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References
2.1 The Role of State in a Federal System

Federalism or the idea of multi-level government is now widely acknowledged to be the best founding principle of politics around the world. The advantages of the federal form are manifold. It enables the constituent units to reap the benefit of 'Strength in Unity', while retaining their identity and autonomy in organizing their public sector in accordance with the wishes of their people. The fact that the governments can, and should, assume responsibility for the management of the economy, and that 'successful management' comprises the simultaneous attainment of allocation, distribution and stabilization objectives.

A classical economist, Adam Smith (1723-1790) however, restricted the duties of a government to protect the society from violence and invasion. The classical economist believed, that an economic system via price mechanism normally tends to equilibrium, and the productivity of the government services is nil. The best government is that which does the least.

Keynes rejected the classical reasoning and argued that functioning of price mechanism is imperfect at the times of depression and recession. Keynes believed that government intervention in a free enterprise economy was necessary to ensure sustained economic development. He maintained that insufficient aggregate demand causes unemployment and excessive demand results in inflation. Therefore, a government should manipulate the level of aggregate demand by varying the level of its expenditure and taxation. Similarly to tackle recession governments should increase its expenditure in the economy such as public works, reduce taxes and provide easy credit. These measures accelerate investment, employment and increases private spending. Hence, the importance of budgetary policy and government intervention is clear.

After Keynes reinterpretation of the working of a capitalist economic system, it became a widely accepted fact the public sector was to be accorded, a leading role in the
development of the economy. A government may participate directly by assuming the role of a producer, a banker, a distributor. It can also influence the pattern of production and consumption indirectly through fiscal and monetary measures.

This chapter deals with the survey of literature on fiscal federalism. It briefly reviews the theoretical aspect of fiscal federalism related with optimal form of government, optimal division of function and optimal fragmentation of revenue resources. The role of the Theory of Public Revenue and the Theory of Public Expenditure at sub national units is also studied. Since the study, is related with state finance, an attempt is made to review the works of economists related with state finance in India and particularly Gujarat.

2.2 Survey of Literature - Theoretical Aspect

2.2.1 Theory of Fiscal Federalism

Designing a federal constitution that can serve the goals of federalism efficiently and lay foundations of a stable federal polity in a given country is, however a challenging task. Although the idea of federalism is not new, in fact, it is as old as the Greek city-states, and the federal system has been in operation in various forms in different parts of the world for quite some time. No unique model has emerged that can suit all countries for all times.

Inman and Rubinfield (1997) define the issues of a federal constitution as:

(i) How many governments should be there be at low tiers?
(ii) How should the powers and functions of governments be divided among different levels?
(iii) Should the division be watertight or should they be allowed to overlap?
(iv) How should the lower-tier governments be represented in the central legislature?

It is observed that the framework of public economy depends upon the political and social values of the society that it serves; and the implementation of the optimal budget plan depends upon the functional relationship that prevail in the market sector of the economy. However, an evaluation of any fiscal system should be done from the viewpoint of accepted norms and objectives. Generally, accepted objectives of the fiscal policy are
quite known to us. It should ensure an efficient allocation of scarce resources, an equitable distribution of income and wealth and growth with stability. Economists have made efforts to evaluate the unitary extremely, decentralized and federal fiscal system from the above viewpoint.

The theory of fiscal federalism as originally developed by Musgrave (1959) and Oates (1972), concern with the optimum division of government functions and its finances among multiple layers of the government. It mainly deals with the normative aspect of the fiscal federalism such as, appropriate degree of decentralization between the federating units, the efficiency of unitary form of Government in achieving the macro-economic objectives of the economy as compared to the multi form of government, role of central unit for balancing the federal-state-local fiscal system. In short the theoretical literatures concerned with the above issues in a multi unit fiscal system are:-

(a) An Optimal Form of Government

Under the terms of the Indian constitution, India is a Union of States; the underlying spirit of the constitution is one of federalism. Therefore, federal financial theory is relevant to the Indian situation because despite the strong unitary trend, the constitution, in sharing of powers, has assigned significant function and financial powers to the states. Theoretically also, the federal form of Government has been considered the most suitable form of Government in achieving the macro economic objectives of public sector. As W.E Oates concludes:

"Federalism represents in one sense, a compromise between unitary Government and extreme decentralization. In a Federal system there exists both a central Government and sub-central Governments units, each making decisions concerning provision of certain public services in its respective geographic jurisdiction. From an economic stand point, the obvious attraction of the federal form of Government is that it combines the strength of the unitary Governments with those of decentralization. Each level of Government, rather than attempting to perform all the functions of the public sector, does what it can do best. The central Government presumably accepts primary responsibility for stabilizing the economy, for achieving the most equitable distribution of income, and for
providing certain public goods that influence significantly the welfare of all members of
the society.

Complementing these operations, sub-central governments can supply those public goods
and services that are of primary interest only to the residents of their respective
jurisdictions. In this way, a federal form government offers the best promise of a
successful resolution of the problems that constitute the economic raison d'etre of the
public sector."

The Indian Constitution, which came into force in 1950, adopted the federal financial
theories as defined by 'Oates'. This definition includes not only the normal public finance
objective of efficiency (allocation), equity (distribution) and stabilization but also
economic growth and 'regional balance' to maintain national integrity and political
stability.

Musgrave (1959) has emphasized that the aim of the central unit of the federation should
be maximization of social welfare and for this there should be optimal division of
functional responsibilities, division of revenue resources and there should be economics
of scale in the production of public goods and services.

(b) Optimal Fragmentation of Fiscal Responsibility

The optimal division of fiscal functions suggests that the stabilization and distribution
functions should remain with the central unit of the multi-unit fiscal system. This is
because in a federal set up, the sub-national units have no access to the instruments of
monetary policy and they have to rely on the other fiscal tools such as taxation and public
expenditure for stabilizing their respective state economies. The theory argued that firstly,
stabilization function is less effective at sub-national units because their respective
jurisdiction are like open economies and their tax and expenditure multipliers tend to be
small. Secondly, [Musgrave, 1959] the arrangement of assigning the stabilization and
distributional functions to the central has advantage that; the nation enjoys the unitary
form of government and simultaneously avoids its major shortcomings. This type of
arrangement provides the public goods and services to people as per their preferences and
divides the allocative functions between the layers of government in an optimum manner.
With regard to optimal fragmentation of revenue resources among the federating units, the theories emphasize, that the Central unit should provide only those public goods and services whose benefits are nationwide in scope, while sub-national units should provide those public goods and services whose benefits accrue within their own jurisdictions only. It also suggests that the federating units should be such that each of the federating units could enjoy fiscal autonomy in exploiting its available revenue resources. The revenue resources made available to each of the units should be adequate for discharging the assigned functions of its unit.

