State Finances

T. Ravi Kumar

Department of Economics

Kirori Mal College

Objectives

- The impact of the Fiscal Reform Programme on the finances of the states.
- Changes in the composition of expenditure on crucial social and economic sectors engendered by the FRP.

Fiscal Indicators

1. **OTR/REX: Own tax revenues collected as a proportion of expenditure on the revenue account.**
2. **ONTR/REX: Own non-tax revenues as a proportion of expenditure on the revenue account.**
3. **NMB/CO: Net market borrowings as a proportion of outlays on the capital account.**

These three indicators are used for the **Quality of Revenue Index**

Fiscal Indicators (Continued)

1. **NDERAC/RR**: The proportion of revenue receipts that goes to finance non-developmental expenditure on the revenue account
2. **IP/REX**: Interest payments - which are committed expenditures - as a proportion of revenue expenditures.

These two indicators are used for the **Quality of Expenditure Index**

Fiscal Indicators (Continued)

1. **GFD/TEX**: Gross fiscal deficit as a proportion of total expenditure, which measures the amount borrowed over and above own resources (plus central transfers) to finance expenditure, and is an indicator of dependence on external resources and addition to aggregate debt.
2. **RD/FD**: Revenue deficit as a proportion to fiscal deficit, which measures the quality of the fiscal deficit, that is, whether borrowing is undertaken for meeting current expenditures or for financing capital formation – the latter being more sustainable.

These two indicators are used for the **Deficit Index**

Fiscal Indicators (Continued)

1. **DRIPC/CFT**: The proportion of central fiscal transfers (net of tax shares) that are returned to the centre by the way of debt repayment and interest payments, and hence are not available for spending by the states
2. **GD/TEXCG**: Gross devolution as a proportion of total central government expenditure, which is a measure of the relative importance of fiscal transfers to states in central government expenditure.

These two indicators are used for the **Devolution Index**

$$C_z^r = (\frac{V_w^r - V_a^r}{V_w^r - V_b^r}) X100$$

Methodology

Component Index for any indicator '*z*' in region '*r*' was derived as

$$C_z^r = (\frac{V_w^r - V_a^r}{V_w^r - V_b^r}) X100$$

where
'*a*', '*w*' and '*b*' are actual, worst and best values respectively of '*z*' over the period 1980-81 to 2005-05. A second version used to derive indices was

$$C_z^r = (\frac{V_a^r - V_w^r}{V_b^r - V_w^r}) X100$$

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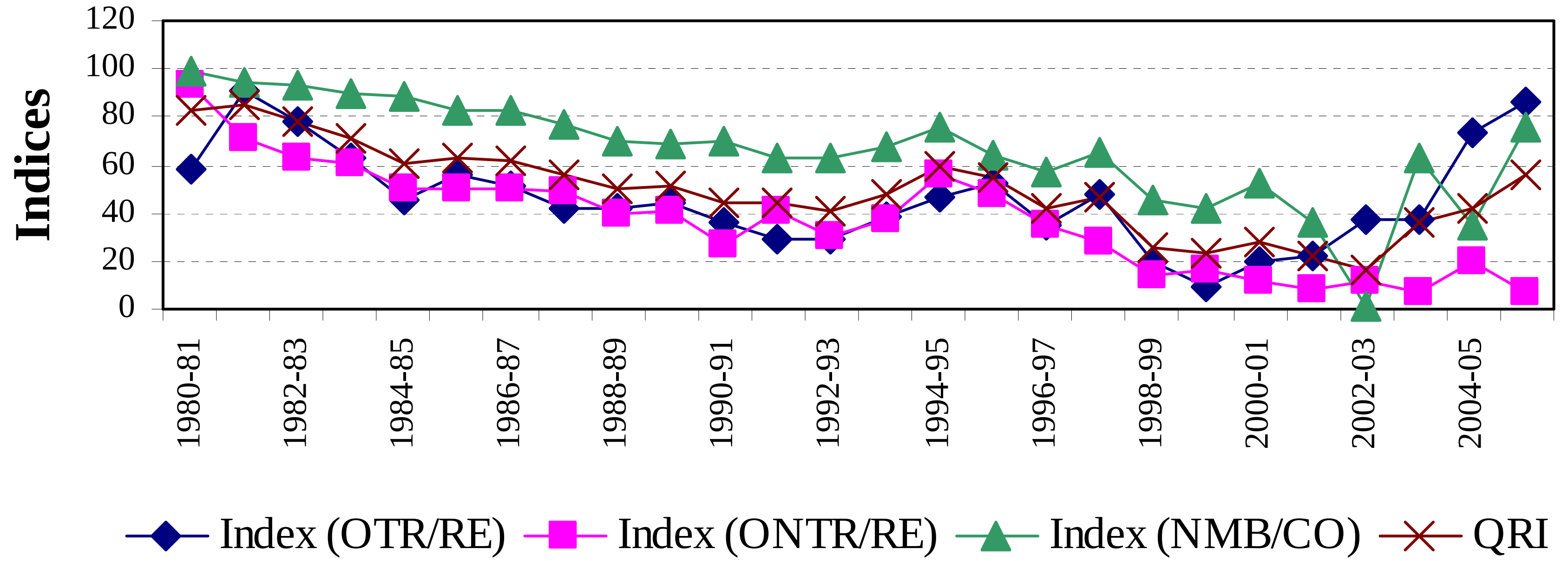
These component indices have several advantages
(a) they are unidirectional,
(b) the minimum and maximum values are based on actual fiscal performance of a state over the reference period and not any hypothetical or normative values, and
(c) they can be horizontally aggregated to derive composite indices to evaluate overall fiscal performance

