Chapter-1

Introduction

1.1 Importance and of Role State Finances

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References
1.1 Importance and Role of State Finances

Public Finance impacts the economy in many ways. The impact is both direct and indirect. The impact is direct as the government finances give shapes and direction to the economic policy that the government wants to pursue through planning and programming to achieve various socio-economic goals. It also impacts indirectly through the level and pattern of expenditure as well as the means through which the resources are raised. It is, therefore, considered as a powerful instrument for accelerating economic growth and development.

The overall macro environment is an important factor determining the growth potential of a state. The structural reforms and stabilization policies introduced in 1991, considered fiscal discipline necessary for the attainment of macro-economic balance. The Government set a target of reducing fiscal deficit as proportion of Gross Domestic Product from 8.5 percent in 1990-91 to 5 percent. However, reduction in fiscal deficit at the centre has implication for the state finances. Thus restructuring at the level of centre is not enough as states in the federal set up of India, are usually taken to be equal partners to the centre in the overall development effort.

States are assigned with important responsibilities in many sectors such as agriculture, infrastructure, poverty alleviation, water supply, irrigation and rural development. Furthermore, they have concurrent jurisdiction in several areas like education, electricity, family planning, economic and social planning. Thus fiscal discipline at state level is considered necessary to accelerate overall growth and development. The role of the state and its fiscal policy are becoming crucial issues and are receiving greater attention from the economists, despite the fact that the state is expected to retreat from economic activities. For example, one of the themes of the World Development Report of the World
Bank (1997) is 'the state in a changing world'. The Report advocates an important role of states in imparting growth and development to an economy.

In India, one important issue at state level or sub-national level is that of fiscal sustainability. Analysts argued that this issue relates to fiscal deficit, revenue deficit, unproductive expenditures and unsustainable subsidies. The composition of receipts and expenditure of the Government sector in India reveals that while the state governments collect about one-third of the total Government sector receipts, they incur more than three-fourths of the total expenditure on social services and more than half of the total expenditure on economic services. Further, as the state government's budgetary support from the central government is gradually reducing, their inability to undertake and perform developmental functions adequately and effectively has become contingent on their fiscal position.

It has been argued that to accelerate economic growth, a higher investment is needed in critical social and economic sectors by state governments. However, the financial position of most of the states is actually forcing a continuing squeeze on plan investment. Thus, in view of larger responsibilities, the present thesis provides an analytical review of the fiscal management of state governments particularly the Gujarat state. It examines the various policy measures undertaken and their effectiveness to improve the fiscal situation.

Gujarat state, which has generally been considered as a well managed state is no exception to the deterioration in the fiscal situation of the country. The state of Gujarat has been incurring deficit in budget for more than two decade.

This chapter provides a brief exposure of the socio-economic situation of Gujarat state for the period under study (1980-2008). It deals with the issues of fiscal discipline and provides the general background about the constraint under which Gujarat and many other states are required to manage their fiscal resources.

1.2 The Economy of Gujarat

(i) General Profile

Gujarat is one of India’s most developed state. It cannot be characterized as typical. The main issues of its public finances are of general concern. The state’s socio-economic
situation has a significant implication on its financial structure and fiscal policies. Table-1-1 presents a comparative data of some of the key parameters used to compare Gujarat vis-à-vis India.

In May 1960, Gujarat State was formed out of the then bilingual Bombay state. It has an area of 196 thousand square Km., which is about 6 percent of total area of the country. It is the seventh longest state in terms of area after Madhya Pradesh, Rajasthan, Maharashtra, Uttar-Pradesh, Andhra Pradesh and Jammu & Kashmir. The Number of districts is 25, with a population of around 50.6 million in the year 2000-01. After independence, its population had increased more than three times and now ranks 10th in population size among the states in India. During the period 1981-2001, its population increased at the rate of 32.6 percent as compared to the national rate of 33.3 percent. This only means that the state needs more resources for revenue in order to meet the demand of its growing population.

However, with the increase in population, State Literacy Level has improved during the period 1980-2001. It evinces from the Table-1 that its literacy level improved from 43.70 percent (1981) to 69.14 percent (2001), where male literacy rate was 80.50 percent and female literacy was around 58.60 percent. Though, there is an increase in total literacy rate from 25.44 percent (1981-2001) compared to all India average of 21.27 percent but yet per capita expenditure on education is the lowest at 0.62 (1990-91) (Kerala is taken as the base Kerala = 1%).

Table I-1 Gujarat at a Glance- Comparison with All-India (states)

|--------|------|------|------|-------------------|
| Population
Gujarat(in lakh) | 341  | 413  | 506  | 32.6%             |
All-India(in lakh) | 6852 | 8463 | 10286| 33.3%             |
| Literacy rate
Gujarat | 43.70 | 61.29 | 69.14 | 25.44 |
All-India | 43.57 | 52.2  | 64.84 | 21.27 |
| Urbanisation(%)
Gujarat | 31.10 | 34.49 | 37.36 | 6.26 |
All-India | 22.6 | 24.56 | 27.82 | 5.22 |

Gujarat is one of the highly urbanized states of Indian Union. The proportion of population living in urban areas of the state was 31.10 percent in 1981 and 37.36 percent in 2001. It recorded an increase of 6.26 percent compared to 5.22 percent of All-India during the period 1981-2001. Kundu and Gupta [1996] pointed that Gujarat has registered a reasonably high rate of inter-state (male) net migration both in the rural as well as the urban areas. Arrival of workers from outside the state and the high growth of employment have sustained the pace of urbanization in the State.

