### State level reforms

2.58 The need for fiscal adjustment has been well recognized by States. Five States have enacted fiscal responsibility legislations till 2003-04. Three more States have indicated that they would be initiating such legislation. A Working Group was constituted by the RBI to evolve draft model fiscal responsibility legislation at the State level. The draft report of the Group is being examined by State Governments.

2.59 The Central Government has been taking proactive steps to encourage State level fiscal reforms through provision of incentives. Based on the recommendations of the Eleventh Finance Commission, the Centre initiated a "States Fiscal Reforms Facility (2000-01 to 2004-05)", in the year 2001, to encourage States to undertake fiscal reforms. Under this facility, Medium Term Fiscal Reform Programmes (MTFRPs) are drawn up by States encompassing fiscal reforms, power sector reforms, public sector restructuring and budgetary reforms. A unique feature of MTFRP is that the ownership of reforms and the initiative rest with State Governments. A Monitoring Committee headed by Secretary (Expenditure) monitors the reform facility. The Monitoring Committee finalises the MTFRP submitted by the State Government, after which the latter enters into a Memorandum of Understanding (MOU) with the Ministry of Finance. So far, MTFRPs have been received from all 28 States and discussed in the meetings of the Monitoring Committee, out of which 22 States have signed Memoranda of Understanding / Letters of Exchange with the Ministry of Finance. The facility has an incentive fund of Rs.10,607 crore, from which States are given incentives, based on a single monitorable indicator, viz., a minimum reduction of 5 per cent per annum in the ratio of revenue deficit to revenue receipts. An amount of Rs.5,756 crore has been released from the incentive fund to States up to February 10, 2005.

2.60 Interest payment is a major item of revenue expenditure. To reduce the interest burden of States, a debt swap scheme enabling States to swap their high cost Central Government loans bearing a coupon rate of 13 per cent and above with relatively low cost market borrowings and loans from NSSF, was put in place in 2002-03, at the initiative of the Central Government. In 2004-05 (upto December 2004), high cost debt amounting to Rs.34,085 crore has been swapped through market borrowings of Rs.13,781 crore and loans from small savings of Rs.20,304 crore. The cumulative amount of high cost debt swapped up to December 2004 amounted to Rs.92,444 crore. The process of swapping high cost debt under the scheme is complete in respect of 20 states.

2.61 Budget for 2004-05 extended the debt swap scheme by allowing States to raise fresh loans and repay their old high-cost loans to NABARD and some other agencies. Further, the Budget proposed passing on external loans to States on a back-to-back basis. In line with falling interest rates, Centre has been reducing the rate of interest charged on its loans to States. The rate was progressively reduced from 12.50 per cent in 1999-200 to 10.50 per cent in 2003-04. The Budget for 2004-05 further reduced the rate to 9.0 per cent per annum. In addition to these measures, an amount of Rs.4,625 crore was provided in the Budget for 2004-05 as additional gross budgetary support to State plans for meeting the NCMP objectives.

2.62 The TFC has made far-reaching recommendations on reform of State finances. Debt relief to States is conditional upon the enactment of fiscal responsibility legislation prescribing specific annual targets with a view to eliminating the revenue deficit by 2008-09 and reduction in fiscal deficit by a path to be specified. Consequently, fiscal reform facilitiy would cease at the end of the current financial year. The practice of loan intermediation by the Centre would be restricted to fiscally weak States and all other States have to approach the market directly for raising loans. All States are required to set up sinking funds in Public Account for amortization of all loans and guarantee redemption funds through earmarked guarantee fees, after risk weighting guarantees.

**Value added tax**

2.63 An accepted principle of tax policy is that taxes on commodities and services must be based on consumption (on consumers) and not on sales (traders). However, the levy of tax on sales of goods and services has been on traders and not on consumers, as it is relatively easier to tax traders rather than consumers. By allowing input credit for taxes paid on the series of sales from the producer to the ultimate consumer, the objective of tax on the basis of value addition can be achieved. Value Added Tax (VAT) is a multistage sales tax with credit for taxes paid on business purchases. One of the major advantages of VAT over sales tax is that the former is non-cascading. Union excise duties are based on value addition principles through the CENVAT system which allows input credit.

2.64 One of the important components of tax reforms initiated since liberalisation relate to introducing State-level Value Added Tax (VAT). The decision to introduce VAT arrived at during the Conference of Chief Ministers of States/UTs held in 1999 was reiterated during the subsequent meetings held in June 2000 and July 2001. An Empowered Committee of State Finance Ministers was also constituted in July 2000 to monitor the process of introduction of VAT. The consensus arrived at to introduce VAT from April 1, 2003 could not be adhered to as States were not fully prepared both in terms of legislative requirements as well as administrative infrastructure required for the purpose. At the meeting of the Empowered Committee (convenor: Dr. Asim Dasgupta) held on June 18, 2004, it was agreed to implement State level VAT from April 1, 2005. This decision has been further reaffirmed in subsequent meetings of the Empowered Committee held on September 23, 2004 and November 2, 2004.

2.65 The proposed VAT is a multi-point destination based system of taxation, with tax being levied on value addition at each stage of transaction in the production/ distribution chain. Some other salient features of VAT are :

a) Uniform schedule of rates of VAT for all States. This would make the tax system simple and uniform and prevent unhealthy tax competition among States.

b) The provision of input tax credit would help in preventing cascading effect of tax.

c) The provision of self-assessment by dealers would reduce harassment. Small traders with turnover up to Rs.5 lakhs would be exempt from the provisions of VAT.

d) The zero-rating of exports would increase the competitiveness of Indian exports.

2.66 Since sales tax/VAT is basically a State subject, the Central Government is playing the role of a facilitator for successful implementation of this significant reform measure. One of the concerns expressed by States in adopting VAT relates to the possible loss of revenue in the initial years. To allay the apprehensions of States and to provide a measure of comfort, the Central Government agreed to compensate the estimated loss on the basis of an agreed formula, on account of the introduction of VAT, to the extent of 100 per cent of the loss in the first year, 75 per cent of the loss in the second year and 50 per cent of the loss in the third year of introduction of VAT.

2.67 The Empowered Committee of State Finance Ministers, constituted by the Ministry of Finance, Government of India which has been engaged in the design and introduction of State-level VAT, has come up with a white paper on State-level value added tax on January 17, 2005. The white paper discusses the issues concerning VAT (Box 2.9).

**Box 2.9 : White paper on State-level VAT**

- Introduction of VAT would help avoid cascading nature of sales tax.
- Present multiple rates and taxes can converge into a few rates and a single VAT.
- Transparency in the system of tax administration through simple self-assessments and departmental audit.
- Rationalisation of taxes to result in lower tax burden and higher tax revenues.
- To avoid tax competition, the design of State VAT needs to be harmonized even as the distinctive needs of individual States are recognized.
- State VAT to have two basic rates of 4 per cent and 12.5 per cent and to cover 550 commodities. About 270 commodities will be under 4 per cent rate.
- 46 items, comprising of natural and unprocessed products in unorganized sector, items legally barred from taxation and items having social implications, are exempt from VAT.
- Gold and silver ornaments subject to a special VAT rate of 1 per cent and other commodities to attract a general VAT rate of 12.5 per cent.