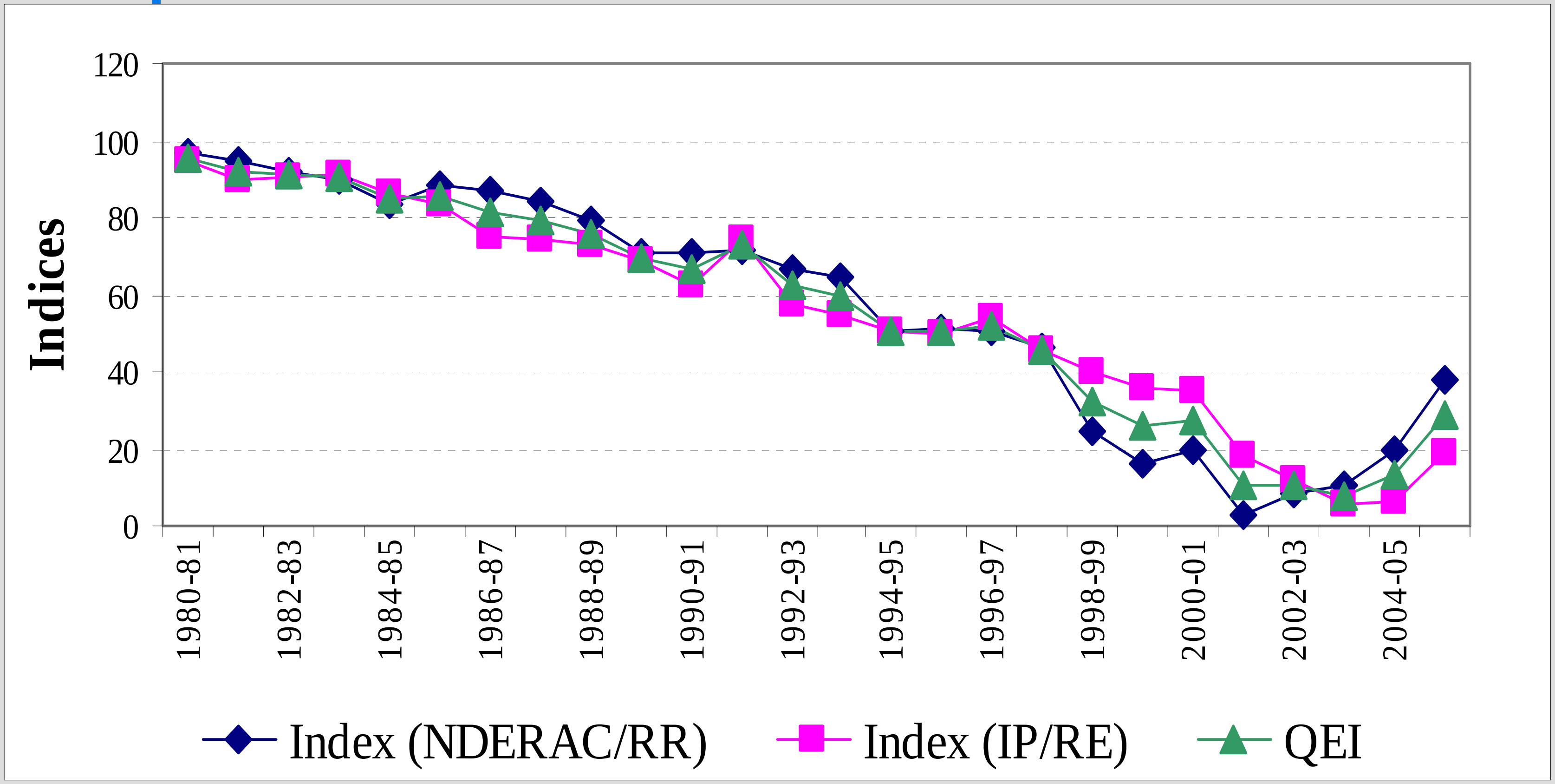
Quality of Revenue Index (All States)



Quality of Revenue Index (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	1991-92 to 2005-06		1991-92 to 1995-96	1996-97 to 2000-01	2001-02 to 2005-06
OTR/RE	55	39		39	26	51
ONTR/RE	54	25		42	21	11
NMB/CO	83	54		67	52	42
QRI	64	39		49	33	35