(ii) State Domestic Product or State Income

The GDP is the most important economic indicator as it represents a broad measure of economic activity. The growth experience shows that Gujarat is one of the most prosperous and fast growing states in India. Its position in comparison to all other states show that the state’s average annual growth rate at current prices is always ahead of the national average. However, the difference was narrowed during the nineties and in the years of two thousand in comparison to the eighties. This means that during the period of the post economic reform, the growth rate of Gujarat slipped down in comparison to All states.

Graph-I.1

![Graph-I.1](image)

*Source: CSO, New Delhi and Gujarat State Domestic Product, Gandhinagar*
The compound growth rate of state domestic product (TableI-2) evinces that in the beginning of eighties, the growth rate is lower as compared to other states, mainly, due to successive drought after 1984-85. It is worth mentioning here that the three successive droughts in the state had been managed efficiently and satisfactorily. However, after mid eighties, Gujarat was able to manage a high growth and it ranked second in comparison to other states. It is also observed from that in the nineties the state managed a growth rate of 7.96 percent and stood second among the states in India. In the years of two thousand the state ranked first with 8.99 growth rate at constant 1993-94 prices.

Per capita state domestic product reflect the status of the population in terms of production and hence income. TableI-3 shows that Gujarat in a disadvantaged position as compared to the other states, it ranks sixth in terms of Per Capita income in the period 1980-2005, and fourth during the post reform period. However, its Per Capita SDP was Rs.22047 in the year 2001 as compared to the national- Rs.13715.

Table I-2 Continuous Compound Growth rate of Gross State Domestic Product by State at constant 1993-94 prices

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
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<td>5.21</td>
<td>5.89</td>
<td>5.66</td>
<td>5.61</td>
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<td>8.06</td>
<td>3.83</td>
<td>3.83</td>
<td>3.83</td>
</tr>
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<td>Goa</td>
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<td>3.09</td>
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<td>8.99</td>
<td>6.08</td>
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<td>5.59</td>
<td>5.49</td>
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<td>5.25</td>
<td>4.64</td>
<td>4.64</td>
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<td>2.78</td>
<td>2.31</td>
</tr>
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<td>6.30</td>
<td>5.80</td>
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<td>3.91</td>
<td>4.42</td>
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<td>4.02</td>
<td>4.61</td>
<td>4.34</td>
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<td>6.39</td>
<td>6.71</td>
<td>5.98</td>
<td>5.46</td>
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<td>5.42</td>
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<td>4.54</td>
<td>3.67</td>
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</tr>
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<td>5.81</td>
<td>6.68</td>
</tr>
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<td>7.17</td>
<td>7.04</td>
<td>7.14</td>
</tr>
</tbody>
</table>

Source: CSO, New Delhi and Gujarat State Domestic Product, Gandhinagar

Note: * indicate data are from 1993-94 to 2004-05
Regression use: y=A.e^{b*t}
Table I-3 Continuous Compound Growth rate of Per Capita SDP by State at constant 1993-94 prices

<table>
<thead>
<tr>
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<td>3.64</td>
<td>4.84</td>
<td>3.97</td>
<td>4.33</td>
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<td>-2.22</td>
<td>5.46</td>
<td>5.05</td>
</tr>
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<td>Goa</td>
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<td>6.53</td>
<td>-2.22</td>
<td>5.46</td>
<td>5.05</td>
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<td>4.96</td>
<td>3.18</td>
<td>2.98</td>
</tr>
<tr>
<td>Jarkhand*</td>
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<td>2.91</td>
<td>5.61</td>
<td>1.99</td>
<td>1.99</td>
</tr>
<tr>
<td>Karnataka</td>
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<td>3.7</td>
<td>4.39</td>
<td>5.13</td>
</tr>
<tr>
<td>Kerala</td>
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<td>4.78</td>
<td>5.71</td>
<td>3.95</td>
<td>4.54</td>
</tr>
<tr>
<td>M.P.</td>
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<td>3.26</td>
<td>2.24</td>
<td>2.15</td>
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<td>4.64</td>
<td>5.89</td>
<td>4.19</td>
<td>3.70</td>
</tr>
<tr>
<td>Orissa</td>
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<td>2.62</td>
<td>6.49</td>
<td>1.99</td>
<td>2.85</td>
</tr>
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<td>Panjab</td>
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<td>2.63</td>
<td>2.69</td>
<td>2.43</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>3.16</td>
<td>3.93</td>
<td>5.06</td>
<td>3.54</td>
<td>3.05</td>
</tr>
<tr>
<td>T.N.</td>
<td>3.4</td>
<td>5.18</td>
<td>1.87</td>
<td>4.36</td>
<td>4.17</td>
</tr>
<tr>
<td>U.P.</td>
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<td>0.85</td>
<td>2.36</td>
<td>1.53</td>
<td>1.07</td>
</tr>
<tr>
<td>W.B.</td>
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<td>4.95</td>
<td>5.62</td>
<td>3.94</td>
<td>5.21</td>
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<tr>
<td>Delhi</td>
<td>3.16</td>
<td>4.76</td>
<td>4.17</td>
<td>4.17</td>
<td>4.64</td>
</tr>
</tbody>
</table>

Sources: C.S.O, New Delhi and Gujarat State Domestic Product, Gandhinagar

Similarly, according to NSS-58th Round, the monthly Per Capita Consumer Expenditure both in rural and urban area, was around Rs.590.20 and Rs.1229.16, which was higher than the national rate of 531.39 and 1011.97 respectively.

