Chapter 4

Review of Union and State Finances

Introduction

4.1 The post-2003-04 period witnessed a number of important developments which had a bearing on the public finances of the Centre as well as the states. The country entered a higher growth trajectory, marking a distinct break from the past. There was considerable improvement in revenue growth following the higher growth in the economy. The operationalisation of the Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre in 2004-05 ushered in an era of rule-based management of public finances. The introduction of Value Added Tax (VAT) by most states in 2005-06 considerably enhanced their tax base. Revenue augmentation by states was supplemented by the recommendations of the Twelfth Finance Commission (FC-XII), whereby the share of states in the net tax revenues of the Centre was raised from 29.5 per cent to 30.5 per cent. The Commission also recommended higher specific purpose grants to states. The benefit of the Debt Consolidation and Relief Facility (DCRF) recommended by the Commission was conditional on the states enacting Fiscal Responsibility Legislation (FRL). All states, with the exception of West Bengal and Sikkim, responded by enacting FRL. The DCRF, by linking the debt waiver to reduction of revenue deficit and containing fiscal deficit at least at the level of 2004-05, incentivised the states to undertake fiscal correction. The DCRF resulted in considerable relief to the states in terms of debt write-off and savings in interest payments on outstanding central loans.

4.2 Following these developments, there was considerable improvement in the finances of both the Centre and the states till 2007-08. The revenue deficit of the Centre declined from 3.57 per cent of Gross Domestic Product (GDP) in 2003-04 to 1.11 per cent in 2007-08. The Centre's fiscal deficit declined by 1.79 percentage points, to 2.69 per cent of GDP in the same period. The revenue account of the states recorded a surplus of 0.94 per cent of GDP in 2007-08 as compared to a deficit of 1.25 per cent of GDP in 2004-05. The aggregate fiscal deficits of the states declined by 1.89 percentage points, to 1.51 per cent of GDP over the same period. At the level of both the Centre and the states, fiscal consolidation was, to a considerable degree, enabled by enhanced tax effort and tax reforms.

4.3 The global downturn caused a sharp decline in GDP growth in 2008-09 and is likely to adversely affect growth prospects in 2009-10. GDP growth declined sharply to 6.7 per cent in 2008-09, from an average of 9.4 per cent in the preceding three years. Apart from the impact of international developments, the deficient south-west monsoon in 2009-10 has also been an adverse factor for growth. The Economic Advisory Council (EAC) to the Prime Minister puts the likely GDP growth in 2009-10 at about 6.5 per cent. The Reserve Bank of India (RBI) has forecast GDP growth in 2009-10 at 6 per cent, with an upward bias. The sharp decline in growth of the economy has triggered an expansionary fiscal stance by the Centre as a countercyclical measure. The Centre has put in place three fiscal stimulus packages in quick succession (December 2008, January 2009 and February 2009) comprising reduction in tax rates, enhancement of drawback rates for exports, extension of tax exemptions and additional allocations under the plan for Centrally Sponsored Schemes (CSS) like the National Rural

Employment Guarantee Scheme (NREGS). Implementation of the recommendations of the Sixth Central Pay Commission (CPC) by the Centre, farm debt waiver and additional provision of funds for food and fertiliser subsidies have added to the fiscal burden. These additional commitments, though not a part of the stimulus, have, nevertheless, served as fiscal stimulus to the economy. Collectively, these have meant a 'pause' in the implementation of the FRBMA by the Centre. The states, too, have been allowed a relaxation in their fiscal and revenue deficit targets.

4.4 The current expansionary fiscal stance must also be seen against the requirement in our Terms of Reference (ToR) that we consider the need to improve the quality of public expenditure to obtain better outputs and outcomes while formulating our recommendations. Increased expenditure by the government must also lead to superior outcomes through higher productivity, enhanced efficiency and greater effectiveness. While equity considerations have dominated the devolution debate in the past, recent Finance Commissions have also incorporated the efficiency criterion in their recommendations. This has, however, mostly been linked to raising of revenue and the extent of fiscal correction undertaken. Taking this initiative forward, linking efficiency and effectiveness of public expenditures to the quality of service delivery and achievement of desirable outcomes remains a major challenge.

4.5 Aganist the above backdrop, we analyze and examine below the trends in the finances of the Centre and states as a prelude to the formulation of our views on the vertical and horizontal distribution of resources.

Review of Central Finances

4.6 In the first instance, aggregate trends in central finances are analyzed in terms of deficit indicators. These are revenue, fiscal and primary deficits. Deficits matter as they signal the impact of changes in public finances on debt sustainability. As the fiscal indicators will be analyzed in relation to the targets set under the FRBMA, a brief description of the FRBMA is in order. Faced with persistent fiscal problems, manifested in the form of increasing revenue and fiscal deficits, the Central Government enacted the FRBMA in 2003, which was brought into force from 5 July 2004. In addition to stipulating ceilings on fiscal indicators, the legislation laid down fiscal management principles combining fiscal transparency, budget integrity and accountability. The main obligations of the Centre under the FRBMA 2003 and FRBM Rules 2004, as amended through the Finance Act, 2004 are as follows:

i) Eliminating revenue deficit by 2008-09 by ensuring a minimum annual reduction of 0.5 per cent of GDP every year from 2004-05.

ii) Reducting fiscal deficit by at least 0.3 per cent of GDP annually from 2004-05, so that fiscal deficit is reduced to no more than 3 per cent of GDP at the end of 2008-09.

iii) Limiting government guarantees to 0.5 per cent of GDP in any financial year and limiting additional liabilities to 9 per cent of GDP in 2004-05 and thereafter reducing the limit of 9 per cent by one percentage point of GDP in each subsequent year.

iv) Central Government not to borrow from the Reserve Bank of India from 2006-07.

v) Disclosing specified information, such as arrears of revenue, government assets and guarantees, latest from 2006-07.

vi) Undertaking quarterly review of receipts and expenditure.

4.7 Table 4.1 presents a profile of the fiscal indicators of the Central Government from 2003-04 onwards. Originally, the FRBMA mandated that the revenue deficit should be eliminated and fiscal deficit contained at 3 per cent of GDP by March 2008. In 2004, the target was shifted to March 2009 by an amendment of the Act. The annual deficit reduction targets could not be adhered to in 2005-06 as the Centre pressed the 'pause button' to accommodate the higher transfers recommended by FC-XII. The revenue deficit of the Centre declined to 1.11 per cent of GDP in 2007-08, its lowest level since 1990-91. In 2008-09, there was a total reversal of fiscal correction with the revenue deficit reaching a level of 4.53 per cent of GDP. The Union Budget for

Table 4.1: Centre: Profile of Fiscal Indicators

(*per cent of GDP*)

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Ratio of Revenue to Fiscal Deficit (%)
2003-04	4.48	3.57	-0.03	79.71
2004-05	3.98	2.49	-0.05	62.57
2005-06	4.08	2.57	0.38	63.03
2006-07	3.45	1.94	-0.19	56.27
2007-08	2.69	1.11	-0.93	41.42
2008-09 (RE)	6.14	4.53	2.51	73.89
2009-10 (BE)	6.85	4.83	3.00	70.51

Note: Minus (-) sign indicates 'surplus'.
Source: Basic data from Central Budget documents

2009-10, which was formulated against the backdrop of the global downturn and subdued domestic demand, envisaged a revenue deficit of 4.83 per cent of GDP.

