FINANCES OF STATE GOVERNMENTS

3.50 The finances of State Governments traditionally follow a pattern similar to that of the Centre. State's own tax receipts, as a proportion of GDP, increased from 5.6 per cent in 2002-03 to 6.2 per cent in 2006-07 (RE) and are projected to further improve to 6.3 per cent of GDP in 2007-08 (BE). The tax receipts inclusive of tax transfers from the Centre during the same period increased from 7.9 per cent to 9 per cent and further to 9.2 per cent respectively. The total revenue receipts increased to 12.9 per cent of GDP in 2007-08 (BE). The total expenditure, on the other hand, declined from 18.7 per cent of GDP in 2003-04 to 16.3 per cent in 2007-08 (BE). As a result, in 2006-07 (RE) all States put together have achieved revenue deficit of 0.1 per cent and fiscal deficit of 2.7 per cent of GDP. The States were, therefore, close to achieving the FRBMA mandated target of eliminating revenue deficit two years ahead of the scheduled year of 2008-09. Similarly, with significant reduction in total disbursements as a proportion to GDP, the consolidated fiscal deficit of all the States put together is already lower than the FRBMA mandated target of 3 per cent since 2005-06, ahead of schedule. Further during the current financial year, 2007-08, the States are estimated to have a revenue surplus of 0.3 per cent and fiscal deficit of 2.3 per cent, of GDP (Table 3.12 and Figure 3.10).

3.51 Most recent indicators of State finances show a distinctly improved picture. The causative factors of fiscal deterioration in the past will, however, need to be monitored in the future as well to sustain this progress and keep the balance at the desired level. The causative factors are: interest payment; pension liabilities; losses of State PSUs; lack of proper user charges; and a possible moderation in buoyancy in taxes. The successful introduction of VAT by 30 States/UTs and the TFC incentive to enact State level FRBM legislations appear to have deepened State level fiscal reforms and put them on the path towards fiscal sustainability.

State level reforms

3.52 The pace of fiscal adjustment and corrections at State level has gained further momentum during 2007-08. So far 26 out of 28 States have enacted FRBMAs. Sikkim and West Bengal are the two States yet to enact FRBMAs.

3.53 Debt Consolidation and Relief Facility (DCRF), formulated as per recommendations of Twelfth Finance Commission (TFC), has two components – consolidation of Central loans (from the Ministry of Finance); and debt waiver. So far, Central loans (from the Ministry of Finance) of 24 out of 28 States have been consolidated to the extent of Rs. 1,09,977 crore. Jharkhand and Jammu and Kashmir are among the States that have enacted FRBMAs, a prerequisite for availing of benefits under DCRF, whose debts are to be consolidated. Debt consolidation has provided interest relief to the States to the extent of Rs. 4,392 crore and Rs. 3,995 crore in 2005-06 and 2006-07, respectively.

3.54 The second component of DCRF is debt waiver. For 2005-06, consolidated debt of 14 States amounting to Rs. 3,879 crore was waived, and for 2006-07, debt of 19 States to the extent of Rs. 4,595 crore was waived. During 2007-08, 21 States are estimated to get debt waiver of Rs. 4,812 crore. Debt consolidation and waiver have facilitated States to achieve targets of elimination of revenue deficit and containing fiscal deficit to GSDP ratio at 3 per cent well ahead of 2008-09. It also poses a challenge to States to sustain this momentum; and provides an opportunity to leverage gains achieved to concentrate on social sectors to make the growth process more inclusive.

3.55 In 2006-07, the States have been able to have larger corrections, which are expected to lead to lower fiscal deficit as compared to the revised estimates. During the current year also, against the budgeted fiscal deficit of 2.3 per cent of GDP, the States could do better.

3.56 In pursuance of the provisions of Article 280 of the Constitution of India, the Thirteenth Finance Commission has been constituted by the President of India under the Chairmanship of Dr. Vijay L. Kelkar vide a notification dated November 13, 2007. The Commission shall make recommendations covering a period of five years commencing on April 1, 2010. In making its recommendations, the Commission shall have regard, among other considerations, to the impact of the proposed implementation of goods and services tax with effect from April 1, 2010, including its impact on the country's foreign trade, the need to manage ecology, environment and climate change consistent with sustainable development, and the need to improve the quality of public expenditure to obtain better outputs and outcomes.