Thus, in the case of gross SDP as well as per capita SDP, Gujarat has maintained its rank, and its position improved in nineties as compared to eighties. In the years of two thousand Gujarat’s growth rate was high at 8.99 percent. Ahluwalia [2000] pointed that during the post reform period the growth rate of Gujarat grew at rates normally associated with ‘miracle growth’. Gujarat superior performance was not the result of any conscious policy of limiting benefits of liberalization but it was due to the fact that the states were able to provide an environment most conducive to benefit the new policies.

(iii) Structural Pattern of State Domestic Product

The studies on structural pattern of Gujarat economy suggest that like other states, Gujarat is experiencing a phase of structural transformation. The agriculture sector which accounts for 35 percent in the year 1980-81 now accounts only 15 percent of SDP in 2007-08. Similarly, the contribution of secondary sector increased marginally from 30 percent to 39 percent in total gross SDP. The share of service sector, however show an
increase of about 40 percent. It has increased from 36 percent to 47 percent between the period 1980 to 2008.

Table I-4 Gujarat-Sectors of the Economy

<table>
<thead>
<tr>
<th>Year</th>
<th>Primary</th>
<th>Secondary</th>
<th>Tertiary</th>
<th>Total SDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-81</td>
<td>34.65</td>
<td>29.04</td>
<td>36.35</td>
<td>100</td>
</tr>
<tr>
<td>1990-91</td>
<td>31.63</td>
<td>32.59</td>
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</tr>
<tr>
<td>2000-01</td>
<td>17.15</td>
<td>34.53</td>
<td>48.32</td>
<td>100</td>
</tr>
<tr>
<td>2007-08</td>
<td>15.2</td>
<td>39.00</td>
<td>46.80</td>
<td>100</td>
</tr>
</tbody>
</table>

Sources:- Gujarat State Domestic Product, Gandhinagar.

With the change in the composition of SDP, the distribution of workforce has also changed. In the year 2004-05, agriculture accounts for 56 percent of workforce, which is much less compare to thirty years ago (65%). This clearly indicates that the state is reducing its dependence on agriculture for income and employment generation.

Another important factor is the change in the total public investment in the economy. Agriculture accounts only 8 percent, industry 25 percent while rests is shared by the service sector during the period 1980-2008. The total gross capital formation in agriculture from 1991 to 2004 has declined from 33 percent to 26 percent at constant 1993-94 prices. Kashyap. S. P, [2000] pointed that Gujarat needs investment in agriculture infrastructure and strategies for sustainable resources which can be used to improve its productivity.

Table I-5 Continuous Compound Growth rate of Gross Domestic Product by Economic Activity of Gujarat and India (Constant 1993-94 price)

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gujarat</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary</td>
<td>-0.55</td>
<td>3.96</td>
<td>1.17</td>
<td>2.11</td>
<td>2.29</td>
</tr>
<tr>
<td>Agriculture</td>
<td>-1.16</td>
<td>4.01</td>
<td>1.35</td>
<td>1.89</td>
<td>2.27</td>
</tr>
<tr>
<td>Secondary</td>
<td>7.76</td>
<td>9.93</td>
<td>8.94</td>
<td>7.84</td>
<td>7.92</td>
</tr>
<tr>
<td>Tertiary</td>
<td>7.27</td>
<td>8.45</td>
<td>7.86</td>
<td>7.22</td>
<td>7.90</td>
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<tr>
<td>Total GSDP</td>
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<td>7.84</td>
<td>8.99</td>
<td>5.91</td>
<td>6.57</td>
</tr>
<tr>
<td>India</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary</td>
<td>3.20</td>
<td>3.37</td>
<td>2.14</td>
<td>3.16</td>
<td>2.83</td>
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<tr>
<td>Agriculture</td>
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<td>6.31</td>
<td>6.66</td>
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<td>5.96</td>
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<tr>
<td>Tertiary</td>
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<td>7.40</td>
<td>7.82</td>
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<td>7.47</td>
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<tr>
<td>Total GDP</td>
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<td>5.94</td>
<td>6.20</td>
<td>5.50</td>
<td>5.83</td>
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</table>

Sources:- Gujarat State Domestic Product, Gandhinagar
Regression use: y=A.e^{Nx}

7
The Table I-5 shows growth experience of primary sector volatility and highly fluctuating trend. This fluctuation has been largely because of the ups and downs in agricultural output, which mainly depend on rainfall. The growth rate of primary sector was negative (-0.55) followed by agricultural growth rate of -1.16 in the period 1980-90. It improved during the period 1990-2000 to 4.01 but it fell to 1.35 in the years 2001-2005. However, it has maintained the growth rate of 2.27 as compared to the national average of 2.67 during the 1990-2005. The principal crops are rice, wheat, jowar, bajra pulses, groundnut and cotton. With only 20 percent of cultivable area under irrigation, the state is vulnerable to the vagaries of monsoons. Indira Hiraway [2000] pointed out that the deceleration of agricultural growth in the post Green Revolution era, is largely because of the situation of results of the earlier strategies, lack of development of new approach and decline in the share of the Government expenditure on irrigation and agriculture.

Thus, we conclude that the agriculture growth has stagnated if not declined during the phase 1980-2000 due to the lack of development of new technology that can accelerate land productivity in agriculture. However, Gujarat’s ultimate irrigation potential, the Sardar Sarovar project which is assisted by World Bank, estimated that 50 percent of the total area is put under agricultural cultivation.