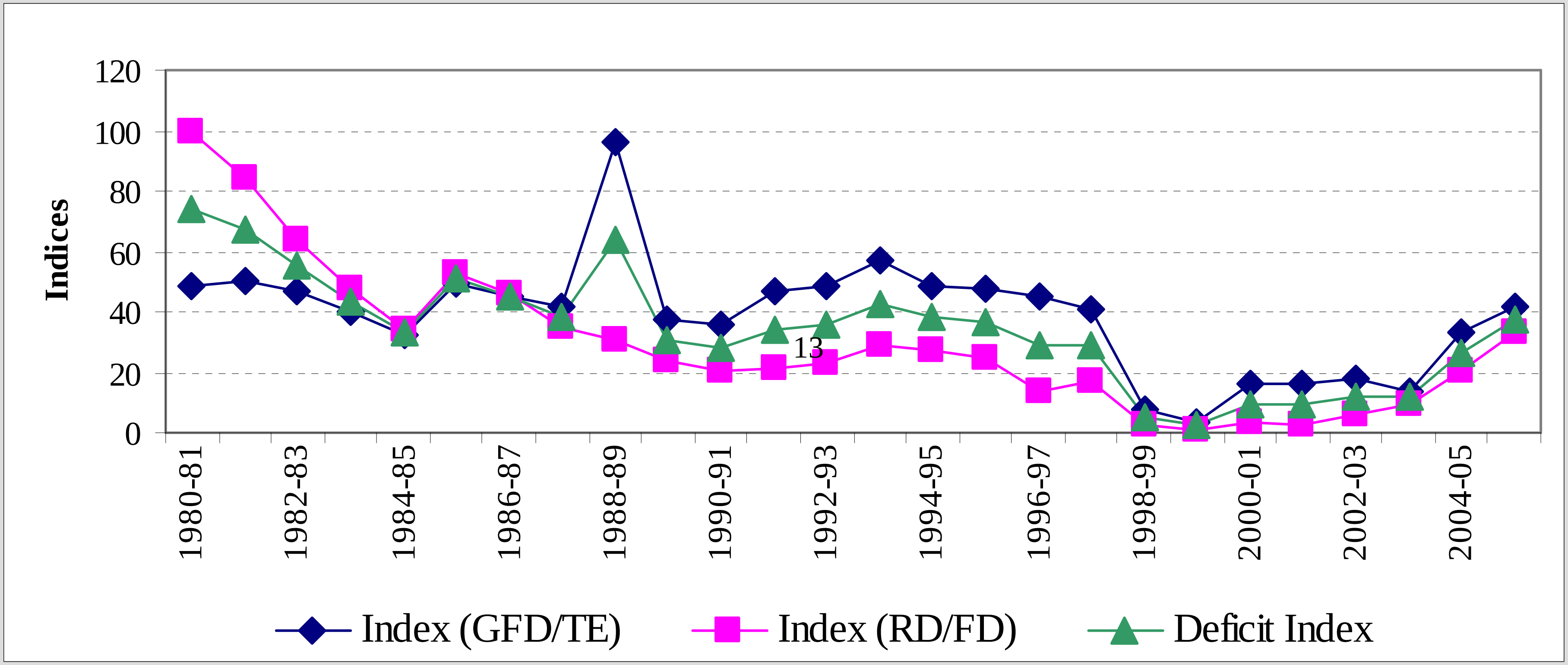
Quality of Expenditure Index (All States)



Quality of Expenditure Index (All States)

	P1	P2	P2A	P2B	P2C
	‘80-81 to ‘90-91	1991-92 to 2005-06	1991-92 to 1995-96	1996-97 to 2000-01	2001-02 to 2005-06
NDERAC/ RR	85	36	61	31	16
IP/RE	81	37	57	42	12
QEI	**83**	**37**	**59**	**37**	**14**

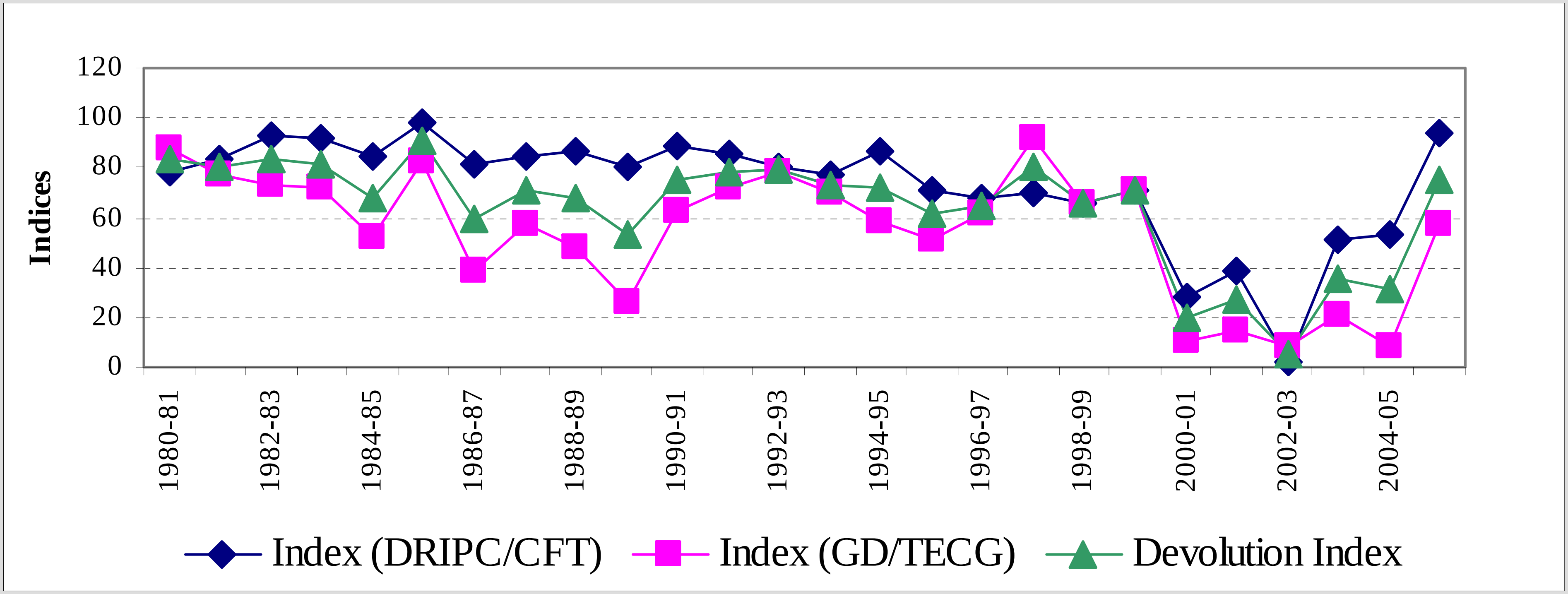
Deficit Index (All States)