Table 3.12 Receipts and disbursements of State Governments[a]

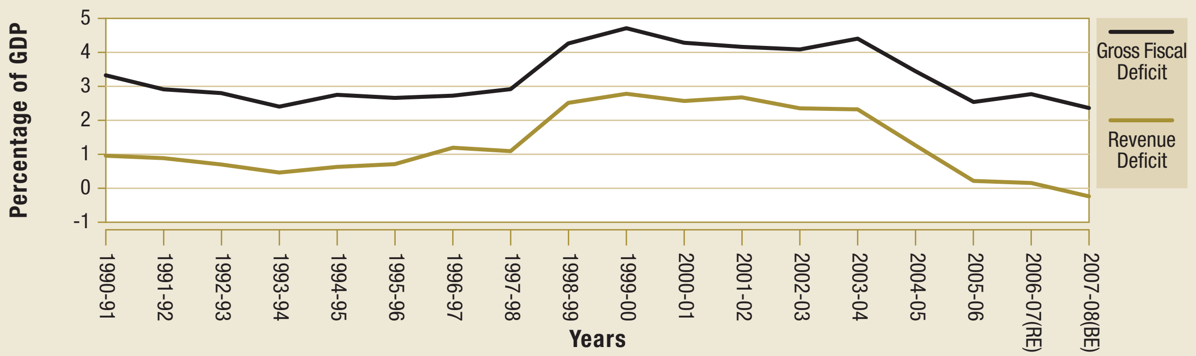
		2002-03	2003-04	2004-05	2005-06	2006-07 (RE)	2007-08 (BE)
1	2	3	4	5	6	7	8
		(Rs. crore)					
I	**Total receipts (A+B)**	**4,14,539**	**5,14,829**	**5,63,661**	**5,95,629**	**6,74,736**	**7,67,845**
	A Revenue receipts (1+2)	2,73,673	3,09,187	3,63,513	4,31,022	5,31,429	6,06,733
	1 Tax receipts	1,93,474	2,21,115	2,60,577	3,06,332	3,72,817	4,30,222
	of which						
	State's own tax revenue	1,36,819	1,54,037	1,82,027	2,12,307	2,57,080	2,94,038
	2 Non-tax receipts	80,199	88,072	1,02,936	1,24,690	1,58,612	1,76,511
	of which:						
	Interest receipts	9,031	7,748	8,648	9,380	9,302	11,008
	B. Capital receipts	1,40,866	2,05,642	2,00,148	1,64,607	1,43,307	1,61,112
	of which:						
	Recovery of loans & advances	3,698	16,158	8,039	8,904	8,482	4,592
II.	**Total disbursements (a+b+c)**	**4,10,248**	**5,14,303**	**5,53,427**	**5,61,682**	**6,87,946**	**7,66,619**
	a) Revenue	3,30,852	3,72,594	4,02,670	4,38,034	5,36,995	5,94,760
	b) Capital	68,806	1,19,899	1,34,235	1,09,224	1,36,010	1,55,666
	c) Loans and advances	10,590	21,810	16,522	14,424	14,941	16,193
III.	**Revenue deficit**	**57,179**	**63,406**	**39,157**	**7,012**	**5,566**	**-11,973**
IV.	**Gross fiscal deficit**	**99,727**	**1,20,631**	**1,07,774**	**90,084**	**1,13,913**	**1,08,323**
		(As per cent of GDP)					
I.	**Total receipts (A+B)**	**16.9**	**18.7**	**17.9**	**16.6**	**16.3**	**16.4**
	A. Revenue receipts (1+2)	11.1	11.2	11.5	12.0	12.8	12.9
	1. Tax receipts	7.9	8.0	8.3	8.6	9.0	9.2
	of which						
	State's own tax revenue	5.6	5.6	5.8	5.9	6.2	6.3
	2. Non-tax receipts	3.3	3.2	3.3	3.5	3.8	3.8
	of which:						
	Interest receipts	0.4	0.3	0.3	0.3	0.2	0.2
	B Capital receipts	5.7	7.5	6.4	4.6	3.5	3.4
	of which:						
	Recovery of loans & advances	0.2	0.6	0.3	0.2	0.2	0.1
II.	**Total disbursements (a+b+c)**	**16.7**	**18.7**	**17.6**	**15.7**	**16.6**	**16.3**
	a) Revenue	13.5	13.5	12.8	12.2	13.0	12.7
	b) Capital	2.8	4.4	4.3	3.1	3.3	3.3
	c) Loans and advances	0.4	0.8	0.5	0.4	0.4	0.3
III.	**Revenue deficit**	**2.3**	**2.3**	**1.2**	**0.2**	**0.1**	**-0.3**
IV.	**Gross fiscal deficit**	**4.1**	**4.4**	**3.4**	**2.5**	**2.7**	**2.3**