On the industrial front, Gujarat was considered as one of the most industrialized states in India. The state’s long established industries produce goods like textiles, dairy products, edible oils, leather products and cement. The state has performed well (TableI-5) with the growth rate of the secondary sector maintained at 7.76 percent in the eighties, 9.93 percent in the nineties and 8.94 percent during the period 2001-2005. During the post reform period, the growth rate was around 7.92 which is quite higher than the national rate of 5.96.

As Government of Gujarat came out with the industrial policy (NIPI) in August 1995 and later the industrial incentive policy (NIPII), the industrial structure in the state has been gradually diversifying with development of industries like chemicals, petrochemicals, fertilizer, engineering and electronics. The textile sector which dominated during the 1960's and 70's no more hold sway in terms of output, investment and number of factories. The significant shift in industrial structure is in favor of chemical and chemical product (16.02 percent share), food product (9.80 percent share) and chemical product...
(6.44 percent share) machinery and machine (8.52 percent share). During the period 1980-2008, Gujarat established itself as a leader in various industrial sectors- Textiles, Engineering, Chemicals, Petrochemicals, etc.

The state government announced the Gujarat Industrial Policy in 2003. The main objective of the policy is to achieve sustainable industrial development with a view to create large scale employment opportunities and achieve global competitiveness by improving productivity.

The tertiary sector has shown a consistently better performance, both before and after 1990. The Gujarat growth rate (Table I-5) was around 7.22 percent and 7.90 percent as compared to the national growth of 6.89 and 7.47 during 1980-2005 and 1990-2005 respectively.

(iv) Investment and Infrastructure

The state has achieved one of the objectives mentioned in NIPI and NIPII, namely, it has attracted large amounts of investment. It ranks sixth in respect of foreign direct investment (FDI) approved during 1991 to 2004 following Maharashtra, West Bengal and Delhi.

Table I-6 State-Wise Flow of FDI Approvals during August 1991 to March 2004

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<th>State</th>
<th>No of Approvals</th>
<th>Amount (Rs. Crore)</th>
<th>Percent of Total</th>
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<td>51115</td>
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<td>2607</td>
<td>25072</td>
<td>8.6</td>
</tr>
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<td>9317</td>
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<tr>
<td>Karnataka</td>
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<td>24138</td>
<td>8.3</td>
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<td>Gujarat</td>
<td>1204</td>
<td>18837</td>
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<td>Andhra Pradesh</td>
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</tbody>
</table>

Source: Ministry of Commerce and Industry (GOI); Newsletter, April 2004.

As on June, 2005, the share of the state in terms of investment in the country worked out to be 7.6 percent. However, most of the investments are primarily in the manufacturing sector with a share of over 51 percent, followed by infrastructure at 46.70 percent. Investment in infrastructure is considered crucial for economy development as it has direct relationship with productivity. Centre for Monitoring Indian Economy (CMIE) has
developed an index for infrastructure development (Basic Statistics Relating to Indian Economy vol: 2, State 1994) using fifteen important infrastructure indicators. The major indicators are power, irrigation, roads, railways, port, office, education, health and banking. According to their analysis, Gujarat, in 1992-93, with an index of 125, ranked sixth amongst the eight states, having indexed higher than all-India average of 100. On the whole, the state within the sphere of road, road transport, ports and bridges etc has responded to the changing need of the economy during the decades 1980 to 2008.

However, increase in investment does not mean increase in employment. In a recent review of the investments in the industrial project, [Kashyap (1995)] has pointed out that the employment potential of the proposed investment is limited. He says, 'Overall, an investment of nearly Rs.70 thousand Cr. would generate additional employment of about three lakhs workers.' The employment implications of larger projects (Investment of 100 Cr. and above) are depressing. An investment of over Rs.50 thousand Cr. would employ less than 40 thousand workers. He argued that the state has supported the low employment potential industrial projects more than the small enterprises, which are more widespread, autonomous and have the potential to generate employment.

The absolute levels of employment have risen marginally during the decade 1980 – 2008. But there is also a marked increase in the frictional employment, because of the closure of textile mills (1980), obsolete technology and decentralization of public sector industry.

The state has high unemployment rate among males in rural and females in urban areas. The unemployment rate among females is 4 percent substantially higher than the national level according to the National Sample Survey data on 50th round.

(v) Education and Health

The effort gone in to the promotion of Social Sector, especially Health and Education has increased significantly. The Health infrastructure shows a marginal improvement as Health centers have increased from 2186 (1980-81) to 13844 (2000). It ranked 16th with respect to Child Birth Rate (CBR) and 14th with respect to Child Death Rate (CDR) out of the of 29 states and Union Territories. The state education programmes reveal that it is not enough to allocate resources for education, it is also necessary that education is imparted in proper school buildings, and through trained teachers.
To conclude, the Gujarat economy does not show any discernible impact on economic front but it has responded significantly to the stimuli provided by reforms and various state programs and policies during the period 1980-2008. However, in order to achieve sustained growth rate in future, Gujarat state needs a corrective action in its fiscal performance. During the last two decades the Gujarat fiscal deficit has increased 5 percent of SDP. Larger investment is needed in all areas such as schools and health facilities, power system, irrigation and water management system, land development etc. The state has to strengthen the existing financial position in order to identify the potential and to promote growth and development.

1.3 Issues of Fiscal Discipline

1.3.1 States Fiscal Issues

(i) Turning Point in State Fiscal Position

Almost all the states in India witnessed a secular deterioration in their fiscal health since the mid 1980’s. In fact, in the initial years of 1980’s, the states generated a revenue surplus of one percent of gross SDP. By 1987-88, however, the surplus had vanished. In subsequent years until 1993-94, there was gradual increase in deficit, but thereafter, it increased sharply, ranging between 3 to 5 percent of gross SDP. In the nineties, out of 15 non-special category states, only one state had a revenue surplus while other 14 states entered into the phase of revenue deficit. With the growth of revenue deficit, the fiscal deficit increased from 2-3 to 3-4 percent of gross SDP. The situation further deteriorated in year 2001, when nine states reached a gross fiscal deficit of more than 5 percent of gross SDP.