4.8 The fiscal deficit of the Centre declined from 4.48 per cent of GDP in 2003-04 to 2.69 per cent in 2007-08, the lowest since 1990-91.There was a reversal of the declining trend in 2008-09, with the fiscal deficit ballooning to 6.14 per cent of GDP. For 2009-10, it has been budgeted at 6.85 per cent of GDP. The reasons for the reversal of fiscal correction in 2008-09 have been alluded to in Para 4.3. The reversal of fiscal correction was not entirely on account of the fiscal stimulus measures. Pay revision, farm debt waiver and additional expenditure on food and fertiliser subsidies have added substantially to the fiscal burden. Much of the deterioration in fiscal indicators observed in 2008-09 was on account of these additional expenditure commitments. The EAC, in its Economic Outlook for 2009/10, has placed the deficit on account of reduction in tax revenue due to economic slowdown as well as the tax cuts in excise and service taxes effected as part of the fiscal stimulus at about 1 per cent of GDP. The fiscal deficit figures presented in Table 4.1 do not take into account the off-budget bonds issued to the oil marketing and fertiliser companies amounting to Rs. 95,942 crore or 1.8 per cent of GDP in 2008-09.

4.9 The primary balance which turned into a marginal surplus in 2003-04 continued to remain in surplus till 2007-08 with the exception of 2005-06. The year 2008-09 witnessed a sharp increase in primary deficit to 2.51 per cent of GDP. It is budgeted at 3 per cent of GDP in 2009-10, the highest in the post-reform period. Primary deficits add to the debt-GDP ratio unless GDP growth is higher than the interest rate on public debt.

4.10 The ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowings are used to meet current expenditure, declined from nearly 80 per cent in 2003-04 to 41.42 per cent by 2007-08. However, this proportion went back to nearly 74 per cent in 2008-09 (RE). Thus, a review of the fiscal situation reveals that all fiscal indicators, after registering an improvement in the years following the enactment of the FRBMA, have witnessed sharp deterioration in 2008-09 and 2009-10. The Union Government has expressed its intention to return to the FRBM path of fiscal correction at the earliest, as soon as the negative effects of the global crisis on the Indian economy have been overcome. We have been asked to revisit the roadmap of fiscal adjustment and suggest a suitably revised roadmap factoring in the need to bring the liabilities of the Central Government on account of oil, food and fertiliser bonds into fiscal accounting as well as the impact of various other obligations on deficit targets with a view to maintaining the gains of fiscal consolidation through 2010-15.

4.11 Table 4.2 shows the sources of correction in central finances between 2003-04 and 2007-08. Between 2003-04 and 2007-08, the revenue deficit of the Centre declined by 2.46 percentage points of GDP. Much of this decline came from an improvement in tax revenues. The marginal decline in revenue expenditure of the Centre was entirely on account of the decline in interest payments following softer interest rates. What also contributed to the reduction

Table 4.2: Fiscal Correction at the Centre: 2003-04 to 2007-08

(*per cent of GDP*)

	2003-04	2004-05	2005-06	2006-07	2007-08	Change 2007-08 over 2003-04	2008-09 (RE)	2009-10 (BE)
I Total Revenue Receipts (a+b)	9.58	9.72	9.69	10.52	11.47	1.89	10.56	10.49
a) Net Tax Revenue	6.79	7.14	7.54	8.50	9.31	2.52	8.76	8.10
b) Non Tax Revenue	2.79	2.58	2.15	2.02	2.17	-0.62	1.81	2.40
II Revenue Expenditure	13.14	12.20	12.26	12.46	12.58	-0.56	15.10	15.32
Of which: *Interest Payments*	4.50	4.03	3.70	3.64	3.62	-0.88	3.62	3.85
III Capital Expenditure	3.96	3.62	1.85	1.67	2.50	-1.46	1.83	2.11
IV Total Expenditure (II+III)	17.11	15.82	14.11	14.13	15.09	-2.02	16.93	17.43
V Revenue Deficit (II-I)	3.57	2.49	2.57	1.94	1.11	-2.46	4.53	4.83
VI Fiscal Deficit	4.48	3.98	4.08	3.45	2.69	-1.79	6.14	6.85
Memo Item: Non-debt Capital Receipts	3.05	2.11	0.34	0.16	0.93	-2.12	0.23	0.09

Source: Basic data from Central Budget documents

in fiscal deficit was compression of capital expenditure. Thus, the fiscal correction at the Centre was largely on account of revenue augmentation and partly on account of capital expenditure compression.

4.12 The outstanding liabilities of the Central Government, after reaching 63.33 per cent of GDP in 2004-05, started declining consistently (Table 4.3). This is because an economy can maintain a stable debt-GDP ratio and incur a primary deficit as long as the average nominal interest rate on debt is lower than the nominal GDP growth rate. This decline occurred even though a new component had been added to internal debt in 2004-05, which is not reflected in the fiscal deficit. The Government of India introduced the Market Stabilisation Scheme (MSS) in consultation with the RBI in April 2004. Under the scheme, the Government of India raises money through the issue of dated securities/treasury bills to absorb excess liquidity in the market on account of foreign inflows. The amount so raised was to be kept in a separate account with the RBI and was not meant to meet the expenditure needs of the government. Despite a sharp increase in the fiscal deficit in the years 2008-09 and 2009-10, a marginal decline in the ratio of outstanding debt to GDP is projected even in these two years.

