Finances of state governments

3.57 The combined finances of the states, which had exhibited a somewhat intractable negative trait earlier, showed a dramatic turnaround in 2005-06 with the level of fiscal deficit ruling well below the target of 3.0 per cent of GDP mandated to be achieved three years later. Three important factors attributable to this included the award of the Twelfth Finance Commission in terms of grants and the incentive scheme of debt consolidation and waiver linked to fiscal consolidation under fiscal rules, revenue buoyancy of the Centre and the introduction of state-level VAT, which proved to be a very buoyant source for states. As a proportion of GDP, combined gross fiscal deficit of the states fell to a level of 2.5 per cent in 2005-06-the first year of the award of the Twelfth Finance Commission and revenue deficit was limited to a level of 0.2 per cent (Figure 3.10). A revenue surplus of Rs. 24,856 crore in 2006-07 accompanied by the level of fiscal deficit at 1.9 per cent of GDP meant that collectively states recorded outstanding performance in terms of fiscal consolidation.

3.58 The introduction of state-level VAT had led to improved performance in terms of the states' own tax effort collectively, which grew in excess of 16 per cent in all the three years (2005-06 to 2007-08). Besides, non-tax revenues had also risen sizeably (Table 3.11). Simultaneously, there has been a compression in expenditure (as a proportion of GDP) in both revenue and capital accounts. In terms of the classification of development and non-development expenditure (adopted by the RBI in its publication "State Finances: A Study of Budgets 2008-09") as a proportion of GDP, development expenditure rose from a level of 9.2 per cent in 2005-06 to a level of 10.5 per cent in 2007-08 (RE) and non-development expenditure declined marginally from a level of 5.3 per cent to 5.1 per cent. The share of social sector expenditure in total expenditure of the states, which had exhibited a sharp decline in the period 1999-2000 to 2003-04, rose in the recent years. As a proportion of GDP, social sector expenditure rose from a level of 5.1 per cent of GDP to reach 6.3 per cent of GDP in 2008-09 (BE). While the states had posted an impressive record in terms of the aggregate fiscal indicators, there are variations in the levels of fiscal consolidation across states. The RE for 2007-08 for states indicated that 13 states (non-special category) had achieved revenue surpluses with Bihar achieving the highest revenue surplus at 3.6 per cent of GSDP. Besides, nine states achieved the target of limiting their gross fiscal deficit to 3.0 per cent of GSDP in 2007-08 (RE).

State level reforms

3.59 The process of rule-based fiscal reforms began with the state of Karnataka putting in place the first fiscal responsibility legislation prior to the Centre's FRBMA (enacted in August 2003). So far 26 out of 28 states have enacted FRBMAs. Sikkim and West Bengal are yet to enact FRBMAs. Thus, the pace of fiscal adjustment and correction at state level has gained further momentum.

3.60 The Debt Consolidation and Relief Facility (DCRF), formulated as per the recommendations of the Twelfth Finance Commission (TFC), has two components: consolidation of Central loans (from Ministry of Finance); and debt waiver. So far, Central loans to 25 out of 28 states have been consolidated to the extent of Rs. 1,13,596 crore. The most recent consolidation was that of Jammu & Kashmir on 24.4.2009. Debt consolidation provided interest relief to these 25 states to the extent of Rs. 4,392 crore, Rs. 3,995 crore, Rs. 3,903 crore and Rs. 3,398 crore in 2005-06, 2006-07, 2007-08 and 2008-09 respectively as against TFC's estimation of Rs. 4,711.5 crore, Rs. 4,375.0 crore, Rs. 3,937.8 crore, and Rs. 3,445.4 crore. The difference is due to the fact that consolidations have been carried out for these states over three years as and when