It is in this sense the theory of fiscal federalism prescribes in economic terms, the optimal form of Government. It provides all the advantages of an extremely decentralized form of Government without its major shortcomings.

Since the federal government operates several functions the two most important theories related with federal finance are the theory of public revenue and the theory of public expenditure.

2.2.2 The Theory of Public Revenue

The Theory of Public Revenue deals with the sources from which the states might derive its income. It discusses and analyses the comparative advantages and disadvantages of the various forms of revenue and the principles which should govern the choice between them. Theory of Taxation covers various principles governing the choice of tax measure, the problems of incidence, and the effects of taxation on the working of the economy. Although the division of revenues differs from country to country but almost everywhere local governments get mostly indirect taxes viz. sales tax and the central governments get most from direct taxes viz. income taxes. Inman and Rubinfeld (1997) opined that most of countries have uniform fiscal system of tax sharing but it is found that states and local governments have access to only those revenue sources that higher level governments do not wants for themselves.
2.2.3 The Theory of Public Expenditure

The Theory of Public Expenditure deals with welfare, growth stabilization and other policies of the governments. The two basic theories of public spending are Wagner’s law of Increasing State Activities and the Wisemen - Peacock Displacement Effect Hypothesis.

(a) Wagner’s Law of Increasing State Activities

Adolph Wagner (1835-1917) was a German economist who based his Law of Increasing State Activities on historical facts, primarily of Germany. According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively. There was a functional relationship between the growth of an economy and the growth of government activities so that the governmental sector grows faster than the economy. F.S. Nitti supported Wagner’s thesis and concluded with empirical evidence that this law was not only applicable to Germany but to various governments which differed widely from each other. All kinds of governments, irrespective of their levels (central or state), intentions (peaceful or warlike), and size etc., had exhibited the same tendency of increasing public expenditure.

After the publication of English translations of Wagner’s works in 1958, Wagner’s Law has become very popular in academic circles and it has been analyzed and tested by many researchers, for example, Musgrave (1969), Bird (1971), Mann (1980), Abizadeh and Gray (1985), Ram (1986), Henrekson (1992), and Chletos and Kollias (1997).

As pointed by Bird (1971) in most of the industrializing nations public expenditure increases at a faster rate than that of national output. In other words,” as per capita income rises in industrial nations, their public sectors will grow in relative importance. Wagner saw three main reasons for the increase in the government’s role. First, industrialization and modernization would lead to a substitution of public for private activities. Expenditures on law and order as well as on contractual enforcement would have to be increased. Second, an increase in real income would lead to an expansion of the income elastic “cultural and welfare” expenditures. Wagner cited education and culture to be two areas in which the government could be a better provider than the private sector. Thus,
the public sector would grow after basic needs of the people are satisfied and consumption pattern of people expands towards activities such as education and culture. Third, natural monopolies such as the railroads had to be taken over by the government because private companies would be unable to run these undertakings efficiently and it would be impossible to raise such huge finance that are needed for the development of these natural monopolies.

There are at least six versions of this law which has been empirically investigated by OCED and other countries like U.S.A. Malaysia, Turkey (Demirdas S, 1999) etc. They examine a long-run relationship between public expenditure and GNP, along the lines suggested by Wagner's law. All these countries found that public expenditure growth was a natural consequence of economic growth.

(b) Wiseman-Peacock Hypothesis

The displacement effect hypothesis was propounded by Peacock and Wiseman in U.K for the period 1890—1955. In the literature, it has been closely linked to the Wagner's law although there are some differences between the two. The theory says that public expenditure does not increase in a smooth and continuous manner, but in jerks or step like fashion. At times, some social or other disturbances take place creating a need for increased public expenditure which the existing public revenue cannot meet. The inadequacy of revenue as compared to the required public expenditure creates an inspection effect. The government and the people review the revenue position and need to find a solution of the important problems that have come up and agree to the required adjustment to finance the increased expenditure. They attain new level of tax tolerance. They are now ready to tolerate a greater burden of taxation and as a result the general level of expenditure and revenues goes up. In this way, the public expenditure and revenue get stabilized at a new level till another disturbance occurs to cause a "displacement effect'.

Peacock and Wiseman argue that under normal conditions of peace and economic stability, changes in public expenditure are rather limited. These changes are bounded by "Tolerable" limits of taxation. However, during crisis and calamities, such as wars, people do not mind higher taxes and their threshold level of taxation rises permanently.
Thus, government expenditure over time appears to outline a series of plateaus separated by peaks. However, Empirical studies do not support for the hypothesis.

Thus the theory of Fiscal Federalism describes the various layers of the government machinery in which various functions has been fragmented to achieve the objectives of equity, stability and growth. However the new theory of fiscal federalism which is emerging is the theory of decentralization. Ter-Minassian Tersa (1997) quotes that over the past few decades; a clear trend has emerged worldwide towards the devolution of spending and to a lesser extent, revenue raising responsibilities to state and the local governments. Decentralization of spending responsibilities can entail substantial gains in terms of distributed equity and macroeconomic management.

2.3 Survey of literature-Empirical Studies

There are well-researched papers and studies on the state finances in India. Most of the empirical studies have looked at the state finances as a whole, while others have examined specific states or have made inter-state comparative studies. States Finances is also examined by the Finance Commission, Reserve Bank of India and by the various working groups on state resources. Some of the work [Year-Wise] which merit consideration is being enumerated below.


The author has examined the factors pertaining to future expenditure policy of Gujarat. She analyzed the data for the period 1978-96, which she has divided into two sub-periods 1978-79 to 1984-85 and 1985-86 to 1995-96.