Deficit Index (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	1991-92 to 2005-06		1991-92 to 1995-96	1996-97 to 2000-01	2001-02 to 2005-06
GFD/TE	48	32		50	23	25
RD/FD	49	16		25	7	14
DEFI	**48**	**24**		**37**	**15**	**19**

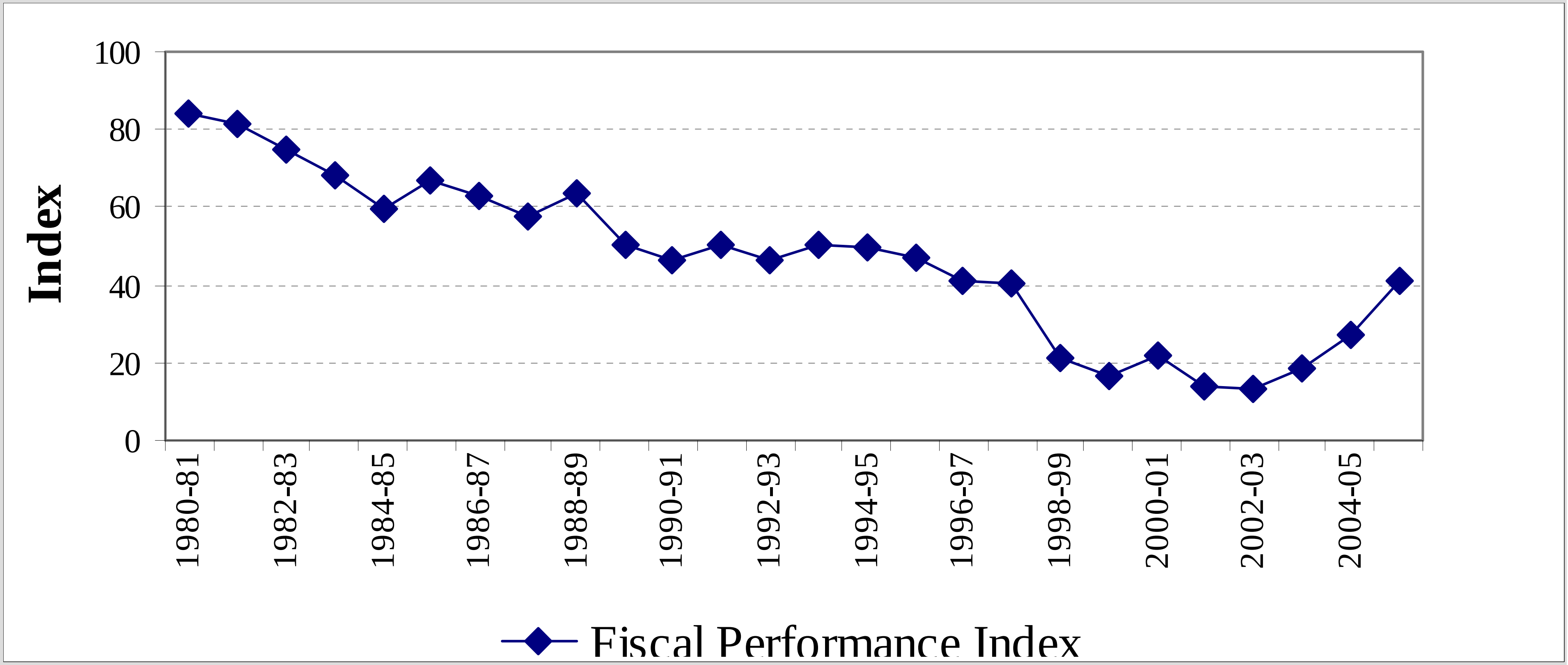
Devolution Index



Devolution Indices

	P1	P2	P2A	P2B	P2C
	1980-81 to 1990-91	1991-92 to 2005-06	1991-92 to 1995-96	1996-97 to 2000-01	2001-02 to 2005-06
DRIPC/CFT	87	63	80	60	48
GD/TECG	61	49	66	60	20
DEVI	**74**	**56**	**73**	**60**	**35**

Fiscal Performance Index (All States)



Fiscal Performance Index (All States)

	P1	P2	P2A	P2B	P2C
	1980-81 to 1990-91	1991-92 to 2005-06	1991-92 to 1995-96	1996-97 to 2000-01	2001-02 to 2005-06
DEFI	48	24	37	15	19
QRI	64	39	49	33	35
QEI	83	37	59	37	14
FPI	**65**	**33**	**49**	**28**	**23**

Major Causes Of Deterioration Of State Finances

(I) the increased need to borrow by the state governments due to

- decline in the buoyancy of state taxes.
- tax concessions/exemptions.
- the implementation of the Fifth Pay Commission recommendations.
- the large overhang of the overall stock of state government debt.
- lower devolution of resources from the centre.