Figure 3.10 : Revenue and fiscal deficit of states

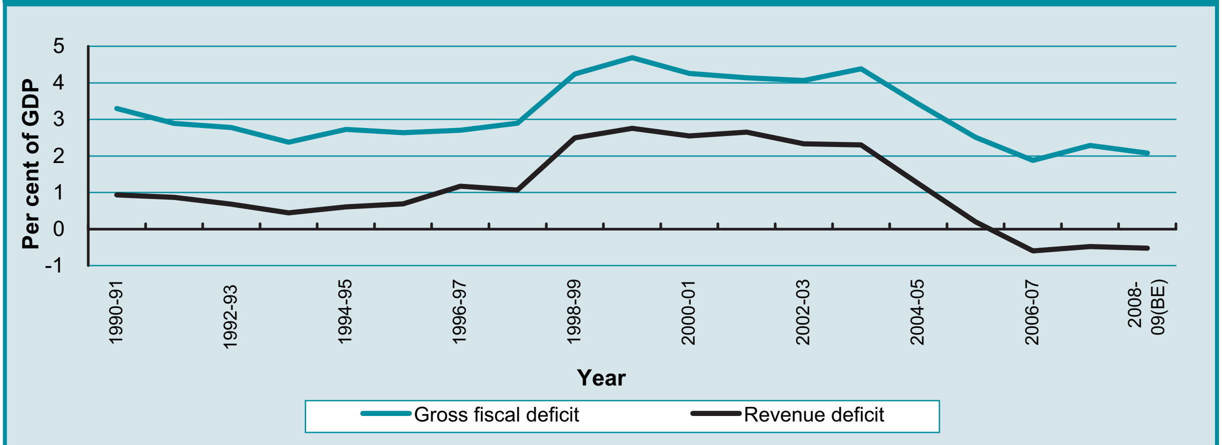

Table 3.11 : Receipts and disbursements of State Governments[a]

	2003-04	2004-05	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
			(Rs crore)			
I. Total receipts(A+B)	**5,14,829**	**5,63,661**	**5,95,629**	**6,73,604**	**7,63,377**	**8,95,141**
A. Revenue receipts (1+2)	3,09,187	3,63,513	4,31,022	5,30,555	6,28,742	7,19,835
1. Tax receipts of which	2,21,115	2,60,577	3,06,332	3,72,841	4,41,526	5,09,957
State's own tax revenue	1,54,037	1,82,027	2,12,307	2,52,548	2,93,392	3,36,810
2. Non-tax receipts of which:	88,072	1,02,936	1,24,690	1,57,714	1,87,216	2,09,878
Interest receipts	7,748	8,648	9,380	11,825	13,041	12,686
B. Capital receipts of which:	2,05,642	2,00,148	1,64,607	1,43,049	1,34,635	1,75,306
Recovery of loans & advances	16,158	8,039	8,904	7,579	6,212	5,172
II. Total disbursements(a+b+c)	**5,14,303**	**5,53,427**	**5,61,682**	**6,57,281**	**7,87,489**	**8,92,783**
a) Revenue	3,72,594	4,02,670	4,38,034	5,05,699	6,06,216	6,91,409
b) Capital	1,19,899	1,34,235	1,09,224	1,37,793	1,64,507	1,85,282
c) Loans and advances	21,810	16,522	14,424	13,789	16,766	16,092
III. Revenue deficit	**63,406**	**39,157**	**7,012**	**-24,856**	**-22,526**	**-28,426**
IV. Gross fiscal deficit	**1,20,631**	**1,07,774**	**90,084**	**77,508**	**1,07,958**	**1,12,653**
			(As per cent of GDP)			
I. Total receipts(A+B)	**18.7**	**17.9**	**16.6**	**16.3**	**16.2**	**16.8**
A. Revenue receipts (1+2)	11.2	11.5	12.0	12.8	13.3	13.5
1. Tax receipts	8.0	8.3	8.5	9.0	9.3	9.6
of which						
State's own tax revenue	5.6	5.8	5.9	6.1	6.2	6.3
2. Non-tax receipts of which:	3.2	3.3	3.5	3.8	4.0	3.9
Interest receipts	0.3	0.3	0.3	0.3	0.3	0.2
B. Capital receipts of which:	7.5	6.4	4.6	3.5	2.9	3.3
Recovery of loans & advances	0.6	0.3	0.2	0.2	0.1	0.1
II. Total disbursements(a+b+c)	**18.7**	**17.6**	**15.7**	**15.9**	**16.7**	**16.8**
a) Revenue	13.5	12.8	12.2	12.2	12.8	13.0
b) Capital	4.4	4.3	3.0	3.3	3.5	3.5
c) Loans and advances	0.8	0.5	0.4	0.3	0.4	0.3
III. Revenue deficit	**2.3**	**1.2**	**0.2**	**-0.6**	**-0.5**	**-0.5**
IV. Gross fiscal deficit	**4.4**	**3.4**	**2.5**	**1.9**	**2.3**	**2.1**

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 National Accounts 1999-2000 series.
2. Capital receipts include public accounts on a net basis.
3. Capital disbursements are exclusive of public accounts.
4. Negative (-) sign indicates surplus in deficit indicators.