The author has pinpointed some reasons about the aggregate government expenditure in Gujarat. The major findings are:-

i. The total fiscal expenditure of the state has been continuously growing 18.49 percent to 26.75 percent to NSDP. However its growth rate has decelerated between 1978-86 and 1985-96.
ii. The share of developmental expenditure has declined in relation to non-
developmental expenditure and also its trend rate shows higher deceleration
between the two sub-periods viz. 1978-85 and 1985-96.

iii. Non-developmental expenditure has increased due to increase in interest payment
and subsidy both of which have grown at a fairly high rate over the years.

iv. Between the two sub-periods, the growth rate of interest payment has considerably
decelerated, but that on subsidy payment has accelerated which is quite an
unhappy development.

v. Increase in non-development revenue expenditure has been a major factor behind
increase in total revenue expenditure, which in turn is mainly responsible for the
persistence of revenue deficit on fiscal account. Due to this the state has been
labeled as fiscally indiscipline state.

The writer has observed that there had been considerable changes taken places during
1978-1997 in the level, growth and structure of various expenditure items.


This paper examined the performance of Gujarat’s revenue and expenditure systems for
the period 1980-97. The paper highlighted the major weaknesses of the existing revenue
sources and suggested a broad direction of future reforms. The major findings are:-

i. Revenue expenditure continued to grow far in excess of revenue receipts. During
the period 1980-97 Expenditure-income ratio is higher than the revenue-income
ratio.

ii. The revenue expenditure as percentage of NSDP has increased by 3 percent while
the capital expenditure has declined by 1.5 percent. The author opined that the
reduction in fiscal deficit can be achieved largely by compressing capital expenditure.
iii. Similar trend is observed with respect to Development and Non-development expenditure. Development expenditure as percentage of state's NSDP tended to decline while the ratio relating to non-developmental expenditure rose.

iv. Some of the sources of constrain on Gujarat finance's fall outside the realm of decision-making. The author opined that the central government reform measures have adversely impacted state's budgets. For instance, the central government in order to curb fiscal deficits reduced the fiscal transfer to states in some years. Its tax reforms, liberalization of interest rates and prices of goods such as coal and petroleum products produced by its public sector undertakings also induced direct and indirect impact on Gujarat's budgets.

v. The author also opined that some of the weaknesses in budgetary and expenditure management have risen from the existing system of inter-governmental transfers. The method of determining inter-governmental transfer has not promoted efficiency in expenditure management by states. On the contrary, Finance Commission transfers based on gap filling approach together with its loan forgiveness had given wrong messages to state. This could also be one of the reasons for imprudence in the management of state finances. Similarly, the Planning Commission assistance in the ratio of 30:70 between grants and loans for the major states which is invariant between different types of activities has not encouraged states to base their investment decisions on the basis of rate of returns and terms of finance.

Following the acceptance of planning for economic development, the state governments have developed a compulsion to continually enlarge the size of their respective five year plans without any reference to resources availability. This has eventually led to a number of adverse consequences (such as widening gap between resources availability and expenditure level planned) on budgetary and expenditure policies at states.

In view of this the author has suggested a few future reform measures which involve:

The state should adopt a threefold strategy for restructuring its expenditure.
(a) One, restrict the role of the government to the areas of market failures inclusive of the provision of merit goods and the activities and institutions that flourish private initiatives and investments.

(b) Two, offload the activities outside the above domain.

(c) Three, modernize the state machinery by
   i. Updating the existing rules, procedures and norms.
   ii. Restructuring organizational structure eliminating multi-lateral decision-making process and updating the skill of staff.
   iii. Introducing computerization and building MIS and
   iv. Removing staff redundancy.

(d) The traditional budgeting process lacks cost effectiveness. The author opined that if zero base budgeting, is used as a management tool, it will improve expenditure effectiveness.

(e) Expenditure programmes incorporated in the budget should define links with macro and micro objectives. This leads to prioritization as well as budget monitoring and controls, and thus leads to expenditure efficiency.

The writer concluded that it is only with such fiscal reform, will the state be better positioned to sustain higher industrial growth and meet the challenges of faster urbanization.

❖ White Paper on Road Map for Fiscal Reforms in Gujarat (2000)

The paper discussed the fiscal health of Gujarat. The finances of Gujarat government were subjected to considerable stress and strain since 1985-86. Lack of revenue buoyancy and the unprecedented expenditure commitments on accounts of natural calamities and the fifth pay commission put severe pressure on the fiscal health of the state.
With the growing revenue expenditure (18% of NSDP) as compared to revenue receipts (15.4% of NSDP) during the period 1995-2000 hampered the productive potential of the economy as there was no money left for capital expenditure.

The fundamental fact is that increase in GFD would increase market borrowing which would raise the interest obligation. The limited availability of the financial savings of the household sector to accommodate such borrowings and the competing demands for funds from the private sector throws up challenges in the pursuit of growth with stability.

The paper opines that it is high time that the necessary fiscal correction be undertaken by the government to achieve stability in state finances by injection of strict financial discipline.

The paper suggested prudent financial management, revenue management, expenditure management subsidies, debt control to curb deficit is the road map for fiscal reforms. The need to restore fiscal health of the government at all levels be recognized explicitly and to regulate borrowing programme and subsidies and improving PSU performance and disinvestment of unviable units must be addressed on a top priority basis. In view of sizable requirement of funds for integrated growth and development of social, economic and information infrastructure of the state, it is highly essential and desirable that environment conducive to liberalization of inflow of private and foreign funds in the state be created. Besides ADB, World Bank and other international financial corporations be encouraged and induced to invest in infrastructure in Gujarat.

In order to curb expenditure the paper suggested the following initiatives:

i. All on going schemes must be subjected to rigorous zero base budgetary scrutiny.

ii. Right size the government by implementing freezing of all fresh recruitments, abolishing all unfilled posts and announcing VRS for government staff.

iii. The manpower requirement of the government dept. corporations and PSUS must be reassessed through HRD experts or consultants by reviewing the norms for creation of posts and fresh recruitment.

iv. All subsidies should be reviewed with a view to bringing in cost based user charges wherever feasible.
v. Budgetary support to autonomous institutions and corporations should be reviewed and they must be encouraged to maximize generation of internal resources.

vi. In order to monitor the growth and control of expenditure some institutional mechanism like Fiscal Responsibility Act contemplated by Central government should be introduced at the state level also.

vii. Restrict role and involvement of the government in the activities of the state and activities outside the above be off loaded.