GraphI-2

Trends in States' Key Deficit's as Percentage of GSDP

From the Graph 1-2 it can be observed that the fiscal deterioration of the states began after mid-eighties. The trend witnessed a revenue surplus in the year 1980 and 1985. The fiscal deficit was less than 3 percent and the primary deficit was also less than one percent of gross SDP. The trend was reversed after 1990-91 as it is evident from the Graph I-2 that all the fiscal indicators like fiscal, revenue and primary deficit show an upward trend as compared to the eighties. However, the states’ fiscal position has shown some improvement in the years of two thousand, as a downward trend is observed from the graph in all its indicators. The Tenth Finance Commission observed that the very fact that all the states have almost identical turning points implies that there are systematic factors underlying this deterioration rather than state specific reasons.

The Commission has identified three phase deterioration in the revenue account balance of all the states, by disaggregating the revenue account into Plan and Non-plan.

- **First phase (up to 1986-87)** - Non plan account surplus was larger then plan deficit yielding an overall revenue surplus.
- **Second phase (1986-87 to 1991-92)** - the magnitude of plan deficit increased sharply and became larger than non-plan surplus, which was declining.
- **Third phase (after 1991-92)** - the non plan revenue account itself went into deficit.

(ii) **Structural Weaknesses**

Apart from the deficit in the state account, a number of different issues and vexing problems were evident in India’s State Finances which have suffered from adverse trends during the eighties and nineties. All states figure show that in the last two decades the states have witnessed a steady deterioration in revenue receipts –GSDP ratio. Tax receipts-GSDP ratio is more or less stagnant at 7 percent while Non tax receipts to GSDP show negative growth in the eighties and nineties. The near stagnation in states’ taxes and deterioration in states’ own non taxes, resulted in a decline in the States own revenue from 8.9 to 8.6 percent of GSDP in the year 1987-2008.
Another problem which most of the State governments have been facing is the worsening budgetary squeeze, which has adversely affected their developmental expenditure. The expenditure responsibility of the states has led to an increase in the revenue expenditure. Due to growing revenue expenditure, the share of capital expenditure in the total states expenditure had declined from 26 percent to 12.1 percent during the period 1987 to 2000. The capital expenditure as percent of GSDP has also declined from 3.6 to 1.8 percent.

The RBI Report on State Finances (2004) quotes that the factors responsible for these widening imbalances include (i) Growing interest burden (ii) increasing wages and salaries (iii) pension liabilities (iv) losses incurred by state public sector undertakings (v) charges/ cost recoveries and (iv) deceleration in the central transfers. The Report also pointed out that interest payment of some of the states (West Bengal, Orissa, Punjab, Rajasthan, Gujarat, Uttar Pradesh) absorbs 30-50 percent of revenue receipts. The report stressed that the factors influencing the budget outcomes in states are mainly structural and cyclical. Structural deficit is defined as an expansionary fiscal stance of the government. Long run structural weaknesses of the states are identified as expenditure growth tending to outpace the growth of revenues. Thus, states are vulnerable to fiscal management and such a phenomenon affects their ability to undertake and perform the developmental functions.

1.3.2 Gujarat Fiscal Issues

Gujarat state, which is generally considered a well managed state, has incurred a deficit in its budget during the period of the eighties, the nineties and during the years of early two thousand. The growing gap between expenditure and revenue is the main reason for the growing and persistent imbalances in the Gujarat state finances. Gujarat has reached a stage where capital receipts are being utilized to cover revenue deficit. It results into growing debt burden and serving of growing debt affecting thereby the development expenditure.
The major factors attributed to fiscal imbalances of Gujarat state are:-

i. **Widening of Resource Gap:** At state level, resources gap includes five indicator viz; revenue deficit, primary deficit, and gross fiscal deficit, budgetary deficit and capital deficit. The larger the value of any of these deficit, the poorer the fiscal health of a state it indicates. Gujarat budget accounted a surplus before 1984-85. The state started facing the problem from late eighties i.e. from the year 1986-87. In proportion to gross SDP, if we compare the 1986-87 to the year 2000, all the deficit indicators show an upward trend. The revenue deficit increased from 1.91 to 5.17 percent, the budgetary deficit has increased from surplus of 0.65 to deficit of 0.23 and capital deficit from 2.56 to 5.44 percent. With the growing of these deficits, fiscal deficit widened. The fiscal deficit has increased from 3.6 percent to 6.4 percent and primary deficit from 4 percent to 4.4 percent.

ii. **Sluggish Growth in State Revenue:** The major factor attributed to fiscal health is the revenue. Revenue receipts as percent of gross SDP witnessed a near stagnation with very low buoyancy of its own tax revenue and decline in transfers from the central. The revenue receipts were 13.96 percent in 1986-87 and in 2000 it accounts 14.16 percent. The tax revenue was stagnant around 8 percent, while own tax revenue declined from 7.8 (1986-87) to 7.4 percent (2000). The Non tax revenue also shows no improvement as it accounts 4.78 (1986-87) and 4.61 (2000) percent. Central transfer in terms of grants also declined in the same years.