FRBMAs were enacted in line with the recommendations laid down by the TFC in this regard. The second component of DCRF is debt waiver for 2005-06, consolidated debt of 15 states amounting to Rs. 3,984.4 crore was waived; for 2006-07 debt of 20 states to the extent of Rs. 4,691.6 crore was waived; and for 2007-08, debt of 18 states was waived to the extent of Rs. 4,609.6 crore. In 2008-09, 23 states are estimated to get debt waiver to the tune of Rs. 5,536.6 crore. Debt consolidation and waiver have facilitated the achievement targets of revenue deficit elimination and containing fiscal deficit to GSDP ratio at 3 per cent well ahead of 2008-09 as mentioned above. The states together have maintained the aggregate fiscal deficit within the overall borrowing ceiling fixed by the Centre in the years from 2005-06 to 2008-09. Some part of the improved fiscal position owes to the state level reforms, particularly the introduction of the state-level VAT.

Value added tax (VAT)

3.61 The Empowered Committee (EC) of State Finance Ministers is constantly reviewing the progress of implementation of VAT. The progress made in the last three years is as under:

- During 2006-07, the tax revenue of the 31 VAT implementing states/UTs had collectively registered a growth rate of about 21 per cent over the tax revenue of 2005-06 indicating that the VAT system was gradually stabilizing and had started yielding the desired results.
- During 2007-08, the tax revenue growth in 33 VAT states/UTs over the tax revenue of 2006-07, which included a growth of about 24 per cent in the revenue from VAT items.
- During 2008-09, the provisional growth registered in the tax revenue of 33 VAT states/UTs for the period April-December 2008, has been 19.1 per cent over the corresponding period in financial year 2007-08.

3.62 Under the extant compensation scheme of the Central Government whereby 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, claims admissible for these years totalled Rs. 16,349.5 crore as on March 31, 2009. A sum of Rs. 14,805.8 crore has already been released and balance claims are in process.

Central sales tax reforms

3.63 CST, being an origin-based non-rebatable tax, is incongruent with the system of VAT. After deliberations with the Empowered Committee of States, the road map for phasing out CST entailed reducing the CST rate by 1 per cent every year so as to eliminate it coincidental with the introduction of goods and services tax (GST) (Box 3.2). One critical issue involved in phasing out of CST has been that of compensating the states for the resultant

Box 3.2 : Goods and services tax

Over the past several years, significant progress has been made to improve indirect tax structure, broaden the base and rationalize the rates.

Notable among the improvements made are:

- Replacement of the single-point state sales taxes by the VAT in all of the states and union territories.
- Reduction in the central sales tax rate to 2 per cent, from 4 per cent, as part of a complete phase out of the tax.
- Introduction of service tax by the Centre, and a substantial expansion of its base over the years.
- Rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad valorem rates based on the maximum retail price (MRP) of the products.

These changes have yielded significant dividends in economic efficiency of the tax system, ease of compliance, and growth in revenues. The state VAT eliminated all of the complexities associated with the application of sales taxes at the first point of sale. The consensus reached among the states for uniformity in the VAT rates has largly brought an end to the harmful tax competition among them. It has also lessened the cascading of tax. The application of CENVAT at fewer rates and the new system of CENVAT credits has likewise resulted in fewer classification disputes, reduced tax cascading, and greater neutrality of the tax. The design of the CENVAT and state VATs was dictated by the constraints imposed by the Constitution, with neither the Centre nor the states being able to levy taxes on a comprehensive base of all goods and services and at all points in their supply chain.