4.13 Among the components of outstanding debt, there is an increase in the share of internal debt.

Table 4.3: Outstanding Liabilities of the Central Government

(*per cent of GDP*)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (RE)	2009-10 (BE)
I. Public Debt	39.58	41.37	43.20	44.01	43.12	42.45	41.45	39.74	40.66	40.14	42.60
Of which:											
a) Internal Debt	36.59	38.23	40.06	41.58	41.45	40.51	38.82	37.27	38.29	37.85	40.24
b) External Debt	2.99	3.14	3.14	2.43	1.67	1.93	2.63	2.48	2.37	2.29	2.35
II. Other Liabilities	12.72	14.22	16.75	19.51	19.92	20.88	21.68	21.49	19.41	18.79	17.09
Of which:											
Reserve Funds and Deposits	2.43	2.78	3.21	3.26	3.35	2.95	3.06	3.17	2.69	2.31	2.11
Total Liabilities (I+II)	**52.31**	**55.58**	**59.96**	**63.52**	**63.05**	**63.33**	**63.13**	**61.23**	**60.07**	**58.93**	**59.68**

Notes: 1. Balances of external debt are according to book value.

2. Other Liabilities include National Small Savings Funds, State Provident Funds, other accounts such as Special Deposits of Non-Government Provident Funds and Reserve Funds and Deposits.

Source: Basic data from Central Budget documents

Because of the developments unfolding since the global crisis, the Centre increased its net market borrowings sharply, from Rs. 1,31,768 crore in 2007-08 to Rs. 2,61,972 crore in 2008-09 and further to Rs. 3,97,957 crore in the budget estimates for 2009-10. Following the global downturn, the Memorandum of Understanding (MoU) signed with the RBI was amended in February 2009 to allow a part of the amount in the MSS account to be transferred to the Consolidated Fund of India as part of the government's normal market borrowing programme. Following this, an amount of Rs. 12,000 crore was transferred from the MSS account to the Consolidated Fund of the Centre in March 2009. A further amount of Rs. 28,000 crore raised through MSS was de-sequestered in May 2009.

Gross Tax Revenues of the Centre

4.14 Higher GDP growth coupled with better tax administration and introduction of new taxes such as the 'fringe benefit tax', has resulted in higher growth of tax revenues, particularly from 2004-05. The high buoyancy of direct tax revenues may be attributed substantially to improvement in tax compliance following the institution of the Tax Information Network (TIN) and its implementation by the National Securities Depository Ltd (NSDL). According to the report of the Comptroller and Auditor General of India (C&AG), in 2002-03 almost 80 per cent of the assessees for tax deduction at source (TDS) did not file returns. With the setting up of the TIN in January 2004, tax compliance has gone up significantly.

4.15 The gross tax-GDP ratio went up by over three percentage points in a span of four years, from 9.23 per cent in 2003-04 to 12.56 per cent in 2007-08 (Table 4.4). The entire improvement came from the buoyancy of direct taxes, more particularly from corporation tax, reflecting the increasing profitability of the Indian corporate sector. In fact, indirect tax-GDP ratio has remained stagnant between 5 and 6 per cent since the late nineties.

4.16 As a result of the higher growth of direct taxes, there has also been a shift in the composition of gross tax revenues of the Centre. For the first time in the history of public finances of the

Table 4.4: Major Taxes of the Centre: Performance since 2003-04

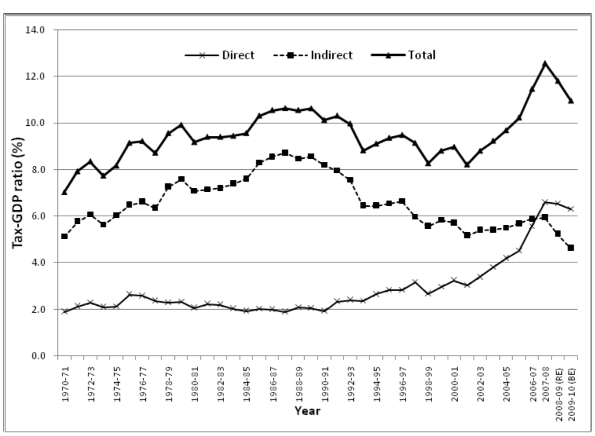
Year	Corporation Tax	Income Tax	Total Direct Taxes	Customs Duties	Union Excise Duties	Service Tax	Total Indirect Taxes	Total Central Tax Revenues (Gross)
				per cent of GDP				
2003-04	2.31	1.50	3.81	1.77	3.30	0.29	5.42	9.23
2004-05	2.63	1.56	4.22	1.83	3.15	0.45	5.47	9.68
2005-06	2.82	1.56	4.61	1.81	3.10	0.64	5.60	10.21
2006-07	3.50	1.82	5.57	2.09	2.85	0.91	5.89	11.47
2007-08	4.08	2.17	6.61	2.20	2.62	1.09	5.95	12.56
2008-09 (RE)	4.17	2.03	6.55	2.03	2.04	1.22	5.25	11.80
2009-10 (BE)	4.38	1.82	6.32	1.67	1.82	1.11	4.63	10.95
				per cent of Centre's Gross Tax Revenue				
2003-04	24.99	16.27	41.31	19.12	35.69	3.10	58.69	
2004-05	27.11	16.15	43.53	18.89	32.50	4.66	56.47	
2005-06	27.66	15.29	45.12	17.77	30.38	6.30	54.88	
2006-07	30.48	15.86	48.61	18.23	24.84	7.94	51.39	
2007-08	32.52	17.30	52.63	17.55	20.84	8.65	47.37	
2008-09 (RE)	35.35	17.20	55.48	17.20	17.26	10.35	44.52	
2009-10 (BE)	40.05	16.66	57.72	15.29	16.61	10.14	42.28	

Note: Total Direct Taxes and Total Indirect Taxes include Other Taxes.
Source : Basic data from Central Budget documents

country, direct taxes have overtaken indirect tax collections in the year 2007-08. This is a healthy development as direct taxes are more progressive than indirect taxes. From less than 20 per cent share in total tax revenues in 1990-91, the share of direct taxes has increased to over 55 per cent in 2008-09. Figure 4.1 shows the trends in growth of direct and indirect taxes as a proportion of GDP.

4.17 Within direct taxes, the share of corporation tax has increased from 24.99 per cent of gross tax revenue in 2003-04 to 35.35 per cent in 2008-09, an increase of over 10 percentage points. The share of income tax in gross tax revenue of the Centre witnessed a marginal increase from 16.27 per cent to 17.20 per cent in the same period. In the case of indirect taxes, while the share of custom duties in gross tax revenue declined marginally by nearly two percentage points between 2003-04 and 2008-09, the share of Union excise duties witnessed a sharp decline of over 18 percentage points. The sharp decline in the share of Union excise duties was largely on account of rate cuts, and in recent years, on account of the slowdown in the growth of the manufacturing sector. The share of indirect taxes would have fallen further but for the buoyant revenue from service tax. Service tax improved its share from 3.10 per cent in 2003-04 to 10.35 per cent in 2008-09. The increase in the share of service tax was on account of an increase in both coverage as well as tax rates.