This measure will improve the debt profile of Gujarat. Similarly a ceiling on borrowing and gradual reduction in debt is fixed up at the earliest.

The paper also suggested administrative reforms for rapid industrialization and urbanization in the face of liberalization and globalization of the state economy. The administrative reforms such as modernization of state apparatus and procedures will have to be introduced so as to enable the state to forge ahead. This aspect needs central focus and close monitoring of the organizational structure of the government so that with the improvement of the governance, enhancement in the productivity and efficiency could be achieved.


In this paper, the author has suggested a medium term strategy to restore the fiscal balance that is conducive for sustainable economic growth in the state. The author opined that the recent slow down of several states in India including Gujarat during the later half of 90's has caused considerable disturbances in the state's fiscal equilibrium. The fiscal deficit has more than doubled during the last five years and the government's debt has jumped up from 17 percent of GSDP to 26 percent. The author has suggested a macro economic model specific for Gujarat with the twin objective of forecasting and policy simulations. The assumed mechanism underlying the model is as follows.

The model assumed that expenditure is responsive to increase in population (POP) representing the growth in demand for public goods and services.
• REXP = f (POP) - for all revenue expenditure.
  Where Revenue expenditure includes
  General services other than interest payments = RXGENOTH.
  Social services = RXSOC.
  Education = RXEDU
  Medical = RXMED
  Irrigation = RXIRRIGN
  Other economic services = RXECONOTH
  Grants to local bodies = GRANTSTOLB

• Interest payments are considered as endogenous as
  INTEREST = a DEBT (t-1)

• Own tax revenue and non tax revenues are assumed to move with GSDP. The tax
  functions are of the type
  Tax = f (GSDP)
  The Taxes considered are sales tax, stamp duties and registration fees, motor
  vehicles tax,
  Passengers and goods tax, electricity duty, profession tax, land revenue,
  entertainment tax, state excise and all other taxes.
  Similarly NONTAX =f (GSDP)
  The non taxes considered are interest receipts, dividends, and other non tax revenue,

• Transfers from the centre are in accordance with the Tenth Finance Commission.

• Net borrowings including public account balances are assumed to be equal to the
  fiscal deficit or the difference between total revenue and total expenditure. The stock of debt outstanding is basically an accumulation of past borrowings. However, the debt-stock function is not an identity as the stock includes the public account balances. Interest and debt- servicing expenditure moves with the accumulated debt.
  DEBT=f (DEBT (t-1), BORROW)

The model is estimated by Generalized Least Squares (GLS) procedures with necessary adjustments for possible auto-regressive error structures.
The major highlights of the findings are:

i. Results show that income buoyancy of major taxes assumed to remain the same as in the past.

ii. Own non-taxes will grow at the historical pace in relation to the base, that is GSDP.

iii. Expenditure components also moved in the same trend of the past.

The writer has suggested a formula for reform strategy alternatives. The primary strategy for reforms is to bring down the fiscal deficit to a sustainable level, say 3 percent of GSDP. For this writer opines that the additional revenue required without disturbing the expenditure pattern if the fiscal deficit is to be achieved.

The additional revenue required is worked out from the status quo model as follows. Let FB= fiscal balance, CB= current balance, CR= capital receipts other than debt and CE= capital disbursement, RR= revenue receipts and RE= revenue expenditure. Since FB= CB+ (CR-CE), the CB that results for a specified level of FB can be derived as CB= FB-(CR-CE). Further, since CB=RR-RE the required revenue receipts can be derived as RR=CB+RE.

In this scenario fiscal deficit is pegged at 3.5 percent of GSDP in each of the forecast period. The other scenario is that instead of pegging 3 percent every year, 3 percent is set to be achieved in a phased manner, over the five year period. The writer opines that this should aim at restructuring both revenue and expenditure. The revenue raising machinery needs to be strengthened by broadening the tax base and rationalizing the tax structure. Improving cost-recoveries on existing capital assets and cutting down direct subsidies will also help improve fiscal balance. On the expenditure side, the primary strategy should be to reduce the rate of growth of government employment.

The writer concluded that a stimulated fiscal scenario with a set of reform package, if implemented will set right trends in deficits and the fiscal balances may turn into surpluses.
In this paper the writer pointed the various efforts towards fiscal stabilization and reform. He suggested certain policy initiatives towards fiscal reform which can be classified into fiscal consolidation, institutional, financial and sectoral reforms. He was of the view that fiscal consolidation measures proposed in the states budget explore ways of moderation of expenditure and revenue augmentation. Institutional reform such as financial and managerial restructuring also support the fiscal consolidation process.

The writer opines that as the reforms progresses, the relative balance between the centre and states tends to tilt in favor of the state. The economic reform favours the states that they have more freedom to access resources for financing economic growth from the market both from domestic and global sources such as Asian Development Bank and the World Bank. Hence, the proportion of net official flows from centre to states as the proportion flows to states will tend to get reduced. In future the states will be competing more intensely for market resources than to the allocation of resources from the centre governments.

As a result of the financial sector reform, the limit of fiscal expansions at state level becomes more stringent. According to the writer non-bankable component such as anti-poverty programs and social services could be met by fiscal policies and bankable components of development if commercially viable could be squarely shifted by state government to financial sector.

The author concluded that there is a widespread realization about the need for fiscal stabilisation and reform. Each state has devised its own measures but most of these related to reform of public enterprises, reduction in subsidies, expenditure containment and revenue augmentation. There are, however, severe limitations in regard to the adjustment effort in view of the large magnitudes of committed expenditure viz., salaries, pensions and interest charges.
This paper examined the trends in fiscal imbalances at the state level. The writer has pointed out various reasons for the slow growth of revenue, expansion in expenditure and the central government transfer to states. The writer opines that the principal reason for declining revenue-GDP ratio is both; the tax and non tax revenue. The reasons for slow growth of tax revenue are due to inability of the states to extend the base of the tax, large-scale exemption, evasion and avoidance of taxes and lack of proper information system and administrative machinery to implement taxes. Ineffective enforcement mechanism and weak administration not only reduces the revenue productivity but also causes serious distortion and inequity. He points out that the states inability to recover reasonable returns from the large investment resulted in declining growth in non-tax revenue.