Source: Reserve Bank of India.

a Data pertains to 28 State Governments.

Note: 1. The ratios to GDP at current market prices are based on CSO's new 1999-2000 series.
2. Capital receipts include accounts on a net basis.
3. Capital disbursements are exclusive of public accounts.
4. Negative sign indicates surplus.

Figure 3.10 Revenue and fiscal deficit of states



Value Added Tax (VAT)

3.57 Introduction of State level VAT is the most significant tax reform measure at State level. The State level VAT being implemented presently has replaced the erstwhile sales tax system of the States. Under Entry 54 of List II (State List) in the Seventh Schedule to the Constitution of India, "tax on sale or purchase of goods within a State" is a State subject. The decision to implement State level VAT was taken in the meeting of the Empowered Committee (EC) of State Finance Ministers held on June 18, 2004, where a broad consensus was arrived at amongst the States to introduce VAT from April 1, 2005. Accordingly, VAT has been introduced by all States/UTs by now. Uttar Pradesh is the latest State which has introduced VAT on January 1, 2008.

3.58 Since sales tax/VAT is a State subject, the Central Government is playing the role of a facilitator for successful implementation of VAT. A compensation formula has also been finalized in consultation with the States, for providing compensation to them, during 2005-06, 2006-07 and 2007-08, for any loss on account of introduction of VAT and compensation is being released according to this formula. Technical and financial support has also been provided to the States for VAT computerization, publicity and awareness and other related aspects.

3.59 The Empowered Committee, through its deliberations over the years, finalized a design of VAT to be adopted by the States, which seeks to retain certain essential features commonly across States while, at the same time, providing a measure of flexibility to the States to enable them to meet their local requirements. Box 3.4 gives the salient features of the VAT design finalized by the Empowered Committee.

Box 3.4 Salient features of the VAT design

- The rates of VAT on various commodities shall be uniform for all the States/UTs. There are two basic rates of 4 per cent and 12.5 per cent, besides an exempt category and a special rate of 1 per cent for a few selected items. The items of basic necessities and goods of local importance (up to 10 items) have been put in the 0 per cent or the exempted schedule. Gold, silver and precious stones have been put in the 1 per cent schedule. The 4 per cent rate applies to other essential items and industrial inputs. The 12.5 per cent rate is residual rate of VAT applicable to commodities not covered by other schedules. There is also a category with 20 per cent floor rate of tax, but the commodities listed in this schedule will not be VATable. This category covers items like motor spirit (petrol, diesel and aviation turbine fuel), liquor, etc.
- There is provision for eliminating the multiplicity of taxes. In fact, several State taxes on purchase or sale of goods (excluding entry Tax in lieu of octroi) have been subsumed in VAT or made VATable.
- Provision has been made for allowing "Input Tax Credit (ITC)". However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, the ITC will not be available on inter-State purchases.
- Exports will be zero-rated, and at the same time, credit will be given for all taxes on inputs/ purchases, related to such exports.
- There are provisions to make the system more business-friendly. These include provision for self-assessment by the dealers, provision of a threshold limit for registration of dealers in terms of annual turnover of Rs. 5 lakh, and provision for composition of tax liability up to annual turnover limit of Rs. 50 lakh.
- States have been allowed to continue with the existing industrial incentives, without breaking the VAT chain. However, no fresh sales tax/ VAT-based incentives are permitted.