Figure 4.1: Centre's Tax-GDP Ratio: Direct, Indirect and Total (1970-71 to 2009-10 (BE))



Trends in Non-tax Revenues

4.18 Non-tax revenue of the Centre mainly comprises interest receipts, dividends and profits from public sector undertakings including banks, and receipts from economic services. Non-tax revenues as a percentage of GDP have declined from 2.79 per cent in 2003-04 to 1.81 per cent in 2008-09 (Table 4.2). The decline is mainly on account of lower interest receipts from the states due to termination of the practice of on-lending to states, and interest relief as a result of the DCRF following the recommendations of FC-XII. The debt swap scheme under which the states swapped their high-cost outstanding debt to the Centre with low-cost market borrowings during 2002-05 also partly resulted in lower interest payments by the states. The share of interest receipts in the non-tax revenues of the Centre declined from over 50 per cent in 2003-04 to less than 20 per cent in 2008-09. Now the predominant share in non-tax revenues is accounted for by dividends and profits and economic services. The non-tax revenue-GDP ratio is budgeted to increase to 2.40 per cent in 2009-10. The bulk of improvement in this ratio is expected from the communication sector through the sale of 3-G spectrum. Exploitation of offshore oil and gas reserves is likely to further contribute to improvement in the non-tax revenues of the Centre.

Trends in the Centre's Expenditure

4.19 After registering a significant fall from 17.11 per cent of GDP in 2003-04 to 14.13 per cent of GDP in 2006-07, total expenditure of the Central Government rose to a level of 16.93 per cent of GDP in 2008-09. The fall in the ratio of total expenditure to GDP came mostly from a reduction in capital expenditure. Capital expenditure of the Centre, which declined from 3.96 per cent of GDP in 2003-04 to 1.67 per cent of GDP in 2006-07, rose to 2.50 per cent of GDP in 2007-08 (Table 4.5). This improvement was mainly the result of an increase in the non-plan capital outlay to acquire RBI's stake in the State Bank of India. Thereafter, capital expenditure declined to about 2 per cent of GDP in 2008-09.

Table 4.5: Trends in Central Government Expenditure

(*per cent of GDP*)

Year	Revenue Expenditure	Interest Payments	Defence	Pay and Allowances	Pensions	Subsidies	Capital Expenditure	Total Expenditure
2003-04	13.14	4.50	2.18	1.21	0.58	1.61	3.96	17.11
2004-05	12.20	4.03	2.41	1.16	0.58	1.46	3.62	15.82
2005-06	12.25	3.70	2.25	1.08	0.56	1.32	1.85	14.10
2006-07	12.46	3.64	2.07	1.00	0.54	1.38	1.67	14.13
2007-08	12.58	3.62	1.94	0.97	0.51	1.50	2.50	15.09
2008-09 (RE)	15.10	3.62	2.15	1.33	0.61	2.43	1.83	16.93
2009-10 (BE)	15.32	3.85	2.42	1.50	0.60	1.90	2.11	17.43

Source : Basic data from Central Budget documents

4.20 Expenditure on interest payments, defence, pay and allowances and subsidies are the main components of the Centre's revenue expenditure, accounting for about 63 per cent of the total. While the proportion of expenditure on interest payments to GDP has shown a marginal decline because of the low interest rate regime, expenditure on defence has remained at more than 2 per cent of GDP in almost all the years since 2003-04. Expenditure on pay and allowances of Central Government employees excluding defence personnel, after moderating from 1.21 per cent of GDP in 2003-04 to 0.97 per cent of GDP in 2007-08, jumped to 1.33 per cent of GDP in 2008-09 and is estimated to go up even further to 1.50 per cent in 2009-10, the highest since 2000-01. The increase in the ratio of pay and allowances is mainly due to the implementation of the recommendations of the Sixth CPC and payment of 40 per cent of the arrears in 2008-09 and 60 per cent in 2009-10. Expenditure on pay and allowances may moderate in the coming years with the tapering off of the effect of payment of arrears.

4.21 Expenditure on explicit subsidies is the third largest item of revenue expenditure after interest payments and defence. Food and fertiliser subsidies are the main explicit subsidies provided by the Centre. Though the administered price mechanism for petroleum products was dismantled, explicit subsidies are provided in the Central Budget for kerosene and cooking gas. Explicit subsidies as a proportion GDP, after moderating from 2004-05 to 2007-08, have been rising since then due to the firming up of commodity prices, particularly those of food, fuel and fertiliser.

4.22 Table 4.6 presents trends in major explicit subsidies as a proportion of the Centre's revenue receipts. Food subsidy is the difference between the procurement prices and carrying costs of food grains and the issue price for the public distribution system. Expenditure on food subsidy as a proportion of total revenue receipts of the Centre witnessed some moderation between 2004-05 and 2006-07. However, thereafter there was a steep rise in the food subsidy to Rs. 43,627 crore in 2008-09 from the previous year's level of Rs. 31,328 crore. This increase was on account of the increase in the minimum support prices of food grains as well as the quantum of food grains procured. Procurement of rice went up from 26.3 million tonnes in 2007-08 to 32.8 million tonnes in 2008-09, while that of wheat more than doubled from 11.1 million tonnes to 22.7 million tonnes in the corresponding period. Further, procurement and carrying costs have increased, but the issue price has remained unchanged since 1 July 2002. These developments were reflected in the increase in expenditure on food subsidy from 5.78 per cent of total revenue receipts of the Centre in 2007-08 to 7.76 per cent in 2008-09. It is budgeted to go up further to 8.54 per cent of revenue receipts in 2009-10. Andhra

Table 4.6: Explicit Subsidies Relative to the Centre's Revenue Receipts

(*per cent*)

Year	Food	Fertiliser	Others	Total
2003-04	9.55	4.49	2.77	16.80
2004-05	8.43	5.19	1.40	15.02
2005-06	6.67	5.34	1.73	13.74
2006-07	5.53	6.04	1.59	13.15
2007-08	5.78	6.00	1.31	13.09
2008-09 (RE)	7.76	13.49	1.74	22.99
2009-10 (BE)	8.54	8.13	1.43	18.11

Source : Basic data from Central Budget documents

Pradesh, Haryana, Punjab and Uttar Pradesh together accounted for 69.5 per cent of the rice procured in the Kharif season 2007-08, while Haryana and Punjab alone accounted for 91.1 per cent of wheat procured in the Rabi season of 2007-08.