On the expenditure side, increase in interest payments, increase in volume of liabilities and average rate of interest have contributed significantly for the period 1995-2000. The impact of pay revision, increase in pension payments are other factor which lead to increase in expenditure. The writer emphasized that the most important cause of expenditure proliferation is the artificial and often, meaningless distinction made between plan and non-plan expenditure. The reason is some of the projects classified as “plan” in the revenue account are merely salary payments that are not productive. Similarly, completed plan schemes which are productive are classified as “non plan” like maintenance expenditure on roads, irrigation works and buildings.

The writer has also focused on the transfer system. The writer opines that most of the schemes proposed by the Ministry of the Finance have serious design problem. There has been proliferation of these schemes in terms of adequate, efficient and equitable distribution. The writer quotes “The problem with the scheme is that the amount of funds available for payments may not be enough to transfer the incentives. The schemes are designed to incentives only the incremental changes in revenue deficit irrespective of the size of the deficit.

The writer suggested that there is need for efficiency in sub-national fiscal policy. Efficiency is needed in terms of both minimizing distortions in tax policy and cost effective provision of public services. Most of the sub national tax policies are ad hoc in
nature responding to special interest groups rather than providing a stable and accommodating policy environment. Similarly proliferation of expenditure on salaries, pensions and interest payments and subsidies have crowded outlay on creation and maintenance of physical infrastructure.

The writer concludes that a political will and administrative competence is needed to achieve consolidation and generation of quality infrastructure and competitive environment for fiscal balance at state level.


In this Paper the author has examined the various parameter of Fiscal Performance Index to measure the fiscal performance of states. The writer opines that the fiscal crisis which started around 1985-86 aggravated further during the post reform period. On account of the severity of fiscal problems in the states it is argued that the fiscal self reliance and improvement index(FSRII) adopted by Tenth and Eleventh Finance Commission are based on single fiscal performance indicator which is narrowly based, unstable and biased against the better fiscal performer state.

According to her major limitations of FSRII index is:

i. This index considers only the ratio of the revenue receipts to revenue expenditure. It ignores other dimensions such as quality of fiscal deficit, composition and sources of expenditure, states’ efforts for repayment of debt and so on.

ii. The indicator value is based on between two periods of time. The distribution of funds on the basis of this change in value is biased and unfair towards the better performing states. Even for the policy purposes consideration of change in values does not give a clear idea about the seriousness of fiscal problems of the states.

iii. The probability of a measurement error in FSRII increases due to the possibility of manipulation in a single required ratio.
Thus, it is not an effective instrument to encourage the states to become fully efficient.

The writer considered eight fiscal parameters reflecting various aspects of fiscal performance and combined them into three major component indices viz., Deficit Index, Revenue Effort Index and Expenditure and Debt payment index. Which are combined to form a proposed fiscal performance index known as FPI.

Deficit Index: Deficit Index comprises of three indices.

i. Gross Fiscal Deficit as proportion of total expenditure (GFD/TEX)- which indicate what part of state spending is met out of borrowing, leading to an increase in its total debt. Thus it measures the degree of dependence on external sources that are used by a state over and above its own revenue and the fiscal transfer from the centre. The second aspect which the writer has taken into consideration is the quality fiscal deficit. i.e. fiscal deficit which is created for meeting the current requirement or is an outcome of major capital projects. If the fiscal deficit is created for capital projects than it can be justified. As capital projects generate a stream of income for several years. If not it needs to reduced urgently.

ii. Own Revenue Effort Index (OREI):- This index indicates the quality of fiscal resource generation by a given state. It includes own tax collection and own non-tax collection as a proportion of revenue expenditure.

These two index together measure the revenue raising efforts of a state in relation to its revenue expenditure and thereby indicate the so called degree of fiscal discipline as defined by the EFC and TFC.

iii. Expenditure and Debt Servicing Index (EDRI):- This index indicate Non-development revenue expenditure as a proportion of revenue receipts, Interest payment as a proportion of revenue expenditure, debt repayment and as a proportion of central fiscal transfers by a state. All these three ratios are horizontally combined to form FPI. i.e. an increase in the value of an indicator index would necessarily mean improvement in the fiscal performance and vice
versa. This method defines absolute performance targets which will enable the states to judge what steps they need to take and with what urgency.

Such absolute performance targets were missing in the calculation of FSRII used by EFC and TFC. The writer highlighted that the successive Finance Commission of India has not been in a position to provide adequate incentives to the states to become fiscally efficient. The criterion of fiscal discipline was explicitly added in the devolution formula of the Eleventh Finance Commission and later suggested in the Tenth Finance Commission formula for measuring fiscal discipline is totally unjustified against the better performing states. Both the Commission recommended FSRII suffers from serious limitations. This will affect the allocation and distribution of resources and thereby, on the growth, development and welfare of the state economies.

❖ Kishor A. Prasad (2007); “Indian Sub National Finances: Recent Performance”

The author has assessed the performance of fiscal responsibility legislations (FRLs) on fiscal performance against the targets set by the TFC. The writer opined that there has been improvement in the finances of states due to fiscal consolidation. States have created fiscal space through raising revenues and reducing and reprioritizing expenditures. The expansion of fiscal space is essential to meet the states’ large infrastructure and social needs in order to alleviate bottlenecks to growth. This needs to be accomplished without undermining fiscal sustainability. The introduction of Fiscal Reforms Facility (FRF) in 2000-01 following the recommendations of Eleventh Finance Commission forced the state to accept the imperatives of reforms and it provided a robust and credible framework for further fiscal consolidation in states.