Major Causes Of Deterioration Of State Finances (Continued)

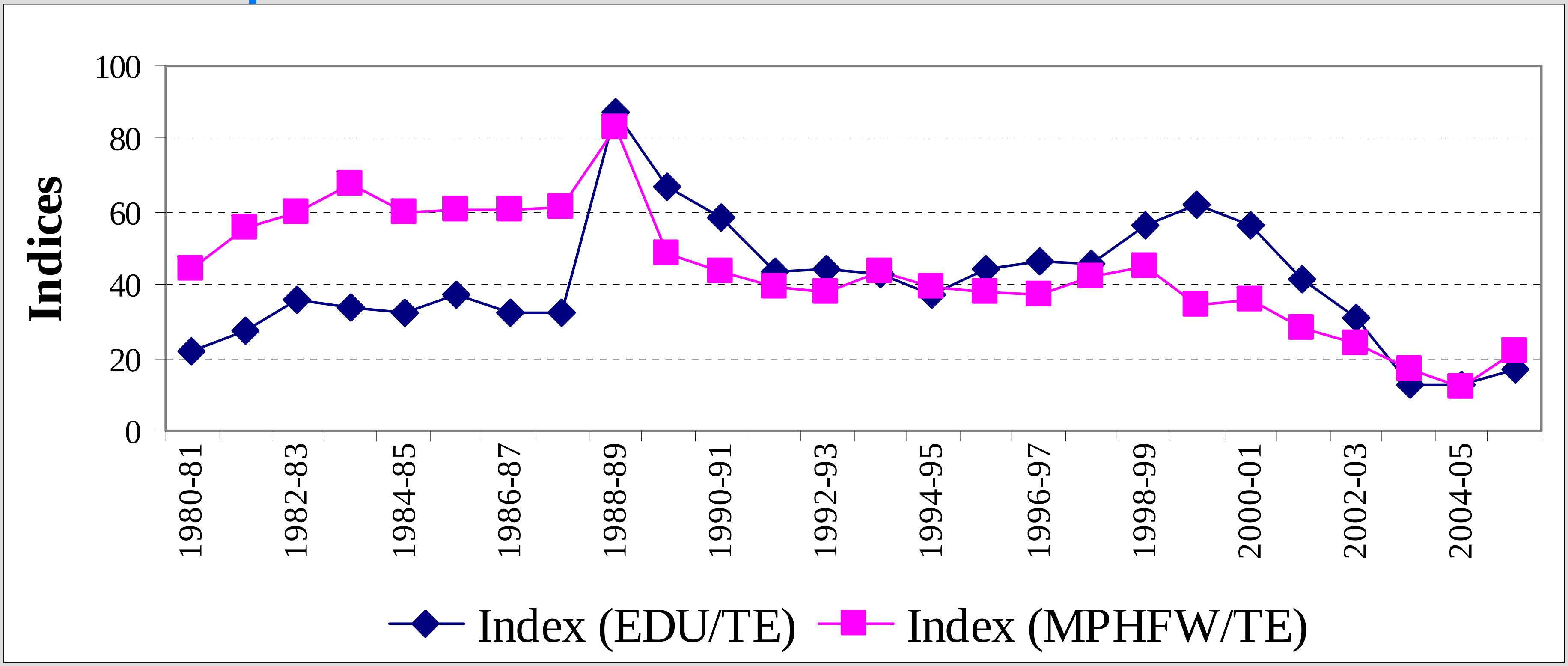
(II) the higher cost of borrowing due to

- market-linked rates for government borrowing,
- need to borrow more resources from the markets,
- higher interest rates paid by state governments

Consequences of Fiscal Deterioration

- The Fiscal Reform Programme does not simultaneously address all the factors adversely affecting the state finances.
- Measures to reduce the RD and FD are unaccompanied by measures to augment the revenues of the states.
- The only way the deficits can be reduced is by cutting back on expenditures.
- Expenditure compression has been on critical social and economic sectors.

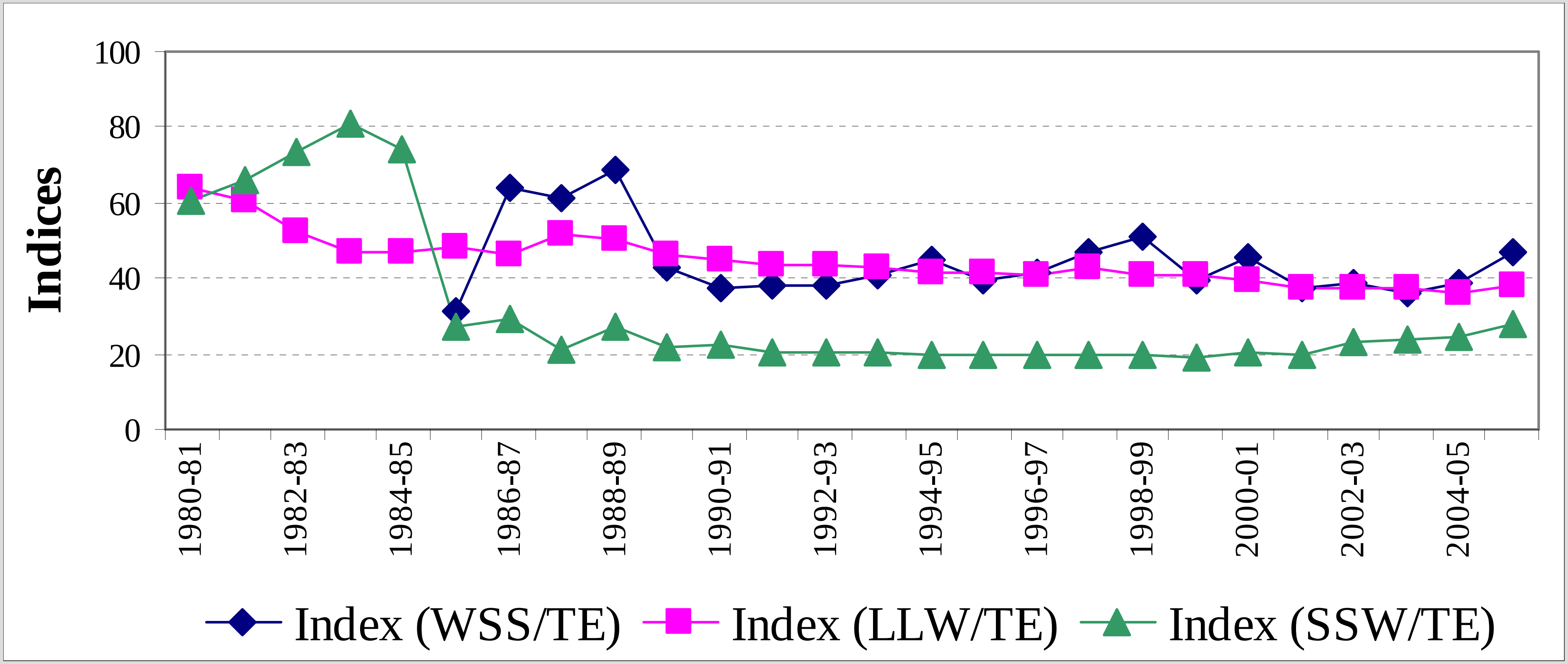
Expenditure on Education and Health (All States)