In spite of the improvements made in the tax design and administration over the past few years, the systems at both Central and state levels still remain complex. The most significant cause of complexity is, of course, policy related and is due to the existence of exemptions and multiple rates, and the extant structure of the levies. These deficiencies are the most glaring in the case of CENVAT and the service tax. The starting base for the CENVAT is narrow, and is being further eroded by a variety of area-specific, and conditional and unconditional exemptions. The introduction of goods and services tax (GST) would thus be opportune for deepening the reform process already underway. The principal broad-based consumption taxes that the GST would replace are the CENVAT and the service tax levied by the Centre and the VAT levied by the states. All these are multi-stage value-added taxes.

In defining options for reform, the starting point is the basic structure of the tax. The Empowered Committee of State Finance Ministers in November 2007 had recommended a "dual" GST, to be levied concurrently by both levels of government. The dual GST option strikes a good balance between fiscal autonomy of the Centre and states, and the need for harmonization. It empowers both levels of government to apply the tax to a comprehensive base of goods and services, at all points in the supply chain. It also eliminates tax cascading, which occurs because of truncated or partial application of the Centre and state taxes.

Source: 1. Satya Poddar and Ehtisham Ahmad (2008) : "GST Reforms and Intergovernmental Considerations in India", Dept. of Economic Affairs' Working Paper, Ministry of Finance

2. Department of Revenue, Ministry of Finance

revenue losses. The scheme finalized in consultation with the Empowered Committee of State Finance Ministers (EC) provides for new revenue generating measures for states as the primary source of compensation. It also provides for meeting 100 per cent of the residuary losses to a state, if any thereafter, through the budgetary resources of the Centre. Central Government has received claims admissible for 2007-08 and 2008-09, totaling Rs. 5,017.0 crore till March 31, 2009. A sum of Rs. 4,118.9 crore has been released and balance claims are in process. The phasing out of the CST facilitates the introduction of a GST.

3.64 The report of the task force "Towards Implementation of the FRBM Act (June 2004)" identified the introduction of GST as a major policy reform measure. The GST would facilitate greater vertical equity in fiscal federalism, reduce cascading nature of commodity taxes and through shift to value addition as the basis for assessment unify the market for goods and services. The budget for 2006-07 indicated that GST could possibly commence from the financial year 2010-11. The introduction of GST would entail a restructuring of state VAT and central excise and as such involves a degree of coordination and due process of consultation with various stakeholders. The EC (which was instrumental in the operationalization of state level VAT) in consultation with the Central Government has initiated the process in May 2007 through the constitution of a Joint Working Group (JWG) consisting of officers of the Centre and State Governments to examine the various models and options for GST for the EC to take a view. The JWG presented its report to the EC on November 19, 2007. The EC has sent its recommendations to the Government of India in the form of "A Model and Road Map for Goods and Services Tax in India" dated April 30, 2008, which includes outline of the GST design proposed. The views of the EC are being examined in the Ministry.

Consolidated General Government

3.65 The growth dividend that the economy reaped in the period 2003-04 to 2007-08 was in large measure due to the improvement in the fiscal health of the consolidated General Government (Centre and states combined). As a proportion of GDP, receipts of the consolidated General Government rose from a level of 15.0 per cent in 2003-04 to 18.5 per cent in 2007-08 (RE) (Table 3.12). It was budgeted at 19.1 per cent in BE 2008-09. With non-tax receipts to GDP ratio remaining more or less static, this translated into higher revenue receipts (Figure 3.11). With total disbursement remaining more or less same levels in 2007-08 (RE), the combined revenue and fiscal deficit came down.