iii. **Increase in Expenditure Responsibility of State:** Another fiscal health issue is the expenditure responsibilities of the State. Interest payment, expenses towards administrative services, wages and salaries, pensions and subsidies all led to increase in revenue expenditure. With the increase in revenue expenditure the total expenditure in percent of gross SDP increased from 20.5 (1986-87) to 24.4 (2000) percent. The revenue expenditure has increased from 15 to 18.38 percent while the capital expenditure declined from 5.28 to 4.62 percent in the same year.

iv. **Unsustainable Debt and Growing Burden of Debt Servicing:** Over the years, large revenue deficit have led to large fiscal deficit which resulted into steady
accumulation of debt as reflected in the rise in the debt-SDP ratio. The debt dynamics turned more adverse in the nineties as public debt as percent of SDP witnessed rapid growth from 3.8 (1986-87) to 6.6 (2000) percent. The average annual growth rate of public debt has increased from 6.7 in the eighties to 41 percent in the years of two thousand. The RBI Report on State Finances [2001] pointed that 15 percent of the total expenditure of the Gujarat state in the year 2000 comprised of interest payment and debt servicing. The average annual growth rate of public debt has increased from 6.7 percent 1980-81 to 41 percent in the year 2000.

Thus, the major concern is, first the rapidity with which public debt and its servicing is growing poses a challenge and a threat to the stability of state finances. Second, given the fact that the states face a hard borrowing constraint, any significant rise in the public debt burden may have adverse implications for resources allocation to some of the critical social sectors.

v. **Subsidies:** Another major fiscal health issue which has dominated during the eighties and nineties is expenditure towards subsidies which is provided to various social and economic services. Though the accurate amount of subsidies provided by the state through their budgets is difficult to make out as they are both hidden and direct. The Gujarat Finance Report [1994, GOG] had carried out a desk study of the trend in subsidization of social services during the period 1980 to 1991 in Gujarat. The study analyzed that in Gujarat the average annual growth rates of subsidy is around 21 percent while its recovery rate is 13 percent per annum. However, the situation has improved recently as the growth rate assumed on general subsidies is negligible.

vi. **Public Sector Enterprises:** The deteriorating financial condition of public sector enterprises is a matter of serious concern to all the states. This is considered to be an avoidable burden on public exchequer which can be gradually reduced by resorting to privatization. However, during the years Gujarat state is able to find success with two public sector companies out of 24 undertakings and like other states the state is also finding it difficult to close down the loss making public sector units.
Although the Gujarat fiscal health has shown some improvement after the enactment of the Fiscal Responsibility Management Act 2005, still, the existing system lacks a link which could preserve its fiscal position for a long period. Therefore, the major consequences will be very serious because:-

i. High fiscal deficit implies that the government is making large investment in the economy. Unfortunately, large fiscal deficit, which the state has, is not due to public investment but due to current expenditure.

ii. The growing revenue deficit leads to increase in unit cost of public services as the borrowed funds are used to finance revenue expenditure. The borrowed funds increase the interest liability which further increases debt payment and in the long run may lead to a sacrifice of development expenditure in general and capital expenditure in particular.

iii. Tax reform measures have been introduced from time to time keeping in view the medium term strategy. However, measures like rationalization and reforms of indirect taxes (service tax at centre and VAT at state) did not have desired results. RBI Report on States Finances 2007-08 states that VAT has been an unqualified success in raising tax revenue, while revenue growth in states in general remains sluggish.

iv. Similar efforts are done by the Government to curb expenditure but the impact is more on the capital expenditure than on the revenue expenditure. The growing expenditure on interest payment, fifth pay commission, expenses towards administrative services reveals an increase in revenue expenditure.

v. The state is increasingly being dependent on central government and market borrowings. This dependency is reflected by the debt ratio. State debt-SDP ratio increased from 3.15 from eighties to 6.17 in the years of two thousand. If this upward trend continued for a longer period, it may cause further accumulation of debt and in the near future may lead to the situation of Debt Trap.
Therefore, there is an urgent need to improve the overall quality of fiscal adjustment of a well developed state Gujarat. According to State Finance RBI Report [2003-04] in Gujarat state, growth in the expenditure during post-reform period is (17.95%) higher than the growth in capital formation (13.9%). The report also holds the view that all states except Goa and Gujarat have shown substantial improvement in respect of social services, rural development, food storage etc. Such a phenomenon has implications not only for the state finances but it also has an overall effect on development of the state and social welfare.

The RBI State Finance Report [2006-07] mentions that the development expenditure in better off states like, Gujarat, Maharashtra and Goa is declining as a percentage of SDP and is rising in underdeveloped states like Bihar and Jharkhand. Like other states, Gujarat's consumption expenditure as a percent of total expenditure has increased while expenditure on capital formation has declined. Such a phenomenon will add obstacle, not only for investment but also for growth and development of the economy. For instance, in order to have infrastructure development, the Gujarat government needs approximately Rs.116993 Cr. of which both domestic and foreign account only 34 percent in the year 2007. In the Eleventh Five Year Plan, the Gujarat state Government has laid out its goal of attaining “Faster and More Inclusive Growth” by setting out certain priorities. The government aims to allocate more resources to health, education, agriculture and poverty alleviation-in line with the strategy of achieving an order of magnitude improvement in the state’s Development Index.

The existing system lacks a link between borrowing and end use of expenditures in capital investment. The whole control to preserve the fiscal health of the State is being exercised with central government. The state governments are not allowed to run deficit – financing activities and are therefore constrained from fiscal excess.