According to the writer fiscal rules such as deficit rules, expenditure rules, revenue rules, and debt rules are generally transparent and relatively easy to monitor and hence they confer predictability and credibility on fiscal policy. However they become ineffective if not backed by political commitment and clear rules of enforceability. In India most of the states follow strict fiscal correction but the six years from 1997-2003 has been described as the worst in the history of India’s sub-national finances. The adjustment efforts of states, especially after the FRF, were negated by the adverse impact of the cyclical slowdown of the economy. This period witnessed falls in the central transfers to state and
decline in the own tax revenue to GDP ratio. Similarly the debt-GDP ratio also increased to 31 percent due to increases in salary bill and an increase in interest payments.

The writer opines that the TFC’s framework provides three channels through which states could improve their fiscal circumstances.

i. Restructuring plan
ii. Macro Assumptions
iii. Fiscal Consolidation.

States would benefit from a higher revenue share and higher grants, debt restructuring and debt relief. States would also confront a stricter borrowing regime with centre setting global ceilings on borrowings and henceforth only lending to fiscally weak states. The TFC had developed state Fiscal Adjustment Scenarios based on a set of macro assumptions (inflation, saving rate, Investment rate, Current account/GDP ratio). It assumed that the gross fiscal deficit would be reduced to 6 percent of GDP on the combined account and that the revenue deficit would be reduced to zero, which would enable an increase in the aggregate saving rate as well as in the government capital expenditure as a percentage of GDP. Consequently, the TFC assumed that as the aggregate investment rate increases, growth would stabilize at above 7 percent and nominal interest rates would remain at prevailing levels, which would imply a continuing fall in the average interest rates for the centre and the states. Since fiscal deficits were reduced and inflation was kept under control, there would be no pressure for interest rates to rise.

Table II-1 Macro Assumptions: Twelfth Finance Commission (percent)

<table>
<thead>
<tr>
<th>Assumptions of 2004-05</th>
<th>TFC 2009-10</th>
<th>Actual 2006-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth rate (percent)</td>
<td>6.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Inflation</td>
<td>6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Saving rate</td>
<td>24</td>
<td>26</td>
</tr>
<tr>
<td>Investment rate</td>
<td>24.5</td>
<td>27.5</td>
</tr>
<tr>
<td>Current Account/ GDP ratio</td>
<td>0.5</td>
<td>-1.5</td>
</tr>
</tbody>
</table>
Since the beginning of the TFC period, fiscal policy in states has been geared toward fiscal consolidation and reducing the high public debt ratio. The writer opines that the improvement in the states finances is evident from the reduction in alternate measures of deficit as well as liquidity management. The overall fiscal correction by states is reflected in the declining deficit indicators, revenue, fiscal and primary. The consolidation in revenue account recorded as 16 states shows surpluses in revenue account in the year 2005-06. According to the writer the initial tax collections through VAT has been encouraging recording 13 percent and 23 percent growth rates respectively during 2005-06 and 2006-07. Continuation of these trends points towards the achievement of the overall revenue receipts target set by TFC, but the prospects for increasing own revenues remain uncertain. Further tax administration reform and institution of good information system could enhance the buoyancy of revenues from states taxes.

It is critical that states are able to sustain the marked correction achieved so far in key fiscal indicators. The speed with which fiscal responsibility legislations have been formulated and enacted reflects some eagerness by states to avail themselves of the debt relief recommended by the TFC, since the adjustment seen in the revenue account predominantly reflects central transfers and grants and lower interest payments and not states’ own revenue raising efforts. However, by passing FRLs states have benefited from a number of externalities resulting from other causes relating to fiscal transparency, liabilities, guarantees and medium-term fiscal plans.

The writer concluded in future, expansion of fiscal trade is essential to meet the states’ large infrastructure and social needs in order to alleviate bottlenecks to growth. This would require difficult political decisions.


In this Paper the author suggested the dimensions or criteria of fiscal correction at state level, sources of correction and state strength for measuring fiscal correction. The writer opines that the fiscal deficit of the states have declined from 4.7 percent (1999-2000) of gross domestic product to 3.2 percent (2005-06). However, some high and middle income
states lag behind, continuing to accumulate unsustainably high levels of debts and guarantees. Even after enacting fiscal responsibility legislation Punjab, Maharashtra and Gujarat lagged behind in fiscal correction.

The writers argued that decline in primary fiscal deficit of the states is due to increase in central transfer and states’ own correction. The states’ own effort is due to increase in own revenue and contraction in non-interest expenditure. While some of the states have relied mainly on enhancing own tax revenue to reduce deficits rather than contracting expenditure.

The writer has suggested three criteria for measuring fiscal correction. First, is the principle of “golden rule”. The golden rule plays a central role in the form of the revenue deficit. The writer opined that borrowing must only be undertaken for financing capital investment, i.e. for the creation of productive assets. Second, there is the requirement of debt sustainability –ensuring that the burden of servicing debt and guarantees do not pre-empt too high a share of the states’ revenues—which requires reducing and containing the primary(non-interest) fiscal deficit, and controlling deficits. Third, there is the performance of the state in enhancing its own revenue, which is being used as a proxy for the quality of fiscal adjustment.

The writer opines that fiscal discipline can also enhance output and outcomes of public spending, if the state leadership can use overall financial constraints as a factor to strengthen on what gets delivered on ground rather than merely on how much is spent.

Writers suggested that a lesson can be learned from the experience following Twelfth Finance Commission award that the poorest and most indebted states can meet targets of overall deficit as 3 percent GSDP if there is strong political commitment to fiscal discipline.
In this paper the author opined that in general state finance has shown a marked improvement recently (both fiscal and revenue deficit declined during 2007-08 as compared to 2003 from 8.4% to 5.5% and 5.9% to 1.3%) but the situation in some of the states still remains grim. According to them the improvement in deficit has been brought down by compressing developmental expenditure. Thus, fiscal adjustment has been adjusted at the cost of economic growth and macroeconomic stabilization.

In addition to it, fiscal liability has created significant fiscal risk both at the centre and at the state, which include pay revision, increase in food subsidy in the wake of sharp increase in the prices of food grains, expenditure associated with electoral cycle and increase in capital inflows and its sterilization by the Reserve Bank.