4.23 The second largest explicit subsidy is that on fertilisers, which was in the range of 5-6 per cent of revenue receipts between 2004-05 and 2007-08, but shot up to 13.49 per cent in 2008-09. In absolute terms, fertiliser subsidy increased from Rs. 32,490 crore in 2007-08 to Rs. 75,849 crore in 2008-09. The subsidy is designed to provide fertilisers to farmers at a fixed maximum retail price (MRP), a price that is administratively set, and varies by the type of fertiliser. This dispensation has completely discouraged fresh investment in indigenous production of fertilisers, and the cost-plus formula carries little incentive for improved production efficiency. Stagnant domestic production has resulted in increasing import dependence over time. India, as a major importer with a commitment to providing subsidised fertiliser at a fixed price, has in turn, been at the mercy of an international fertiliser oligopoly. The subsidy has risen explosively because the subsidised price has not been revised since 2001, whereas the prices of inputs into fertiliser production as also of fertiser imports, have risen substantially, exacerbated by the adverse international market structure. Further, despite the rising subsidy bill, use of fertilisers has not brought about a commensurate increase in agricultural productivity. On the contrary, the price pattern has had a distortionary impact on the pattern of nutrient application, resulting in declining fertiliser response ratios.

4.24 The explicit subsidies reported in the budget of the Central Government do not include off-budget bonds issued to oil marketing and fertiliser companies. Though the administered price mechanism for petroleum products was discontinued, there is still no deregulation of petroleum product prices. International price of crude increased from an average of US $38 per barrel in 2004 to US $54 per barrel in 2005, and further to US $70 per barrel in April-June, 2006. This was followed by a sharp increase in the price of crude to US $147 per barrel in July 2008. Linked with this increase in crude prices there was also a significant increase in the prices of fertiliser imports. In order to partly compensate the oil marketing companies selling petroleum products at government determined prices, the Centre has started issuing bonds to oil companies. The value of oil bonds, which amounted to about 0.50 per cent of GDP in the years 2005-06 to 2007-08, has shot up to 1.43 per cent of GDP in 2008-09. Oil bonds do not fully reflect the extent of subsidy on petroleum products. Upstream oil companies and oil marketing companies share a part of the under-recoveries on petroleum products. The practice of issuing off-budget bonds to fertiliser companies started in 2007-08. Fertiliser bonds as a percentage of GDP increased from 0.16 per cent of GDP in 2007-08 to 0.38 per cent of GDP in 2008-09. Taking into account the off-budget bonds issued to oil marketing and fertiliser companies and to other institutions, the augmented revenue and fiscal deficit would work out to 6.34 and 7.99 per cent of GDP, respectively, in 2008-09.

4.25 A study sponsored by us and carried out by the National Institute of Public Finance and Policy (NIPFP) shows the regressive nature of all major explicit subsidies on food, fertiliser and petroleum products. Per capita explicit subsidies received in the poorer states of Bihar, Jharkhand, Madhya Pradesh, Orissa and Uttar Pradesh are found to be much lower as compared to the average for all states. Despite inherent defects in the subsidy regime, reforms have remained a major policy challenge. Subsidies differ from other components of public expenditure, which target provision of public goods like defence. Subsidies variously support private consumption and/or production inputs in a manner such that their incidence is difficult to quantify. Unless the subsidies are pruned and better targeted, investment in public infrastructure will suffer. As regards oil subsidy, continuation of the present system of insulating domestic consumers against rising international prices will be a drag on the fiscal situation of the country and goes against the tenets of conservation.

Oil subsidy, besides disproportionately benefiting the more developed states, has negative effects on the environment.

Summary

4.26 To sum up, the following are the main trends in the Centre's finances in recent years:

i) The fiscal correction path, following the enactment of FRBMA was more or less on track till 2007-08, after a pause in 2005-06. A number of developments, particularly the slowdown of the economy and its adverse impact on revenue growth, increasing commodity prices, anti-recessionary measures, farm loan waiver and implementation of the recommendations of the Sixth CPC, have resulted in a worsening, going beyond the reversal of the fiscal correction achieved till 2007-08.

ii) Despite deterioration in all fiscal indicators in 2008-09 and 2009-10, the debt-GDP ratio remained stable, or even declined marginally. This was because of the growth of nominal GDP remaining higher than the average nominal interest rate.

iii) Though the tax-GDP ratio has come down in 2008-09, it is still higher than the level reached in 2004-05. The fall in the aggregate tax-GDP ratio in 2008-09 would have been sharper but for buoyant revenues from corporation tax and service tax. There has been a continuous increase in the tax-GDP ratios of these taxes till 2008-09. While the tax-GDP ratio in respect of corporation tax is expected to be maintained even in 2009-10, that of service tax is expected to witness a marginal fall. With buoyant revenues from corporation tax, revenue from direct taxes has, for the first time, overtaken that from indirect taxes in 2007-08.

iv) Total expenditure of the Centre relative to GDP witnessed a significant contraction between 2003-04 and 2006-07, after which it started rising again, despite moderation in capital expenditure. Rising revenue expenditure, particularly in 2008-09 and 2009-10, contributed to growth in total expenditure. Within revenue expenditure there was sharp increase in expenditure on pay and allowances, as well as subsidies.

v) Resumption of the path of fiscal correction is crucial to achieving a sustainable fiscal situation at the Centre. Though softening of international oil prices has provided some relief, reverting to the high growth path and a strategy to exit from the expansionary fiscal stance put in place as a countercyclical measure will hold the key to fiscal correction. In recent years, off-budget liabilities of the Centre have assumed alarming proportions. In 2008-09, off-budget bonds issued to oil marketing and fertiliser companies amounted to Rs. 95,942 crore or 1.80 per cent of GDP.

Review of State Finances

4.27 Improvement in state finances started around 2004-05, aided by a higher rate of growth of the economy and the resultant increase in buoyancy of the states' own tax revenues as well as central transfers. This improvement further received a boost with the FC-XII recommending an increase in the states' share in net central taxes from 29.5 per cent to 30.5 per cent. FC-XII also recommended the Debt Consolidation and Relief Facility (DCRF) comprising consolidation of central loans contracted till March 2004 and outstanding on 31 March 2005, along with debt write-offs, linked to reduction of the revenue deficits of states and containment of fiscal deficit at the 2004-05 level. Enactment of fiscal responsibility and budget management legislations was made a pre-condition for states to avail the benefits under DCRF. FC-XII recommended that each state enact FRL which should, at the minimum, provide for elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to 3 per cent of GSDP. Following this pre-condition stipulated by FC-XII, 21 states put in place FRL beginning 2005-06. Karnataka, Kerala, Tamil Nadu, Punjab and Uttar Pradesh had already enacted fiscal responsibility legislation even before

Table 4.7: Aggregate State Finances: Fiscal Indicators

(per cent of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue Deficit/ Fiscal Deficit	Debt/GDP
2004-05	1.25	3.40	0.65	36.77	32.49
2005-06	0.19	2.56	0.20	7.52	31.81
2006-07	-0.71	1.69	-0.60	-41.98	29.73
2007-08	-0.94	1.51	-0.61	-62.46	27.59

Note: Minius (-) sign indicates surplus.
Source: Basic data from State Finance Accounts

this condition was imposed by FC-XII. West Bengal and Sikkim are the only states which are yet to do so. The enactment of FRL brought an element of discipline into budget-making by the states. Another major development having a considerable bearing on improvement of state finances was the introduction of VAT by most states in 2005-06. This has improved the tax base of the states by replacing the single point sales tax previously in place.

