VII Issues and Perspectives

Improvement in the fiscal situation witnessed in recent years has been achieved by pursuing the fiscal correction and consolidation process under a rule based fiscal framework aided by the fiscal restructuring path suggested by the TFC. The knock-on effect of the global financial crisis and the consequent slowdown in economic activity has impacted the finances of States. Incipient signs of slippage are evident currently in State finances on revenue and expenditure, thus halting the process of fiscal consolidation. Once the economy begins to recover there is a need to resume the process of fiscal correction and consolidation through revenue augmentation and expenditure rationalisation measures and through strengthening the rule based framework. State governments have to address many challenges such as improving the level of fiscal transparency, managing a large amount of surplus cash balances, providing fiscal stimulus programmes and implementing the Sixth Pay Commission awards.

1. Introduction

7.1 The fiscal correction and consolidation witnessed in State finances in the recent past is under pressure due to the economic slowdown. This Chapter highlights issues and challenges that State governments confront in enhancing resource mobilisation both on tax front and non-tax fronts, improving the quality of expenditure, implementing the Sixth CPC/SPCs, managing large amounts of surplus cash balances, improving fiscal transparency, strengthening fiscal rules and providing fiscal stimulus programmes. In view of the slippage in the finances of the State governments in 2009-10 on account of the re-appearance of revenue deficit and rising GFD, rising share of committed but non-developmental expenditure, declining share of social sector expenditure and low and declining non-tax revenues, State governments may need to strengthen efforts for improving revenue collection from tax and non-tax resources and rationalising their expenditures.

2. Revenue Augmentation

7.2 Moderation in economic activity due to the global slowdown is having an adverse impact on the overall tax revenue of the States— both on their own tax revenue as also devolution from the Centre to States in terms of sharable taxes and grants from the Centre. In the recent past, the buoyancy of revenues coupled with higher Central transfers helped the States to generate revenue surplus. The slowdown in the economy may result in lower revenue mobilisation for the States from VAT, stamp duty and other taxes. Incipient signs are visible in terms of a decline in States' own tax revenue during 2008-09 (RE) over budget estimates (BE). The State governments, therefore, need to reinvigorate their efforts to expand the scope and size of revenue flows into the budget so as to ensure adequate funds for development activities.

7.3 The decline in the States' own tax revenues is a matter of concern. The States may need to consider expediting measures on revenue augmentation through improvements on the tax front , *viz.*, including checking under-valuation of property to improve collections under stamp duty and registration fees and phasing out exemptions under sales tax. On the non-tax front, the States' own non-tax revenue at around 10 per cent of the total revenue receipts appears to be low by international standards. The States may, therefore, make efforts to increase their reliance on non-tax revenues by levying appropriate user charges such as time bound revision of water supply tariffs, introduction of user charges in health, education and veterinary services and cost recovery from social and economic services. In the Union Budget 2009-10, the goods and services tax (GST) has been proposed to be implemented from April 1, 2010. Implementation of GST would be a significant step towards tax reforms. The implementation of GST is however, likely to be postponed to a future date. The States may also rein in tax expenditure which is revenue foregone because of preferential provisions of the tax structure, including exemptions, deductions, credits, deferrals and reduced tax rates to arrest the fall in tax receipts. State governments may consider strengthening their tax administrations through measures such as computerisation of commercial taxes, online registration and e-filing of returns and computerisation of land records. These measures may help the States to augment their revenue bases in the medium and long run.

3. Quality of Expenditure

7.4 The expenditure pattern of the State governments suffers from inherent structural rigidities from components such as subsidies, salaries and wages and interest payments. As the States have an important role in the development of social and economic infrastructure, expenditure compressions should focus on non-essential expenditure. Getting the right size and the right composition of government expenditure to facilitate achieving the highest attainable growth rates, meeting the government's obligations including provision of health and education should be considered integral in re-sizing the public expenditure of the States. Many countries have embarked on a massive effort of 'government reengineering' to better target dwindling budgetary resources towards higher priority uses. This relates to both size and sectoral allocations aimed at removing inefficiencies arising from misallocation, design and implementation of schemes and delivery of services. This process seeks to deepen reforms and strengthen capacity for an effective and efficient delivery of basic public services. In view of the importance of this aspect, the Thirteenth Finance Commission (ThFC) has for the first time been mandated to consider 'the need to improve the quality of public expenditure to obtain better outputs and outcomes'. A reorientation of expenditure towards productive purposes may necessitate adherence to the principles of public expenditure management. In this context, international experience indicates a wide variety of techniques including placing of limits on certain expenditures, prioritisation of expenditures, greater decentralisation of executive functions, improved cash management and greater accountability in the delivery of services against specified targets. The adoption of some of these principles could facilitate the management of expenditure guided by economy, efficiency and effectiveness.