Mohan R (2000) pointed out that the overall worsening fiscal situation of state governments is due to the financing of investment expenditures. Capital outlays as a proportion of gross fiscal deficit have fallen from about 62 percent in the late 1980’s to less than 50 percent in nineties. Similarly revenue deficit has risen as proportion of gross fiscal deficit from about 7.7 percent in the late 1980’s to more than 53 percent in nineties. Consequently borrowing by the state government is now being devoted more and more to
the financing of revenue expenditure rather than capital expenditures. All this can only lead to further worsening of the fiscal situation in the coming years. The resources available for investment will decline continuously in the foreseeable future, unless, there is a change in the system.

Ahluwalia (2000) also argued that to accelerate growth, higher levels of public investment is required in critical social and economic infrastructure sectors by state governments. However, the financial position of most states is actually forcing a continuing squeeze on plan investment. During 1990-91 several states had a positive balance from current revenues (BCR). This balance has now turned negative for almost all states which mean that state governments have to borrow to finance the negative BCR. And then borrow more to finance the plan.

The planning Commission, while stressing the need for fiscal and other reforms at the states level, observed that ‘….a joint effort by the centre, and states need to reform more and much faster, and raise substantially higher levels of their own resources to mobilize the financial resources essential for the much needed productive investments….’(Mid Term Appraisal, Xth five year plan)

Although state finance has improved over the last few years, major challenge for the state governments would be the likely impact of the sixth pay commission award. The fiscal space available to governments is limited and it is a difficult task to have sustainable fiscal consolidation path.

Many states undertook various policy measures to strengthen their finances mainly in late 2000. Given the size of the problem, the effectiveness of such policy measures, however, remain inadequate. Most of the policy measures were ad hoc in nature and were guided by the exigency rather than their being structural in nature. The vicious cycle that is set in motion leaves little scope for raising tax rates while rising debt and fall in the growth rate of developmental expenditure put pressure on the state economy.

The present study on Gujarat state finances therefore assumes importance as fiscal discipline is necessary to the growth and the structural reform process. It is important to
find out the peculiar characteristics which affected the quality of fiscal behavior of a well
developed state like Gujarat.

Most of the empirical studies on state finances have concentrated on the working of the
current federal fiscal system like variations in tax effort of the states, differentials in the
relative expenditure and/or performances of the states. Their objectives, approach,
database and period for analysis are varying. Hence, we get a wide range of prescriptions
from these studies. There are few studies on fiscal management at Gujarat State level
which have explored the state fiscal situation. Gujarat is the most developed state of
India and its financial structure and fiscal policies have a significant implication on its
socio-economic status, therefore, a study on fiscal management of Gujarat state has been
undertaken.

1.4 Objectives of the Study

The broad objectives of the present research are:

(i) To study the effectiveness of revenue mobilization measures of Gujarat state with
    reference to buoyancy of tax revenue, yield stability and yield growth.

(ii) To study the expenditure pattern and effectiveness of expenditure management
     measures of Gujarat state.

(iii) To study the issues of debt management and its impact on the Gujarat economy.

(iv) To review the process of fiscal adjustment i.e. tax sharing, grants and loans in the
     context of fiscal reform and its impact on Gujarat state finances.

(v) To study the policy measures undertaken by the centre to improve the
    effectiveness of state finances.

(vi) To help identify major problem areas and corrective policies for sustaining good
     fiscal health of Gujarat state.
1.5 Hypotheses of the Study

The present study explores the following hypotheses:

(i) The deterioration in Gujarat state finances reflects a combination of eroding revenue base and mounting spending pressures.

(ii) Gujarat. State own tax effort and non tax revenue have not kept pace with the growing requirement of funds for development of the state.

(iii) Uncontrolled growth in current expenditure has created and worsened the problem of deficit in Gujarat.

(iv) The Critiques used to transfer the resources from the centre to the states are primarily responsible for fiscal imbalances in Gujarat.

(v) Debt financed deficit in the budget has contributed in generating fiscal imbalances.

(vi) For sustainable economic growth, a Medium-Term Fiscal Reform strategy to restore fiscal balances is imperative.

1.6 Methodology

(a) Study Approach

(i) Comparative Analysis: - The study is exploratory in nature, both in theoretical and empirical terms. It is based on secondary data. The structure, concepts and role of state finances have been reviewed to analyze the various forms of resources and expenditure. To get a comparative idea about the fiscal situation, a comparative analysis has been done between the different sub-periods. Similarly, the situation of Gujarat is compared with other non-special category states and All states.

(ii) Trend and Composition: - This study tries to examine the structural shift in various receipts and expenditure in terms of both, level as well as growth rate.
Along with the trend, it also analyzes the composition, in order to understand the nature and magnitude of fiscal behavior and its components.

(iii) Buoyancy, Stability and Elasticity :- These coefficients have been estimated in order to know the extent, adequacy or capacity of a particular tax to sustain for a given period of time and to know the extent of relationship between the variable.

(iv) Determinants of Fiscal Deficit:- To identify the determinants of fiscal deficit variables, which effect the various policies relating to revenue generation and control of expenditure.