Trends in Aggregate Fiscal Indicators

4.28 Aided by buoyant own revenues and central transfers following the higher growth of the economy, there was consistent improvement in almost all fiscal indicators of states from 2004-05 to 2007-08 (Table 4.7). The revenue account of states turned surplus in 2006-07 from a deficit of 1.25 per cent of GDP in 2004-05. The fiscal deficit declined significantly from 3.40 per cent in 2004-05 to 1.51 per cent of GDP in 2007-08. The primary balance also turned surplus in 2006-07 from a deficit of 0.65 per cent of GDP in 2004-05. The surplus on the revenue account provided more fiscal space to states to enhance their capital spending. In line with other fiscal indicators, the debt-GDP ratio too exhibited a declining trend.

4.29 Factors contributing to the fiscal correction by states are presented in Table 4.8. There was significant improvement in total revenue receipts of states by 1.71 percentage points of GDP, between 2004-05 and 2007-08. While all the components of revenue receipts contributed to this improvement, the primary contributors are transfers from the Centre followed by own tax

Table 4.8: State Finances: Sources of Fiscal Correction

(per cent of GDP)

	2004-05	2005-06	2006-07	2007-08	Change 2007- 08/ 2004-05	2008-09 (RE)	2009-10 (BE)
I. Total Revenue (A+B)	11.49	11.99	12.92	13.20	1.71	13.87	13.60
A. Own Revenue	7.25	7.24	7.73	7.70	0.45	7.70	7.60
i) Tax Revenue	5.78	5.91	6.11	6.07	0.29	6.21	6.27
ii) Non-tax Revenue	1.47	1.33	1.62	1.63	0.16	1.50	1.33
B. Transfers from Centre	4.24	4.75	5.18	5.50	1.26	6.16	6.00
i) Tax Share	2.49	2.65	2.92	3.22	0.73	3.26	3.17
ii) Grants	1.75	2.10	2.27	2.29	0.54	2.90	2.83
II. Revenue Expenditure	12.73	12.18	12.21	12.26	-0.47	13.59	14.09
Of which: Interest Payments	2.75	2.36	2.29	2.12	-0.63	1.96	1.95
III. Total Expenditure	14.62	14.33	14.53	14.73	0.11	16.53	16.73
IV. Revenue Deficit	1.25	0.19	-0.71	-0.94	-2.19	-0.27	0.50
V. Fiscal Deficit	3.40	2.56	1.69	1.51	-1.89	2.64	3.23
VI. Primary Deficit	0.65	0.20	-0.60	-0.61	-1.26	0.68	1.28
Memo: Non-debt capital receipts	0.26	0.25	0.18	0.17	-0.09	0.31	0.12

Source: Basic Data from State Finance Accounts

revenues. During this period, revenue expenditure declined by 0.47 per cent of GDP largely on account of decline in interest payments by 0.63 per cent of GDP. Thus, as in the case of the Centre, aggregate fiscal improvement at the level of the states was mainly revenue-led, particularly through transfers from the Centre. Central transfers to states will be much higher than those reported in Table 4.8 if the benefit of the DCRF recommended by FC-XII is taken into account. Under the DCRF, central loans amounting to Rs. 1,13,601 crore have been consolidated and an amount of Rs. 18,717 crore has been written off by the end of 2008-09. Interest relief obtained by states amounted to Rs. 15,689 crore in the four-year period 2005-09.

4.30 As part of its countercyclical measures in the wake of the global economic downturn, the Centre had raised the market borrowing limit of states by Rs. 30,000 crore in 2008-09 and allowed them to exceed their fiscal deficit target by 0.50 percentage points, to 3.5 per cent of GSDP in 2008-09. The fiscal deficit target was further raised to 4 per cent of GSDP in 2009-10. The target for elimination of the revenue deficit was shifted by a year to 2009-10. The revised estimates of 2008-09 and budget estimates for 2009-10 indicate deterioration in the aggregate finances of states owing to lower growth of own revenues and transfers from the Centre on one hand, and increase in revenue expenditure on the other. The revenue surplus of states declined from 0.94 per cent of GDP in 2007-08 to 0.27 per cent in 2008-09 (RE). Fiscal deficit increased by 1.13 per cent to 2.64 per cent of GDP in 2008-09. The revenue account of states is estimated to turn into a deficit of 0.50 per cent of GDP in 2009-10 (BE) after registering a surplus in the preceding three years. The aggregate fiscal deficit of states is budgeted to increase further to 3.23 per cent of GDP in 2009-10, close to the level obtaining in 2004-05. The primary balance of states, which remained in surplus in 2006-07 and 2007-08, turned into a deficit of 0.68 and 1.28 per cent of GDP in 2008-09 (RE) and 2009-10 (BE), respectively.

Trends in Aggregate Revenues of States

4.31 There was improvement in all the components of revenue receipts of states between 2004-05 and 2007-08. Own tax revenues as a proportion of GDP improved from 5.78 per cent in 2004-05 to 6.07 per cent in 2007-08, the highest so far (Table 4.9). Non-tax revenues improved, albeit sluggishly, from 1.47 per cent to 1.63 per cent in the same period. Share in central taxes, which had improved considerably following the recommendations of FC-XI, further improved in the award period of FC-XII. Share in central taxes as a percentage of GDP went up from 2.49 per cent in 2004-05 to 3.22 per cent in 2007-08.

4.32 An area of concern for states in the sharing of net central tax revenue is the sharp increase in the proportion of cesses and surcharges in the gross tax revenue of the Centre, from 3.51 per cent in 2001-02 to 13.63 per cent in 2009-10 (BE). This has considerably reduced the proportion in gross tax revenue of the Centre of net tax revenues shareable with states.