4. Strengthening of the Rule Based Framework

7.5 The State governments' fiscal policies in recent years have been guided by a rule based framework. With twenty-six States operating under a rule based framework, the fiscal correction and consolidation process was smooth until 2007-08. However, with the knock-on effect of the global financial crisis there was a pause in the States' fiscal reform process during 2008-09 and 2009-10. In this context, the States may consider strengthening their rule based policy framework. In strengthening the fiscal rule framework, the States need to keep in view that a policy rule faces important trade-offs between targets and varies widely, reflecting State specific circumstances and policy priorities. To minimise the credibility-flexibility trade-off, in practice combinations of targets are often used, but it is important to keep the rule operationally simple and transparent. Based on their experiences of FRLs, the States may consider strengthening the rule based formula by incorporating the following elements:

- A counter-cyclical fiscal policy framework which *inter alia* may include setting up of a fiscal stabilisation fund;
- A target for debt-GSDP and interest payments-revenue receipts with a view to attaining debt sustainability. In addition, a rule may be prescribed for primary revenue balance (PRB), *i.e.,* PRB should be in surplus and adequate enough to meet the interest payments of the States;

- Numerical targets with respect to certain categories of expenditure such as non-interest revenue expenditure with sub-targets for revenue expenditure on social services and on economic services;
- Institutional reforms such as common budgetary practices, transparency rules, accounting system, public expenditure management and outcome budgeting; and
- Independent audit mechanisms and transparent oversight and monitoring.

5. Fiscal Transparency

7.6 Fiscal transparency implies being open to public regarding the structure and functions of the government. Fiscal policy transparency has been emphasized as an important pre-requisite of good governance. As discussed in Box IV.1, there are vast discrepancies across States in terms of preparation of budgets, classification of certain revenue/expenditure heads and reporting of various important indicators. Such lack of uniformity and inadequacy in transparency makes a analysis of State finances tenuous. Some of the issues with regard to transparency of fiscal data at the State level were also highlighted by the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan) in March 2009. Despite the fact that most of the States have introduced FRLs, vast gaps still exist in terms of disclosure of adequate information. Therefore, States lacking disclosures and transparency standards need to gradually improve keeping in view the best benchmarks set forth by some other States. For efficacy of fiscal policy analysis, it is essential that data on State finances are disclosed in a comparable fashion across the States.

6. Surplus Cash Balances

7.7 The build-up of large cash balances at the State level in recent years raises issues regarding cash management by State governments. The build-up in surplus cash balances has implications for: i) revenue balances of the States; (ii) Centre's cash management; and (iii) open market operations of the Reserve Bank. The States have to invest the surplus cash balance in ITBs or ATBs of the Government of India. Since the States earn a lower rate of return on these investments, instead of over-borrowing, the States may consider using surplus cash balances to finance their GFD. Alternatively, the cash surplus may be used for repaying old high cost debt. Further, the States may make efforts towards building up capacity for better cash management. It is suggested that apart from greater coordination among the government entities required for making realistic assessments of their cash needs, the States may also attempt to avoid a build-up of cash surplus by adopting advanced forecasting and monitoring mechanisms keeping in view the best practices across advanced economies.

7. Impact of Slowdown on State Finances and Fiscal Stimulus Programmes

7.8 The consolidated fiscal position of the State governments witnessed significant improvement in the recent years reflecting the higher share in Central transfers as a follow-up of the recommendations of the TwFC, States' own efforts at revenue augmentation, rationalisation of revenue expenditure and the cyclical upturn in the global economy that had a ripple effect on State finances. The States recorded a revenue surplus of 0.6 per cent in 2006-07 for the first time since 1986-87. For 2008-09 (BE), 25 States had estimated revenue surplus and 17 States budgeted GFD at less than 3.0 per cent of GSDP. However, major fiscal indicators witnessed deterioration during 2008-09 (RE) with 24 States reporting revenue surplus and nine States recording GFD at less than 3.0 per cent of GSDP. The pace of fiscal correction and consolidation which suffered a setback in 2008-09 (RE) is likely to continue with further slippage in fiscal indicators in 2009-10. As per the State budgets, the impact of the slowdown on major deficit indicators is estimated to be more pronounced in 2009-10(BE). Out of 28 States, ten States are likely to turn from revenue surplus to revenue deficit States during 2009-10 (BE), while 22 States have budgeted a GFD-GSDP ratio of above 3.0 per cent. Deterioration in the GFD-GSDP ratio appears to be largely due to deterioration in the revenue accounts of States attributed to sluggishness on the revenue side as well as a significant rise in the budgeted revenue expenditure, particularly on account of committed expenditure.

