognized. Interest payment is a major item of revenue expenditure. To reduce the interest burden of states, a Debt Swap Scheme has been formed by states. States has to swap their
high cost Central Government loans bearing a coupon rate of 13 percent and above. With relatively low cost market borrowing and loans from NSSF, was put in place in 2002-03. The process of swapping high cost debt under the scheme is complete in respect of 20 states. The Twelfth Finance Commission (2005-2010) has made recommendations on reform of states finances. Debt relief to State is conditional upon the enactment of Fiscal Responsibility Legislation prescribing specific annual targets with a view to eliminate the revenue deficit by 2008-09 and reduction in fiscal deficit by a path to be specified. All states are required to set up Sinking Fund in public account for amortization of all loans and Guarantee Redemption funds through earmarked guarantees fees, after risk weighting guarantees.

A detailed list of institutional measures taken by 14 major states during the period 1990-91 to 2002-03 are presented in Appendix Table 4.1.

4.7.3 Sectoral

States have also undertaken sectoral measures to improve their finances. Several states have shown interest in undertaking a comprehensive review of functioning of states public sector undertakings (SPSUs) including the closing down of non-viable units after providing suitable safety nets to employees including voluntary retirement scheme (VRS). States such as Tamil Nadu, Kerela, Haryana, Karanataka, Himachal Pradesh, Goa and Orissa have encouraged private sector participation in the transport and power generation sectors. Karnataka has come out with the policy paper on restructuring of state public sector undertakings (SPSUs) while Maharashtra has introduced a bill for restructuring of the (SPSUs). In order to strengthen the administrative machinery many states have initiated measures to computerize their records as well as their day-to-day functioning.

A detailed list of sectoral measures taken for fiscal prudence by 14 major states of India are presented in Appendix Table 4.1.

4.7.4 Power Sector Reforms

States have also initiated measures to reform the power sector, which is crucial for the fiscal reforms. The main objective of these reforms was to mobilize private sector to resources for augmenting power generating capacity.

The power sector reforms have assumed critical importance in recent years. The measures taken by the states in this regard relate to the constitution of State
Electricity Regulatory Commission (SERCs) for determining tariff structure, unbundling of electricity boards and to separate entities for power generations. State electricity Regulatory commission has been constituted in 21 states out of these SERCs of 15 states have issued tariff orders. The states of A.P., Delhi, Gujarat, Haryana, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh have enacted their state electricity acts. Twenty-one states have signed Memorandum of Understanding (MOUs) with the Ministry of Power, Government of India to undertake reforms in time bound manner.

A detail list of power sector reforms undertaken by 14 major states are presented in Appendix Table 4.2.

4.7.5 Reserve Bank of India and Centre’s Initiatives:

As a banker and debt manager to the state governments the RBI has taken many initiatives. The Reserve Bank provides a forum for state governments for discussing various relevant issues through its biannual conferences on state finance secretaries. The RBI provides way saved means state to tide over the temporary mismatches in their receipts and payments. In area of market borrowings, the RBI has enhanced the flexibility available to the states. As per requests received from Maharashtra and Kerala, the bank has permitted these states to raise up to 50% of total market borrowings through action route during 2002-03. The RBI has also constituted a consolidated sinking fund (CSF 1991-200) scheme for market borrowings of states operation since 1999.

The state governments guarantees is the area where the bank has taken a number of initiatives. The Technical committee on state governments guarantees constituted by the bank in its report (1999) has recommended: (1) Imposition of ceilings on guarantees (2) selectively in calling for and providing of guarantees (3) Greater transparency in reporting of guarantees.

Supplementing the states efforts, the Centre has also initiated measures to encourage fiscal reforms at state level. The Eleventh Finance Commission (FFC) has recommended the establishment of Incentive fund for the purpose of encouraging fiscal reforms in the states on the basis of mentionable fiscal reform programme. An incentive fund of Rs. 10,605 crores has been earmarked over the period of five years. In pursuance of this, the Government of India has drawn up a scheme called the states Fiscal Reforms Facility (2000-01 to 2004-05).
The states have also drawn up a Medium Term Fiscal Reforms programmes (MTFRP), which aims at bringing down the fiscal deficit to sustainable levels and elimination of revenue deficit by 2005 and reduction of contingent abilities to sustainable levels.

As per the mid year review of Ministry of Finance, the medium term fiscal plans have been finable for 16 states. i.e. A.P. Arunachal Pradesh, Orissa, Maharashtra, Kerala, Karnataka, Manipur, Sikkim, Tamil Nadu, Himachal Pradesh, West Bengal, Rajasthan, Mizoram, Meghalays, Tripura and Jammu and Kashmir.

To strengthen the finances states have enacted Fiscal Responsibility Legislation. The state of Karnataka has already enacted Fiscal Responsibility Legislation. The states of Maharashtra and Punjab have introduced the fiscal Responsibility Bill in there legislatures. The Kerela government has proposed to introduce fiscal Accountability Bill. A detailed list of Reserve Bank of India and Centers Initiatives taken for states level reforms are presented in Appendix Table 4.3.

The analysis and assessment of the fiscal reforms process of states clearly states that much more efforts needs to be carried out by the states for their expenditure management and revenue mobilization. Fiscal reforms implemented by the states while showing initial returns are still a work-in-progress, and significant challenges remain. While the ultimate responsibility for fiscal adjustment at the state level lies with Indian states, state fiscal reforms cannot be carried out by the states alone. The Government of India has a critical role to play in not only promoting expenditure and tax reforms but also strengthening the federal fiscal framework.

In summary, a joint Central state government reform programme aimed at both fiscal adjustment and at strengthening the development effectiveness of India’s states is both desirable and feasible.

Despite the deepening of the fiscal crisis, attempts to bring fiscal reforms have not been very successful. In fact, the fiscal deficits are only increasing the real reason for this failure lies in the difficulties of the states in redefining there roles, reordering their priorities and improving the efficiency of the government system and the public sector. Containing fiscal deficits involves hard choices. There is a choice between higher expenditure and larger resource mobilization. There is a choice between higher non-tax resource mobilization and higher taxation. There is a choice between subsidizing in efficiencies of the government as also of the public sector and higher
taxation. States are unable to make these hard choices. Thus we conclude that though economic reforms were started in 1990 but for state it started it late 1990's.

In next chapter we analyze the finances of state of Uttar Pradesh from the period 1990-91 to 2002-03.