Figure 3.11 : Combined (centre and state) revenue and fiscal deficit

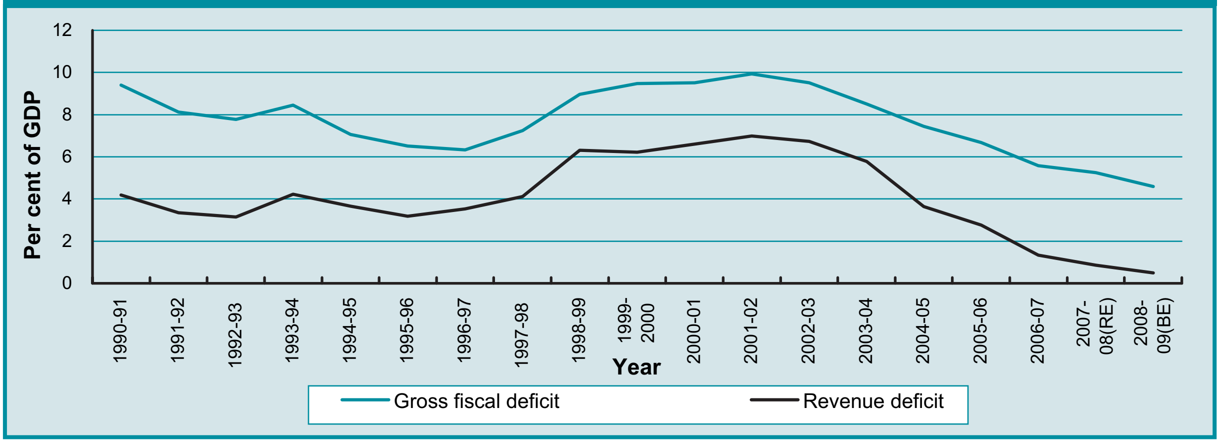

Table 3.12 : Receipts and disbursements of consolidated General Government

	2003-04	2004-05	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
			(Rs crore)			
I. Total receipts (A+B)	7,99,162	8,88,345	10,14,689	11,25,499	13,31,721	14,87,893
A. Revenue receipts (1+2)	5,18,611	6,15,644	7,07,054	8,77,075	10,55,165	12,08,803
1. Tax receipts	4,13,981	4,92,481	5,76,596	7,24,023	8,73,299	10,17,107
2. Non-tax receipts of which	1,04,630	1,23,163	1,30,458	1,53,052	1,81,866	1,91,696
Interest receipts	18,856	19,223	18,735	21,744	19,392	20,108
B. Capital receipts of which:	2,80,551	2,72,701	3,07,635	2,48,424	2,76,556	2,79,090
a) Disinvestment proceeds	16,952	4,424	1,590	2,440	44,525	25,165
b) Recovery of loans & advances	26,318	14,968	11,651	-773	8,309	7,106
II. Total disbursements (a+b+c)	7,96,383	8,69,757	9,59,855	11,09,174	13,55,831	14,85,536
a) Revenue	6,78,019	7,30,405	8,06,366	9,32,441	10,96,124	12,35,562
b) Capital	86,673	1,13,304	1,32,585	1,57,316	2,38,126	2,29,681
c) Loans and advances	31,691	26,048	20,904	19,417	21,581	20,293
III. Revenue deficit	1,59,408	1,14,761	99,312	55,366	40,959	26,759
IV. Gross fiscal deficit	2,34,501	2,34,721	2,39,560	2,30,432	2,47,832	2,44,462
			(As per cent of GDP)			
I. Total receipts (A+B)	29.0	28.2	28.3	27.3	28.2	28.0
A. Revenue receipts (1+2)	18.8	19.5	19.7	21.2	22.3	22.7
1. Tax receipts	15.0	15.6	16.1	17.5	18.5	19.1
2. Non-tax receipts of which	3.8	3.9	3.6	3.7	3.9	3.6
Interest receipts	0.7	0.6	0.5	0.5	0.4	0.4
B. Capital receipts of which:	10.2	8.7	8.6	6.0	5.9	5.2
a) Disinvestment proceeds	0.6	0.1	0.0	0.1	0.9	0.5
b) Recovery of loans & advances	1.0	0.5	0.3	0.0	0.2	0.1
II. Total disbursements (a+b+c)	28.9	27.6	26.8	26.9	28.7	27.9
a) Revenue	24.6	23.2	22.5	22.6	23.2	23.2
b) Capital	3.1	3.6	3.7	3.8	5.0	4.3
c) Loans and advances	1.2	0.8	0.6	0.5	0.5	0.4
III. Revenue deficit	5.8	3.6	2.8	1.3	0.9	0.5
IV. Gross fiscal deficit	8.5	7.5	6.7	5.6	5.2	4.6

Source : Reserve Bank of India

Note : The ratios to GDP at current market prices are based on CSO's National Accounts 1999-2000 series.