7.9 Keeping in view the need for spurring aggregate demand in the economy, the Central Government allowed the States to raise additional market borrowings of 0.5 per cent of Gross State Domestic Product (GSDP), thus increasing the limit of GFD to 4.0 per cent of GSDP during 2009-10 (3.5 per cent of GSDP during 2008-09). The prevailing global crisis has shifted the focus of fiscal policy to providing growth stimulus at the State level too. Information regarding proposals for fiscal stimulus at the State government level is sparse. From the limited information that is available from budget documents for 2009-10 and gathered from the Finance Departments of State governments, it can be concluded that only a few States have decided to undertake dedicated fiscal stimulus packages. However, some States have announced various pro-poor schemes and proposed many sops for trade and industry, particularly relating to small traders, SSI units, lowering of taxes such as stamp duty, luxury tax, profession tax, entertainment tax and enhanced expenditure towards irrigation, PWD, education, local government and health and social welfare stimulus packages relating to subsidised rice for the BPL population and bank loans at subsidised rates for Self-Help Groups and beneficiaries of self-employment schemes, special state housing schemes for the BPL population and for low income groups in rural and urban areas. Some States, *viz*., Tamil Nadu, Rajasthan, Uttarakhand and Jammu and Kashmir which have not announced dedicated fiscal stimulus packages but have budgeted a significantly higher capital expenditure in 2009-10 as compared with that in 2008-09 (RE). However, the States' fiscal position in the coming period would largely hinge upon: (i) how fast the economy recovers with implications for recovery in tax collections by the States as well as the Centre; and (ii) how effectively the additional fiscal space is utilised. As soon as the Indian economy begins to recover, the State governments will need to re-affirm their commitment to fiscal responsibility and revert back to the path of fiscal consolidation.

8. Implementation of Sixth Central Pay Commission (CPC)/State's Own Pay Commissions (SPCs)

7.10 The recommendations of the Sixth CPC have been implemented by the Central Government. A number of States have announced the implementation of the recommendations of the Sixth CPC/SPCs in 2008-09 and 2009-10. The full impact of the Sixth CPC/SPCs on States' finances would, however, be reflected during 2009-10. It may be mentioned here that the impact of the Fifth CPC award on State governments in terms of increase in salary related expenditure worked out to around 1.2 per cent of GDP. Despite a partial implementation of the Sixth CPC/SPCs, the States recorded consolidated revenue surplus during 2008-09 (RE) and it is widely perceived that the States are in a better position to absorb the impact of the implementation of the Sixth CPC/SPCs awards. However, it is difficult to gauge the precise impact of the Sixth CPC/SPCs award as implementation has not been uniform across States. Provisioning for pay has created an additional burden for the States, thus limiting the available space for developmental expenditure. The impact of the implementation of the Sixth CPC/SPCs on State finances may be more visible in the first two years (*i.e.*, 2008-09 and 2009-10). In this regard, given the slippage in State finances in 2009-10, the States may focus on better expenditure management by compressing wasteful expenditure wherever possible.

Conclusion

7.11 An analysis of the fiscal position of the State governments indicates deterioration in key deficit indicators in 2008-09 (RE) *vis-à-vis* the budget estimates. This setback has been due to a combination of factors such as the recent economic slowdown with its corresponding decline in revenue and in turn an increase in expenditure on account of stimulus measures undertaken by many States. Incentives provided by the TwFC and budgetary rules have played a positive role in creating fiscal space for the States to embark on stimulus packages. As a part of counter-cyclical measures to minimise the impact of the global financial crisis and economic slowdown, the Central government allowed the States to increase the limit of fiscal deficit to 3.5 per cent of their respective GSDP during 2008-09 and further to 4.0 per cent of their GSDP in 2009-10. This additional fiscal space needs to be utilised for making capital investment.

7.12 An improvement in the quality of expenditure is vital for sustaining fiscal reforms. A reorientation of expenditure towards productive purposes may necessitate adherence to the principles of public expenditure management. Closely related to expenditure management is the issue of monitoring and evaluation of government programmes. A fiscal strategy based on revenue maximisation would also provide the necessary flexibility to shift the pattern of expenditure towards developmental purposes. To augment the States' resources, State governments need to reinvigorate the efforts to expand the scope and size of revenue flows into the budget through improvement in tax administration and the rationalisation of user charges.

7.13 The foremost concern before the State governments is to bring State finances back on the path of fiscal correction, although this would hinge upon the speed of recovery in the Indian economy. State governments may strengthen the rule based framework by introducing counter-cyclical provisions, debt norms and mechanisms for independent oversight and monitoring.

7.14 The recent turmoil in the financial markets has brought to the fore the importance of enhanced transparency and disclosure of information. At the State government level, fiscal transparency is very crucial on account of the States' increased reliance on market borrowings for financing their GFD. Even though the level of fiscal transparency in State budgets has increased in recent years, particularly during the post-FRL period, there are still a range of transparency issues that need to be addressed which *inter alia* include data on financing of GFD with detailed break-ups, outstanding liabilities as also details of off-budget borrowings, discharge of internal debt, wages and salaries, operation and maintenance, subsidies and uniformity in the nature and contents of various budget documents.

7.15 In recent years, the build-up of large surplus cash balances at the State level raises issues regarding efforts towards building up capacity for better cash management by adopting advanced forecasting and monitoring mechanisms by the State governments. Effective cash management and better synchronisation of cash inflows and outflows would enable the States to minimise their surplus cash balances. A Possible option could be the usage of surplus cash balances for financing GFD or repaying old high cost debt. On the whole, the slippage in State finances observed of late needs to be arrested quickly through a swift designing of a fiscal correction path.