Concern has also been expressed on the wording used in the TORs (Terms of References) of the Commission, which raise two important issues i.e. macroeconomic stability and sustainability while recommending transfers. Writers argued that the Commission has to take a holistic view of the requirements in social services without making a distinction between plan and non-plan or revenue and capital sides. Second, it will avoid the perverse incentives from the gap filling approach. Third, it is possible to design the grants to ensure that the states do not substitute their own expenditure on these services. Fourth, this will facilitate human development in poorer state by improving the standards in public services in them and contribute to increases in productivity.

The paper also highlighted the issues of fiscal consolidation. Writers pointed that legislated fiscal discipline has contributed to fiscal consolidation at state level. The aggregate fiscal deficit of the states relative to GDP declined from 4.2 percent in 2001-02 to 2.3 percent in 2007-08 and aggregate revenue deficit declined from 2.6 percent to a surplus of 0.5 percent of GDP during the period. Reduction in deficit is also linked with writing off of the debt repayment by the central government which has provided the direction to states where the adjustment should take place. Similarly debt restructuring as per the recommendation of the Twelfth Finance Commission, lower volume of borrowings from the National Small Savings Fund and lower interest rate arising from the...
Debt swap scheme contributed some (one percentage point) improvement on the expenditure side.

Another thing which was pointed out in this paper is that the general category states performed better than special category states in reducing fiscal deficit but reverse was the case in revenue deficit. Among the former, the low income states performed better in revenue deficit reduction, but the performance of high income categories of states was better in reducing fiscal deficits. Both high income and low income categories of states brought down fiscal deficits by more than two percentage points, but the latter category states increased their capital outlay by a larger magnitude (3.3 points) than the former (1.5 points).

The writers pointed some possible suggestions need is to be implemented by the Finance Commission and by the States

i. Design of the transfer system should be based on equitable principle and compatible incentives. This would help to improve fiscal discipline at the margin and should at least ensure that the states have the resources to equalize basic services.

ii. Commission could adopt while making assessment tax revenue-GSDP and expenditure at average per capita. Similarly estimation of expenditure can be made besides population which can include the demographic composition of population, its density and various environmental factors.

iii. Another feasible approach the Commission could adopt is to continue with the tax devolution as in the past and equalize social services such as basic education and healthcare completely.

The writer opines that the approach outlined above has the opportunity to assess the requirements of the states in a holistic manner without making any distinction on plan and non-plan sides and change the structure of incentives and accountability as an inherent part of the transfer system. Secondly rather than continuing with the “gap-filling” approach, the Commission can fully equalize expenditures on basic healthcare and
education. This will help to assess the requirement of the poorer states where presence of private sector is negligible.

Since various speeches were delivered by Deputy Governor of RBI, we briefly outline the speeches and their initiative for state finance as they form the part of review of literature on state finance.

2.4 Other Substantive Studies on State Finances

I. There are other substantive studies on state finances like the paper by Lahiri K (2000), who argued that federal fiscal relations constitute a vital component in fiscal arrangement between centre and states. He preferred a leadership role for the centre in fiscal consolidation.

II. Paper by Rao (2006), on ‘Taxing services: issues and strategy’ presented at NIPFP/IMF conference on fiscal policy in India throw light on issues in taxation with a view to improve revenue productivity of the tax system, ensure a measure of neutrality in taxation at central and state levels. The writer argued that the development of service tax should be in the context of evolving the dual VAT. The manufacturing VAT at the central level and destination based consumption type retail stage VAT at the state level. The system of service taxes that should be developed in the context is general rather than selective. The preference for general taxation over selectivity is mainly to relieve all taxes on inputs and for administrative reasons. Selective taxation of services requires that each of the services should be clearly defined. The preference for general approach also implies that the state should be empowered to levy tax on services concurrently with the central government.

III. The paper by Easterly (2004), the widening gyre: The dynamics of rising public debt and falling growth throw light on the theoretical and empirical basis for the idea of a vicious circle (a “widening gyre”) of rising public debt, rising public deficit, falling ratio of private to total credit and falling growth. He suggested that fiscal adjustment to close the inter-temporal fiscal gap could reverse the spiral. Setting up a vicious circle in which the above variables move in the opposite
direction. The paper discussed the real world experiences with debt crisis and found that low or falling growth often played an important role. The paper examined the evidence that fiscal policy variables affect growth and found suggestive evidence in line with the variables affected by fiscal policy like budget deficits inflation and the share of private in total credit do affect growth.

IV. The Economic and Political Weekly Research Foundation (2001), ‘Finances of State Governments in India’ has done study on trends in state finances in the 1990s. They brought out how (a) trends in revenue receipts suffered a setback because of reductions in the share of central taxes as well as grants from the centre as percentage of GDP, while states’ own tax efforts were sustained if not improved.(b) the erosion in the development momentum was reflected in the declining share of states’ development expenditure in their total expenditure (c) the sliding down of development expenditure was more in infrastructure and other economic services whereas the share of social services generally remained unchanged.(d) different indicators of fiscal performance showed deterioration in all states without exception, though there were still significant inter-state disparities. This article also discusses the various initiatives taken by the states, the centre and the RBI to reform the totality of state finances.

V. Dholakia, R (2005) article on, ‘Measurement Issues in Comparing Fiscal Performance of States’ suggested some proper concepts and their uniform measurement for comparing fiscal performances of different states by giving illustrative estimates for the Gujarat. The writer opine that use of inappropriate concepts of income and public debt at the state level can and actually have resulted into misleading target setting and wrong perceptions about fiscal performance of states. These ratings about the economic performance of the states’ economies have been recognized by the responsible agencies like finance ministry, Planning Commission, Asian Development Bank etc. for giving grants. It is the responsibility of the Central Statistical Organization, RBI, the Twelfth Finance Commission and the rating agencies to ensure the right concepts for inter-state comparisons.
VI. The book edited by Rao G (2002) on Development, Poverty, and Fiscal Policy throws important light on finances of States. The volume includes selected papers presented at the seminar ‘Monetary and Fiscal Policy, Poverty and Public Policy’ held at the institute for social and economic change at Bangalore. The book has two articles which highlight the role of fiscal federalism and importance of decentralized governance.

a) The article by Bird R (2000), ‘Intergovernmental fiscal relations: Universal Principles, local Applications’ argued that if decentralization is to work properly those charged with providing local infrastructure and services must be accountable both to those who pay for such services and to those who benefit from them. Three conditions needs to be satisfied to achieve accountability at sub-national level.

i. Sub-national government should, whenever possible, charge for the services they provide.

ii. Where charging is impracticable, sub-national governments should finance such services from taxes borne by local residents, except to the extent that the central government is, for whatever reason, willing to pay for them through transfers.

iii. Where the central government does pay, as a rule sub-national government should be accountable to the central government.