4.33 The second issue with regard to sharing of central taxes relates to the actual share in the net tax revenue of the Centre devolved to states. Following the 80th Amendment of the Constitution facilitating sharing of the net proceeds of all central

Table 4.9: Trends in Aggregate State Revenue Receipts

(per cent of GDP)

Year	Own Tax Revenues	Own Non-tax Revenues	Share in Central Taxes	Plan Grants	Non-plan Grants	Total Revenue
2004-05	5.78	1.47	2.49	1.31	0.44	11.49
2005-06	5.91	1.33	2.65	1.21	0.89	11.99
2006-07	6.11	1.62	2.92	1.44	0.82	12.92
2007-08	6.07	1.63	3.22	1.57	0.72	13.20

Source:Basic data from State Finance Accounts taxes, FC-XI and FC-XII recommended that the share of states in the net proceeds of central taxes be fixed at 29.5 per cent and 30.5 per cent, respectively. However, the actual shares devolved to states as per the finance accounts have been lower than the percentages recommended by these Commissions. The actual shares devolved to states in 2005-06, 2006-07 and 2007-08, the first three years of FC-XII award for which finance accounts are available, amounted to 29.36, 28.95 and 29.64 per cent of net shareable tax revenues of the Centre, respectively. The Ministry of Finance has explained that the amounts reported in the Union finance accounts do not fully cover the actual collections under cesses and surcharges and that after accounting for these, the releases to states are in alignment with their share in net central taxes as recommended by the Finance Commissions. We are of the view that there is a need for more transparency in the current procedure. We, therefore, recommend that this matter be looked into by the Ministry of Finance with a view to ensuring that finance accounts fully reflect the collections under cesses and surcharges under relevant heads, so that there are no inconsistencies between the amounts released to states in any year and the respective percentage shares in net central taxes recommended by Finance Commission for that year.

4.34 Another area of concern is the tax concessions extended by the Centre. In the interests of transparency, the Central Budget reports figures of revenue foregone as a result of tax concessions. Loss of revenue on account of tax concessions in respect of both direct and indirect taxes is estimated at Rs. 4,18,095[1] crore for the year 2008-09. The National Institute of Public Finance and Policy (NIPFP) study for the Commission has allocated revenue foregone on account of select exemptions and tax preferences, accounting for 65 per cent of tax expenditures in direct taxes and about 18 per cent of those reported in the receipts budget for excise duty across states, based on the estimated shares of individual states. The study shows that Himachal Pradesh and Uttarakhand are far ahead of other states in terms of per capita gain from tax expenditures because of area exemptions. Excluding area-based exemptions, Karnataka emerges at the top with a per capita gain of Rs. 922, followed by Haryana and Goa with a per capita benefit of Rs. 700 each. The per capita benefit is much lower for the poorer states. This raises the question about the rationale for continuing with tax exemptions involving huge revenue losses and disproportionate benefit derived by the relatively developed states. There is a strong case for phasing out many of the tax exemptions. This should happen in the normal course with the proposed introduction of Goods and Services Tax (GST).

4.35 Among the other components of revenue receipts, improvement in plan and non-plan grants was 0.26 and 0.28 percentage points of GDP, respectively between 2004-05 and 2007-08. Taking all the components together, the revenue receipts of all states increased from 11.49 per cent in 2004-05 to 13.20 per cent of GDP in 2007-08.

Table 4.10: Aggregate State Finances: Expenditure Indicators

(per cent of GDP)

Year	Total Revenue Expenditure	Interest Payments	Pension	Plan Revenue Expenditure	Non-plan Revenue Expenditure	Capital Expenditure
2004-05	12.74	2.75	1.18	1.89	10.85	1.88
2005-06	12.18	2.36	1.14	1.94	10.24	2.14
2006-07	12.21	2.29	1.13	2.17	10.04	2.32
2007-08	12.26	2.12	1.19	2.39	9.88	2.47

Source : Basic data from State Finance Accounts

[1]The estimates of tax expenditures are based on short term impact analysis assuming that the underlying tax base would not be affected by the removal of tax exemptions and that all other tax provisions would remain unchanged. These assumptions may not hold good in all cases. Thus, the estimates of tax expenditure are subject to a number of limitations and can only be taken as indicative. Furthermore, in the case of customs, the duty foregone is estimated as the difference between the collection rate and the enacted rate, even when the latter might have been substantially reduced by an administrative notification.

Trends in Aggregate Expenditure of States

4.36 In contrast to growth in revenue receipts, all the components of revenue expenditure, with the exception of plan revenue expenditure, have exhibited a declining trend in the period 2004-05 to 2007-08 (Table 4.10). Total revenue expenditure as a percentage of GDP declined from 12.74 per cent in 2004-05 to 12.26 per cent in 2007-08. Within total revenue expenditure, while non-plan expenditure witnessed a sharp decline from 10.85 per cent to 9.88 per cent, plan expenditure increased from 1.89 per cent to 2.39 per cent in the same period. Interest payments moderated from 2.75 per cent of GDP in 2004-05 to 2.12 per cent in 2007-08. This decline can be attributed to the interest relief obtained by states from the DCRF, amounting to Rs. 15,689 crore over the period 2005-09. The debt swap scheme, which was operational during 2002-05 also contributed to the reduction in interest payments. An amount of Rs. 1,02,034 crore of high-cost debt was swapped under the scheme, resulting in savings in interest payments for states. It may, however, be difficult to sustain the reduction in revenue expenditure because of the pay revisions. A number of states have revised pay scales of employees in the light of the recommendations of the Sixth CPC. Karnataka and Kerala revised their pay scales in 2007 and 2004, respectively. The increase in plan revenue expenditure of states is on account of increased transfers through Centrally Sponsored Schemes.

4.37 Aggregate capital expenditure of states registered improvement in the period 2004-05 to 2007-08 following reduction in revenue expenditure and the surplus on revenue account in the years 2006-07 and 2007-08. Between 2004-05 and 2007-08, the aggregate capital expenditure of states went up by 0.59 percentage points of GDP.

Power and Irrigation Subsidies

4.38 Subsidy for the power sector is the largest component of State Government subsidies. Most of the State Power Utilities (SPUs) have negative financial flows. As SPUs are fully owned by State Governments, the financial performance of these entities has a direct bearing on state finances. State Governments' support to SPUs mainly consists of direct subsidies, subventions, contribution to equity, direct loans and extending guarantees to loans raised. According to a study sponsored by the Commission, the aggregate impact of the support to SPUs on state finances amounted to about Rs. 30,000 crore in 2007-08. Out of this, direct subsidy provided by State Governments amounted to about Rs. 18,000 crore. Guarantees extended on loans raised by the power sector constituted 36 per cent of the total guarantees extended by State Governments in 2007-08. The power sector in most states is beset with high technical and commercial losses, irrational power tariffs and inefficient distribution and transmission infrastructure, resulting in huge losses. Losses in the power sector are expected to be a major drag on the finances of State Governments, and therefore, the problems confronting this sector need to be addressed in a time-bound manner.