Expenditure on Education and Health (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	**1991-92 to 2005-06**		**1991-92 to 1995-96**	**1996-97 to 2000-01**	**2001-02 to 2005-06**
Index (EDU/TE)	42	40		42	53	23
Index (MPHFW/TE)	59	33		40	39	21

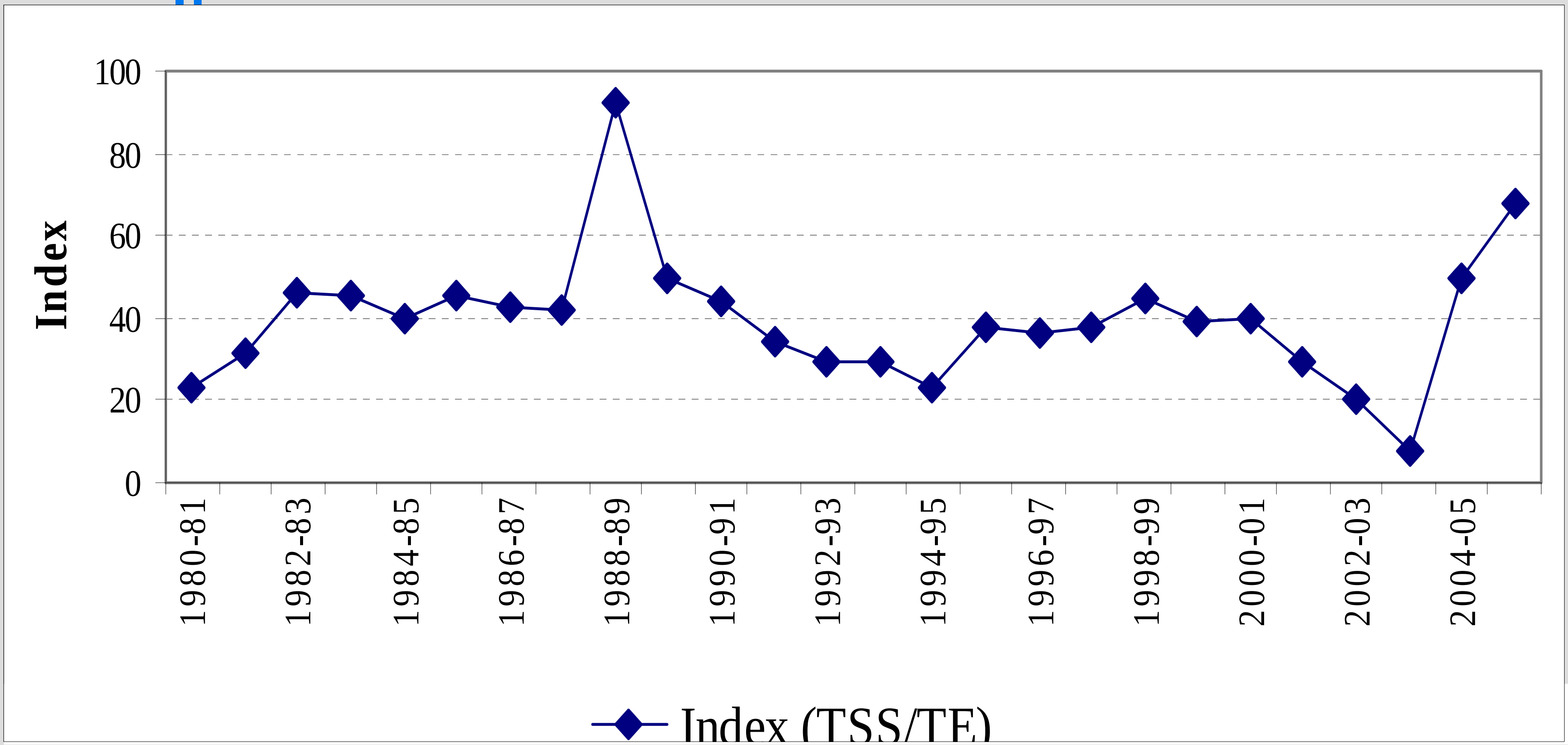
Expenditure on Other Social Sectors (All States)



Expenditure on Other Social Sectors (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	**1991-92 to 2005-06**		**1991-92 to 1995-96**	**1996-97 to 2000-01**	**2001-02 to 2005-06**
Index (WSS/TE)	51	42		40	45	40
Index (LLW/TE)	93	40		43	41	37
Index (SSW/TE)	84	21		20	20	24