He pointed out that experience in developed federal countries suggest that transparency is needed for good fiscal management and good fiscal management is needed for successful decentralized structure. An agency performing at least some of the functions may play a vital role in this process.

b) Bagchi A (1997) article on, ‘Rethinking Federalism’ throw light on cooperative federalism. He pointed out the evolution of federalism in the US from dualism (national and sub-national units) to ‘cooperative federalism’. He argued that when the centre takes too many functions at there disposal, checks and balances get weakened. For a federal constitution need to be stable, the checks and balances must be strengthened in every possible way and the spirit of cooperative federalism must be accommodated in the constitution. The idea of cooperative federalism is the notion
that cooperation is negotiated. If there is no negotiation then cooperation becomes either coercive or antagonistic. The key to cooperative federalism thus lies in negotiation and bargaining.

To reconcile the imperatives of negotiations and interaction with the objectives of economic federalism constitute the core of the federal challenge. The writer suggests that to activate such fora for interaction in Indian context, the revival of inter-state council and a more active role of the national development council are to be welcomed.

Thinking of federalism must take account of the changing context and explore how best the objectives sought to be achieved without compromising the independence and right to self determination of nation states.


Various speeches were delivered by Deputy Governor of RBI, we briefly outline the speeches and their initiative for state finance as they form the part of review of literature on state finance.

2.5 Role of RBI and State Initiatives

Reserve Bank of India (RBI) is known as Banker, Debt-manager and Adviser to the State Governments. As banker, the RBI has been assisting States in improved cash management to maximize returns on deployment of temporary surpluses. Cash management techniques relate to updating of accounts, data analysis, technology improvements, updating of financial accounting etc. which has helped the state to understand the importance of cash management as a medium term objective as there is a limited scope for cash management on the expenditure side. This information also assists the state government to find out the seasonality in the expenditure and their borrowing requirements.
An analysis of state finances revealed increasing pressure and problems of liquidity management, RBI began to pay close attention to needs of state finances by monitoring Ways and Means Advances and overdrafts facilities. The Ways and Means Arrangement was reviewed and a new system was introduced in 1998. The major recommendation of this scheme that all the State Finance Secretaries wanted that the RBI to continue to manage the investment of their surpluses, but change the mechanism in such a way that they get a return close to what they pay for their withdrawals from the RBI, as WMA.

The Reserve Bank of India has been extending Ways and Means to state governments since 1937 with the objective of covering temporary mismatches in the cash flows of their receipts and payments. Till the late 1990's, the Normal and Special WMA limits of state governments were fixed in terms of specified multiples of their minimum balances kept with the RBI. Both the minimum balances and the “multiples” to obtain the normal WMA limits, were revised upwards a number of times over the years. Based on the recommendations of the Report of Finance Secretaries the scheme of Ways and Means Advances revised in 2001. On the basis of this report the normal WMA limits 2.4 percent ratio for non-special category states and 2.9 percent ratio for special category states worked out for three consecutive three years taken as base. A state is allowed to run an overdraft for 12 consecutive working days instead of 10 days earlier. It is noteworthy that WMA arrangements have ceased to be contentious matter amongst the centre, states and RBI(as WMA is only meant for temporary mismatch in the cash flows and hence, any upward revision in the WMA limits to meet structural deficits of the state is inappropriate).

Secondly the overdraft shall not exceed 100 percent of normal WMA limits. If overdraft exceeds 100 percent of normal WMA limits in a financial year, The RBI will on the first occasion advice the state governments and afterwards on subsequent occasions, the state shall be given 5 working days instead of the notice period of 3 working days earlier to bring down the overdraft amount within the level of 100 percent limit. If the state does not adhere to it, payments will be stopped.

As debt manager, the RBI had devised a scheme for Consolidated Sinking Fund (CSF). Flexibility has been provided to state governments since 1998-99 to directly access the market for borrowings between 5 to 35 percent of their Gross borrowing programme. The
CSF was set in 1999-2000. So far eleven states have established CSF with the view as mounting debt will increase the burden on future generations. While others felt that it would not be desirable to consider this at a stage when revenue deficits persists and the scope for return on investments made in CSF is not very clear. The Twelfth Finance Commission had recommended the CSF may cover repayments in respect of all loans of the state governments.

As adviser on a variety of issues, the RBI has been active in matters impinging on fiscal matters relevant to states. It participated in formulating a scheme, helped on the various technical issues related to legislation and represented as advisory panel in various fiscal and monetary policies.

The Reserve Bank of India publishes Reports on State finances, which has been the only source of regular information and analysis of State finances on a consolidated and annual basis. It has also convened seven conferences of State Finance Secretaries.

With the assistance of RBI many states have adopted economic and functional classification of budgets. A Core Group on Disclosure Norms for States Budgets helped to improve the design and coverage of budget related documents in several states.

Considering the prospects of the burden on the future generation on account of the rising public debt, contingent and other liabilities, and with a view to increasing the awareness of this issues RBI developed a model which depicts inter-generational equity considerations in managing public finance.

The RBI has also encouraged the state to access the market for a part of their borrowings. Under new scheme (2003), the state governments can borrow from the market 5 percent to 35 percent of the approved borrowing limit. Within the approved borrowed programme the state governments are provided with the option of raising resources in a flexible manner in terms of method, timing and maturities. The introduction of flexibility in market borrowings helps the better managed states gain through lower yields as compared to the combined borrowing programme and thus put in place incentives for sound fiscal management.
There are many important areas, where there has been close coordination between the RBI and the states. Thus, the role of RBI in states finances, impact the fiscal reform at state level.

It can be concluded that the empirical literature has focused on different issues of State fiscal health over a period of time. Some studies have analyzed the current trend in fiscal issues while some have made suggestions pertaining to the future fiscal reform.
References