VAT Implementation – Experiences and challenges

3.60 The initial experience of implementation of VAT has been very encouraging. The new system has been received well by all the stakeholders. The transition to the new system has been quite smooth. The EC is constantly reviewing the progress of implementation of VAT. The revenue performance of VAT implementing States/UTs has been very encouraging so far, as can be seen from the following:

(i) During 2005-06, the tax revenue of the 25 VAT implementing States/UTs had registered an increase of around 13.8 per cent over the tax revenue of 2004-05, which is higher than the Compound Annual Growth Rate (CAGR) of sales tax revenues of these States for the last five years up to 2004-05.

(ii) During 2006-07, the tax revenue of the 31 VAT State/UTs had collectively registered a growth rate of about 21 per cent over the tax revenue of 2005-06. This indicates that the VAT system is gradually stabilizing and has started yielding the desired results.

Table 3.13 Release of funds under VAT compensation package

(Rs. Crore)

Year	Claims received	No. of States	Release in 2005-06	Release in 2006-07	Release in 2007-08	Balance
2005-06	6942.9	10	2471.3	3696.2	597.9	177.5
2006-07	4334.1	9	-	395.9	896.3	3041.9
2007-08	1890.3	2	-	-	1190.0	700.3

Source : Ministry of Finance, Department of Revenue.

(iii) During 2007-08, the tax revenue of 32 VAT States/UTs showed a further growth of 14.6 per cent during the first six months of 2007-08 (April-September) as compared to the corresponding period of last year.

Status of VAT compensation

3.61 The Central Government had announced a compensation package under which the States are compensated for any revenue loss on account of VAT introduction at the rate of 100 per cent of revenue loss during 2005-06, 75 per cent during 2006-07 and 50 per cent during 2007-08. Central Government has received claims totaling Rs. 13167.3 crore during 2005-06, 2006-07 and 2007-08 (January 31, 2008). It has already released Rs. 9247.6 crore and claims of the balance amount are in process (Table 3.13).

Central Sales Tax Reforms

3.62 It is generally agreed that the Central Sales Tax (CST), being an origin-based non-rebatable tax, is inconsistent with the concept of VAT and needs to be phased out. After deliberations with the Empowered Committee of States, the roadmap for this has been finalized, which provides for a gradual phase out by reducing the CST rate from its level of 4 per cent with effect from April 1, 2007, by 1 per cent every year, to be finally phased out completely by March 31, 2010. Accordingly, the rate has been reduced to 3 per cent with effect from April 1, 2007. This is due to be reduced further to 2 per cent with effect from April 1, 2008. One critical issue involved in phasing out of CST is that of compensating the States for revenue losses on account of such phase out. The scheme for compensation of CST revenue loss due to the reduction of CST rate to 3 per cent with effect from April 1, 2007 had been finalized in consultation with the Empowered Committee of States. During 2007-08 (BE), total amount of Rs. 2,500 crore has been provided for compensating the States/UTs. Claims for total amount of Rs. 1,865.9 crore have been received from 9 States as on January 31, 2008. Out of this, an amount of Rs. 876.05 crore has been released and for the balance amount of Rs. 992.8 crore, the claims are under process.

Planning to introduce goods & services tax

3.63 To avoid double taxation and tax cascading and have a simple and progressive taxation system for goods as well as services, it is proposed to introduce a combined national level goods and services tax (GST). This is similar in concept to State VAT for goods. It provides for input tax credit at every stage for tax already paid till the previous transaction. This will also attempt to provide a rational system by subsuming several State and Central level indirect taxes on goods and services. The design and roadmap for this is being finalized in consultation with the Empowered Committee of States. This is targeted to be introduced with effect from April 1, 2010.