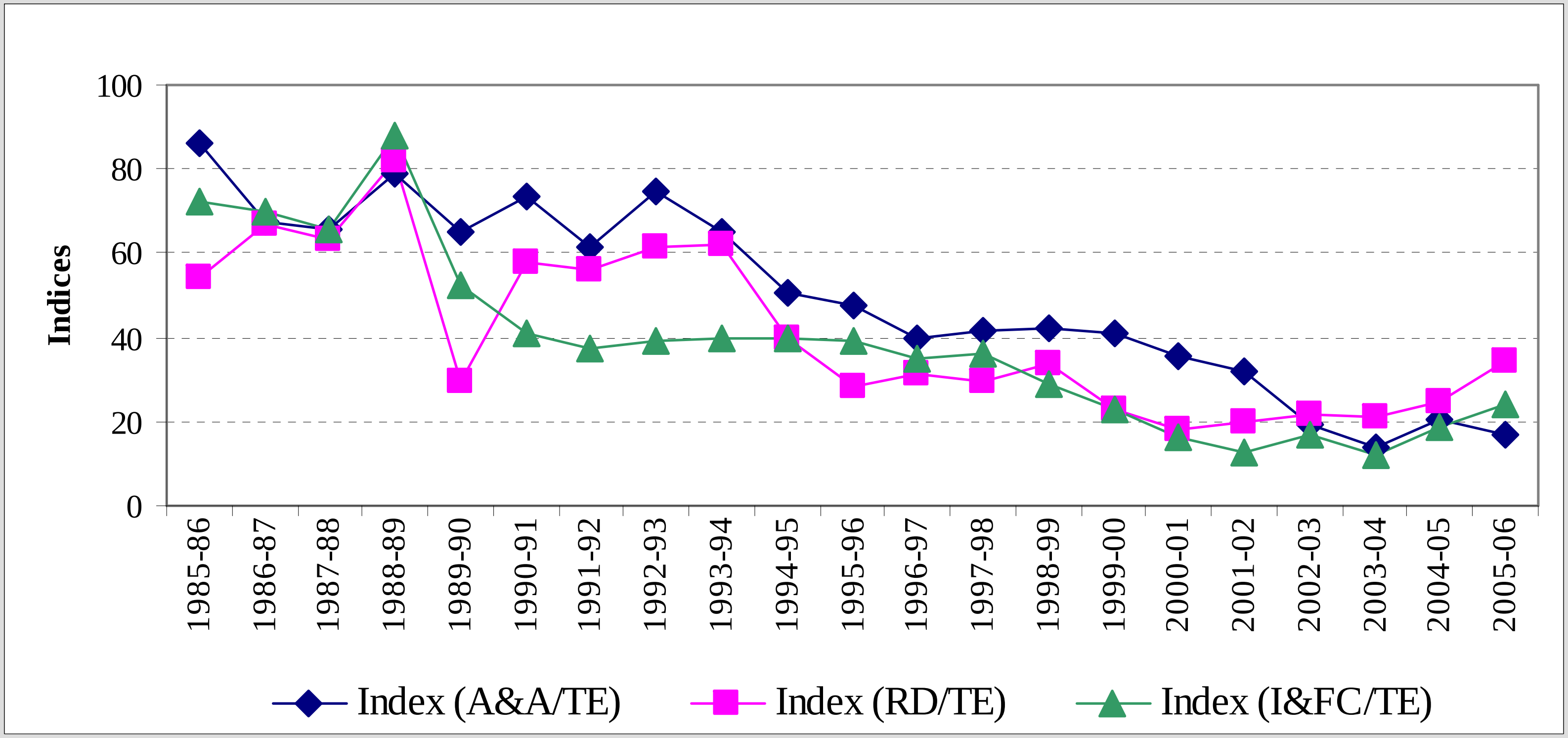
Total Expenditure on Social Sectors (All States)



Total Expenditure on Social Sectors (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	**1991-92 to 2005-06**		**1991-92 to 1995-96**	**1996-97 to 2000-01**	**2001-02 to 2005-06**
Index (TSS/TE)	46	35		31	40	35