(b) Methods and Techniques of Analysis

Various statistical and mathematical techniques have been used for the analysis of data. The analytical techniques employed in the study are:-

(i) Proportions and Growth Rates
(ii) Ratio Analysis
(iii) Regression Analysis
(iv) Co-Integration Test

(c) Time Period of the Study

The fiscal condition of the state in general has steadily deteriorated since 1980’s. Hence, the time period considered for the study is 1980-81 to 2008-09. This is further divided into three sub-periods:-

(i) 1980 - 1990
(ii) 1991 - 2000
(iii) 2001 - 2008
(iv) 1980 - 2008
The data used in the study have been obtained from various sources and issues of the following publications:

(i) Gujarat State: Budget Publications
(ii) Gujarat State Domestic Product
(iii) Economic Survey
(iv) Handbook of Statistics on State Government Finances
(v) Reports on Currency and Finance
(vi) Reserve Bank of India Bulletin
(vii) Reports of the Finance Commission
(viii) Reports of the World Bank

1.7 Thesis Outline

Chapter 1: Introduction

This is the present introductory chapter. It explains the socio-economic profile of Gujarat state for the period under study - 1980 to 2008. It deals with the states fiscal position in India and finally raises pertinent issues related with fiscal discipline under which Gujarat and many other states are required to manage their fiscal resources. On the basis of this, the chapter outlines the objectives, hypotheses and methodology of the study. It also covers a brief summary on each chapter of the thesis.

Chapter 2: Survey of Literature

This chapter aims at providing the prescriptions raised through a number of operational issues in theory and practice of fiscal federalism at sub-national level. The objective is to evaluate the role of the state in optimum allocation and distribution of fiscal functions. Such studies enable one to develop criteria with references to which an assessment can be attempted.
The survey of literature is classified both in terms of theoretical aspects and empirical studies. A theoretical aspect deals with Theory of Fiscal Federalism, Theory of Public Revenue, and Theory of Public Expenditure of multi-unit fiscal system. The empirical studies cover the well researched papers and studies on the state finances in India. Some of the works enumerated in the studies are of Archana Dholakia, Atul Sharma, Bagchi A, Rao M Govinda, V.Y Reddy, Sen Tapas, Jena, Kishor prasad, Role of RBI, and EPW research foundation work on state finances.

Chapter 3: A Comparative Analysis of Gujarat with Non-Special Category States

This chapter deals with the structure and composition of state finances and a comparative analysis with non-special category states.

The working of the federal fiscal system depends upon its own constitutional arrangement. This constitutional arrangement changed considerably over a period of time. An attempt is being made to analyze the impact of such forces which led to changes in the given constitutional arrangement at state level on the framework of state finances, financial relations under the constitution and role of central government.

Besides this, the chapter deals with a comparative analysis of Gujarat state with non-special category states. Such appraisal explores the various indicators which evaluate the system in terms of efficiency, quality, transparency of state policy of Gujarat and its institution, including administrative machinery with respect to other states in India. The major topics covered under it are the framework of state finances, general budgetary position of Gujarat state, comparisons are being made with non special category states with respect to state aggregate receipts, their expenditure, deficit indicators and financial relation under the constitution.

# Analysis of Gujarat State Finances is attempted in three aspects, namely, Receipts, Expenditure and Debt. This is divided into two chapters, Chapter-4 and Chapter-5.

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Chapter 4 : Analysis of Gujarat Receipts and Its Fiscal Relations with the Centre.

In this chapter, an attempt is made to analyze the Gujarat Receipts with respect to revenue receipts, capital receipts and transfer of resources from the Centre. It has two sections. They are:-

Section A : Analysis of the Receipts of Gujarat State

This section attempt to analyze the revenue receipts of Gujarat. It deals with various aspects of tax and non tax revenue. Trends in tax revenue are analyzed in terms of their fiscal importance, recent reforms undertaken by Government of Gujarat and various policy issues pertaining to particular tax receipts. Non Tax revenue is deals with own non tax receipts of Gujarat and disinvestment program of public sector enterprise of State Government.

Section B : Fiscal Relations and Adjustment with the Centre

In this section an attempt is made to analyze the issues related to the devolutions of resources from the centre to the state. The main focus is to analyze the role of Finance and Planning Commission in determining the fiscal performances of Gujarat state. It deals with the recommendations of Gujarat Government to Finances Commission and the Finance Commission approach towards better performed states with respect to tax sharing, grants and loans.

Chapter 5 : Analysis of Expenditure and Public Debt of Gujarat State.

In this chapter, an attempt is made to analyze the expenditure pattern and debt management of Gujarat state. It deals with major issues, both qualitatively and quantitatively, which is affecting the state finances. It has two sections. They are:-

Section A : Analysis of Public Expenditure of Gujarat State

This section analyzes the public spending of Government of Gujarat. It deals with major issues of revenue and capital expenditure, development and non-
development expenditure, economic and social services, interest payment and servicing of debt, administrative services, pensions, and subsides.

Section B: Analysis of Public Debt of Gujarat State

This section analyzes the nature, aspects and problems related with debt of Gujarat state. It deals with the debt indicators, debt sustainability, issues of debt management, role of Commission and debt restructuring program of Gujarat Government.

Chapter 6: Management of Gujarat Fiscal Deficit

Fiscal deficit is considered to be a true indicator of state indebtedness. It is a key parameter of macro-economic policy such as growth, investment and financial system of any state. An attempt is made to analyze the management of Gujarat state finances with references to restructuring the structural weakness which is reflected in the fiscal deficit.

It deals with the behavior, composition, financing and determinants of fiscal deficit. It also tries to identify the various aspects of fiscal health which are under the statement of the Gujarat Fiscal Responsibility Act 2005 and Medium Term Fiscal Policy Statement.

Chapter 7: Conclusions and Policy Options

This chapter summarizes and concludes the findings of the present research endeavour and draws relevant suggestions, policy measures and options with the aim of restructuring of Government finances in terms of both, the qualitative and quantitative aspects.
References


11. Mid-Term Appraisal of the Tenth Five-Year Plan (2002-07)


