State level reforms

2.51 On the recommendation of the Eleventh Finance Commission (EFC), Government of India implemented a scheme called the "States Fiscal Reforms Facility (2000-01 to 2004-05)", to incentivise the States to undertake fiscal reforms. Under this scheme, which came to an end on March 31, 2005, all the 28 States had submitted their medium-term fiscal reforms programme and all but Government of Goa entered into memorandum of understanding with Government of India, individually. As on March 31, 2005, an amount of Rs.7,217 crore was released to States from incentive fund (Total fund Rs.10,608 crore) on the basis of improvement in revenue deficit as a proportion of revenue receipts. States, (excluding NCT Delhi) in aggregate, have registered an improvement of 14.95 percentage points in the ratio of revenue deficit to total revenue receipts during EFC award period (2000-01 to 2004-05), over the base year 1999-2000 (Table 2.11)

2.52 As per the latest information available for 2004-05 (pre-Actual), nine States, namely Bihar, Chattisgarh, Jammu & Kashmir, Karnataka, Madhya Pradesh, Manipur, Mizoram, Nagaland and Sikkim, are expected to be revenue surplus. The TFC discontinued this facility beyond March 31, 2005 and suggested a debt consolidation and waiver scheme. The TFC's recommendations for restructuring public finances envisage a positive growth dividend through fall in dissavings, The major reform initiative that underpins the TFC award is this recommendation for a debt consolidation and waiver scheme for States linked to fiscal responsibility. Under the general debt relief scheme applicable to all States during the award of the TFC, all central loans, contracted till March 31, 2004 and outstanding as on March 31, 2005, get consolidated as loans for a fresh period of 20 years payable in 20 equal annual installments at a reduced interest rate of 7.5 per cent effective from the year in which the FRBM legislation is enacted by the States. TFC has estimated that this would benefit the States in the entire period of its award through lower interest payments of Rs.21,276 crore and through relief on deferment of principal repayment of Rs.11,929 crore. A second scheme of debt write-off under the TFC award linked to fiscal performance is calibrated in a manner that incentivises a self-laid down fiscal correction path on a year-on-year basis leading to elimination of revenue deficit by 2008-09 and containing fiscal deficit.

2.53 As on February 2, 2006, 18 state Governments had passed their FRBM Acts and 13 States had drawn up their fiscal correction path. States have also strived to explore all possibilities of revenue generation, while at the same time trying to prioritize their expenditure needs. A Central Monitoring Committee, set up to for the purpose, has recommended consolidation of Central loans to 12 States, namely Andhra Pradesh, Assam, Haryana, Chhattisgarh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Orissa, Rajasthan and Tamil Nadu. Besides debt liability, there has been a significant increase in the outstanding guarantees given by State Governments during the past few years. However, to control the proliferation of State Government guarantees, as per the latest information available, nine States have imposed cap on guarantees — six (Goa, Gujarat, Karnataka, Kerala, Sikkim and West Bengal) of the statutory variety and three (Assam, Orissa and Rajasthan) of the administrative kind. In pursuance of the accepted recommendations of the TFC, external loans to State Governments are now to be given on a back-to-back basis, i.e. on the same terms and conditions — including interest rate, maturity, commitment charges and foreign exchange variation risk — as it is received by the Central Government.

Table 2.11 : State Governments—Revenue deficit as a proportion of total revenue receipts (RD/TTR)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
RD/TTR	26.88	23.79	24.22	20.89	20.51	12.29

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Value Added Tax (VAT)

2.54 Following the June 18, 2004 decision of the Empowered Committee (EC) of State Finance Ministers to implement State-level VAT from April 1, 2005, 25 States/UTs had introduced VAT to replace the sales tax by December 31, 2005. Andaman & Nicobar Islands and Lakshadweep do not have a sales tax. The eight States/UTs yet to introduce the VAT are Chattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Pondicherry, Rajasthan, Tamil Nadu and Uttar Pradesh. Since Sales Tax/VAT is essentially a State subject, the Central Government is playing the role of a facilitator for the successful implementation of VAT. A formula has also been finalised in consultation with the States for providing compensation to them, during the first three years, for any loss on account of introduction of VAT. Technical and financial support has also been provided to the States for VAT computerization, publicity and awareness and other related aspects. Despite the initial transitional problems and lack of clarity, the implementation of VAT has been smooth and the results encouraging. The EC constantly reviews the progress and tries to sort out the difficulties. The EC has advised the States to constantly interact with trade and industry to remove their apprehensions, if any, and to ensure that the benefits of VAT due to input tax credit and reduction in tax rates (wherever applicable) are passed on to the consumers. The EC is also persuading the remaining States/UTs to implement VAT at the earliest.

2.55 The initial trend in revenue collection in the VAT implementing States is quite encouraging. During the first 7 months of VAT implementation (April-October 2005), the total revenue (Provisional) for VAT implementing States showed an increase of around 14.4 per cent, which is higher than the compound annual growth rate of these States for the last 5 years. Up to January 15, 2006, VAT compensation claims for about Rs.1,674 crore had been filed by eight States, out of which claims for Rs.1,317 crore had been settled. Based on trends so far, the compensation liability for the year 2005-06 is likely to be contained within BE. The non-implementation of VAT by eight States/UTs is creating complications and may also lead to undesirable diversion of trade and business from one State to another. Further, the benefits of the VAT system like simple and uniform tax structure all over the country and achieving a common market for goods would not accrue until all the States/UTs implement VAT. In view of this, it is imperative that the remaining eight States/UTs also implement VAT at the earliest. While the VAT Acts of the States follow a broadly uniform pattern, there is a considerable amount of diversity in the VAT Rules and procedures. The internationally accepted coding system is the harmonized system of commodity description and coding (HS). While foreign trade and tariffs associated are based on HS, VAT system is not. The EC is looking into this issue of aligning the classification system of VAT with HS.

2.56 With input tax credit being allowed in respect of locally purchased inputs involved in inter-State transactions, the central sales tax (CST) reforms have already begun. However, the CST is basically inconsistent with the concept of VAT and needs to be phased out. In fact, it has already been decided, in principle, to phase out the CST. But before doing that, it is essential that the system of information exchange between the States, namely, TINXSYS, is put in place. Further, successful implementation of CST reforms would require that all the States/UTs first successfully implement the State-level VAT. Another critical issue involved in phasing out of CST is that of compensating the States, particularly the developed States where a lot of inter-State sales originate, for revenue losses on account of such a phase out. During 2004-05, the total revenue collection from CST for all States was around Rs.15,100 crore. If CST is phased out, this revenue will be permanently lost and, hence, their insistence on a compensation mechanism on a permanent basis through alternative taxation powers. The Empowered Committee is deliberating on this issue. The EC is expected to finalize its recommendations and place the same before the Central Government, after which the Government of India will take an appropriate decision on this matter.