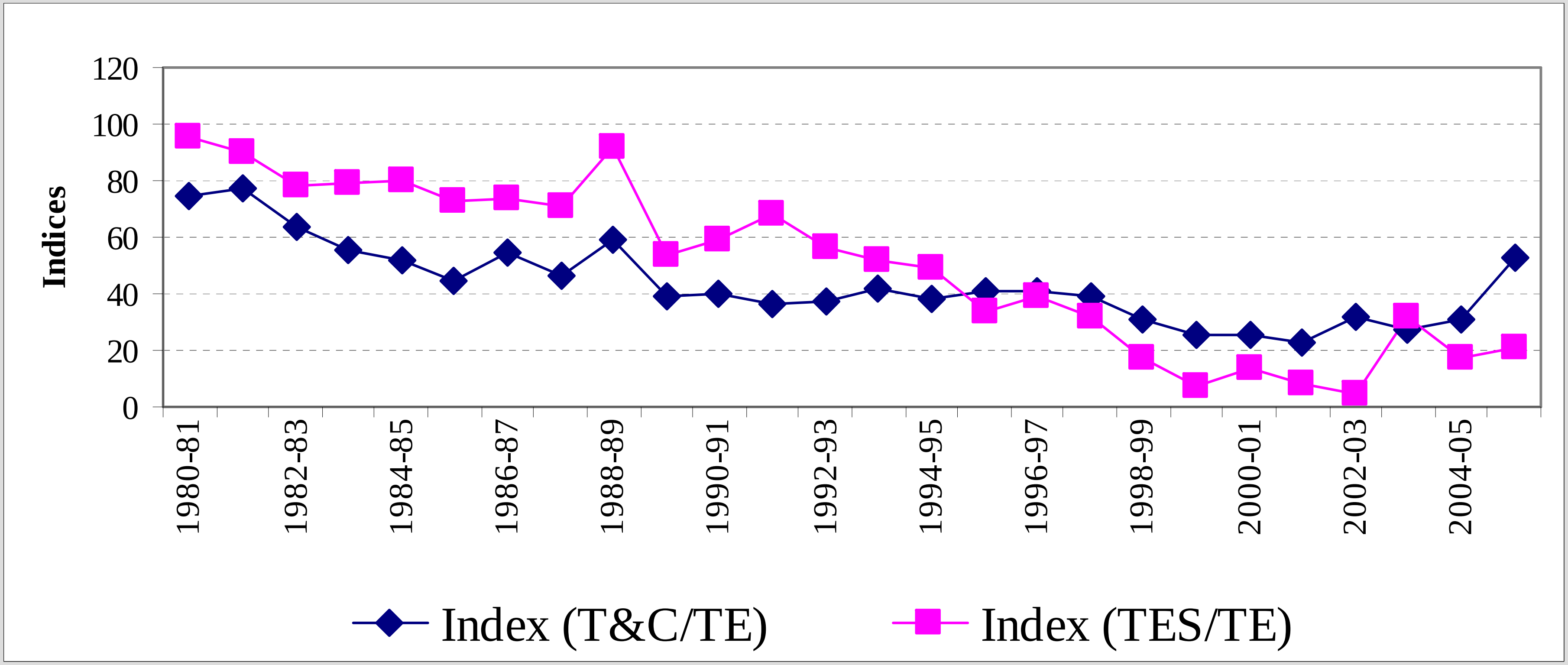
Expenditure on Agriculture, Rural Development and Irrigation (All States)



Expenditure on Agriculture, Rural Development and Irrigation (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	**1991-92 to 2005-06**		**1991-92 to 1995-96**	**1996-97 to 2000-01**	**2001-02 to 2005-06**
Index (A&A/TE)	73	40		60	40	20
Index (RD/TE)	59	34		50	27	24
Index (I&FC/TE)	65	28		39	28	17

Expenditure on Transport & Communication and All Economic Services (All States)



Expenditure on Transport & Communication and All Economic Services (All States)

	P1	P2		P2A	P2B	P2C
	1980-81 to 1990-91	**1991-92 to 2005-06**		**1991-92 to 1995-96**	**1996-97 to 2000-01**	**2001-02 to 2005-06**
Index (T&C/TE)	55	35		39	32	33
Index (TES/TE)	77	30		52	22	17

Conclusions

- The 15 years of the FRP has led to a sharp deterioration in the overall fiscal position of the states.
- The state finances, instead of improving, have fallen well below their pre-reform levels.
- Expenditure compression compelled by the nature of the FRP has resulted in a severe decline in public provision of crucial social and economic services.

Specific Policy Initiatives for Restructuring State Finances

I. Eleventh Finance Commission

- Inclusion of two fiscal performance indicators – tax effort and fiscal discipline – with a combined weight of 12.5 percent in the formula for inter se distribution of tax shares.
- Fiscal Reform Facility (FRF) consisting essentially of an incentive fund formed by the centre. Though five fiscal indicators were identified for the FRF, the centre prescribed only a single monitorable indicator – reduction in the ratio RD/RR - for the purpose of release from the incentive fund.
- The states were required to prepare Medium Term Fiscal Reform plans indicating how this ratio was to be reduced.

Specific Policy Initiatives for Restructuring State Finances (continued)

II. Twelfth Finance Commission

- Continuation of two fiscal performance indicators – tax effort and fiscal discipline – with a higher weight of 15 percent in the formula for inter se distribution of tax shares.
- The RD/GDP ratio for the centre and states, for their combined as well as individual accounts, should be brought down to zero by 2008-09.
- States should follow a recruitment and wage policy, in a manner such that the total salary bill relative to revenue expenditure (net of interest payments and pensions) does not exceed 35 percent.
- Its recommendation of debt relief through rescheduling and debt write-offs is conditional upon the enactment of Fiscal Responsibility Legislation (FRL) by the states.
- The Fiscal Responsibility Legislation should, at a minimum, provide for
- eliminating the revenue deficit by 2008-09 and reducing the fiscal deficit to 3 percent of GSDP by 2009-10.
- achieving own tax-GDP ratio of 6.8 per cent, primary expenditure-GDP ratio of 14.3 per cent and limiting interest payments of States to 15 per cent of revenue receipts by 2009-10.
- bringing out annual reduction targets of revenue and fiscal deficits, and annual statement giving prospects for the state economy and related fiscal strategy.

Report of the Group on Model Fiscal Responsibility Legislation at State Level: Main Features

The Model Fiscal Responsibility Bill of a State Government will contain

- Fiscal management objectives of elimination of revenue deficit, building up of revenue surplus, raising of non-tax revenue and containment of fiscal deficit at a sustainable level.
- Fiscal management principles of transparency, stability and predictability, responsibility and integrity, fairness, and efficiency.
- Fiscal policy statements including the macroeconomic framework statement, the medium term fiscal policy statement, the fiscal policy strategy statement, fiscal targets such as reduction and elimination of revenue deficit, reduction of GFD/GSDP ratio, reduction of outstanding liabilities/GSDP ratio, and limiting the incremental risk weighted guarantees as ratio to TRR and/or GSDP.
- State governments may set up an appropriate agency independent of the Government to carry out the periodic review for the compliance of the provisions of the Act in the manner as may be prescribed under the rules framed under the Act.