4.39 Subsidies to the irrigation sector are mostly implicit in nature, arising from gross under-recovery of user charges. Cumulative public investment in the irrigation sector amounted to over Rs. 2,50,000 crore at the end of the Tenth Five-Year Plan (2006-07). Ideally, these investments should generate a net return. The distressing fact is that receipts from the sector do not even cover the expenditure on operation and maintenance of irrigation projects. In 2006-07, revenue receipts of all states from the irrigation sector aggregated to Rs. 1666 crore, accounting for only 16 per cent of the non-plan revenue expenditure of states on irrigation. The main problems of the sector are very low water rates, poor collection efficiency, high establishment cost and lack of maintenance of irrigation projects.

State Level Public Sector Undertakings

4.40 State level public sector undertakings (PSUs) continue to remain a drag on the finances of State Governments. Cumulative financial support by way of contribution to equity, loans and subsidies to state PSUs stood at Rs. 91,947 crore, Rs. 1,70,492 crore and Rs. 25,026 crore, respectively at the end of March 2008. Outstanding guarantees extended by states on the loans raised by PSUs amounted to

Rs. 1,12,723 crore and constituted 60 per cent of the total outstanding guarantees of all states at the end of March 2008. As per the information received from states, dividend and interest payments by PSUs amounted to Rs. 167.41 crore and Rs. 1684.97 crore, respectively in 2007-08. While dividend amounted to 0.18 per cent of equity, interest payments amounted to 0.99 per cent of the outstanding loans. These percentages are abysmally low and nowhere near the desired levels of 5 per cent return on equity and 7 per cent interest on outstanding loans suggested by FC-XII.

Summary

4.41 The main trends in the aggregate position of state finances can be summarised as follows:

i) There was considerable improvement in the aggregate finances of states following higher growth of own tax revenues and increased transfers from the Centre. The revenue account of states turned surplus in 2006-07 and continued to remain in surplus in 2007-08. This is ahead of the target date of 2008-09 recommended by FC-XII. The process of fiscal consolidation in states was helped in no small measure by the enactment of FRBMA by most states by bringing in rule based management of public finances.

ii) There was only a marginal reduction in the revenue expenditure of states. Reduction in interest payments as a proportion of GDP was higher than reduction in revenue expenditure.

iii) Subsidies by states to power and irrigation sectors, both explicit and implicit, are a big drag on the finances of states. The performance of state level PSUs continues to remain poor.

iv) One noteworthy development was the increase in the aggregate capital expenditure of states following reduction in revenue expenditure and the surplus on the revenue account.

v) The expected reduction in the growth of own revenue receipts and central transfers, along with increasing expenditure commitments on account of pay revisions are likely to pose a threat to the fiscal correction achieved so far.

State Finances: A Comparative Perspective

4.42 Improvement in the various fiscal indicators has not been uniform across states (Table 4.11). In 2004-05, among the general category states, revenue accounts of only four states—Bihar, Chhattisgarh, Karnataka and Madhya Pradesh—were in surplus. By 2007-08, revenue accounts of all states, with the exception of Kerala, Punjab and West Bengal, turned surplus. Thus, in all but three general category states, elimination of the revenue deficit was achieved one year ahead of the target year of 2008-09 prescribed by FC-XII. In the special category, five states were in revenue deficit in 2004-05, but by 2006-07, the revenue accounts of all turned surplus and remained so in 2007-08. The revenue surplus in many of the special category states was of a higher magnitude relative to their respective GSDPs as compared to those in the general category. The higher revenue surplus in these states is indicative of the higher revenue account transfers to these states. Central transfers account for over 70 per cent of the revenue receipts of special category states.

4.43 With surpluses on the revenue account, the fiscal deficits of states went into financing capital expenditure. This marks the qualitative dimension in the fiscal correction achieved by states. There was also significant quantum correction. Eleven of the 17 general category states had fiscal deficits exceeding 3 per cent of GSDP in 2004-05. This number came down to just five in 2007-08. These five states were Goa, Kerala, Punjab, Uttar Pradesh and West Bengal. Of these, two had a revenue surplus in 2007-08. Thus, fiscal correction was largely achieved much before 2008-09, the target year for containing the fiscal deficit at 3 per cent of GSDP.

4.44 Among the 11 special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3 per cent

Table 4.11: Comparative Performances of States: Revenue and Fiscal Deficits

(per cent of GSDP)

States	Revenue Account (Surplus(-))					Fiscal Account Deficit (Surplus(-))				
	2004-05	2005-06	2006-07	2007-08	Difference (5-2)	2004-05	2005-06	2006-07	2007-08	Difference (10-7)
1	2	3	4	5	6	7	8	9	10	11
Andhra Pradesh	1.22	0.03	-1.04	-0.05	-1.27	3.89	3.52	2.10	2.81	-1.08
Bihar	-1.47	-0.10	-2.52	-4.42	-2.95	1.70	4.62	3.05	1.62	-0.08
Chhattisgarh	-0.33	-2.51	-4.13	-3.97	-3.64	2.75	0.79	-0.06	0.17	-2.58
Goa	1.07	0.16	-0.97	-1.01	-2.08	4.80	4.51	3.36	3.29	-1.51
Gujarat	2.13	0.18	-0.70	-0.70	-2.84	4.60	2.85	2.22	1.56	-3.04
Haryana	0.28	-1.14	-1.26	-1.51	-1.78	1.29	0.27	-0.93	0.86	-0.43
Jharkhand	0.61	0.05	-1.51	-1.72	-2.33	4.32	10.18	1.45	2.79	-1.53
Karnataka	-1.09	-1.38	-2.21	-1.75	-0.66	2.40	2.19	2.49	2.48	0.07
Kerala	3.33	2.52	1.85	2.33	-1.00	4.04	3.36	2.68	3.76	-0.28
Madhya Pradesh	-1.60	-0.03	-2.60	-3.57	-1.97	6.05	3.93	2.15	1.95	-4.10
Maharashtra	2.59	0.88	-0.16	-2.56	-5.15	4.81	4.02	2.27	-0.49	-5.29
Orissa	0.73	-0.61	-2.48	-4.11	-4.84	1.91	0.35	-0.90	-1.31	-3.22
Punjab	3.48	1.13	-1.64	2.78	-0.70	4.22	2.42	0.50	3.35	-0.87
Rajasthan	1.83	0.51	-0.43	-0.99	-2.82	5.24	3.98	2.67	2.05	-3.20
Tamil Nadu	0.35	-0.85	-1.01	-1.57	-1.91	2.75	0.98	1.51	1.27	-1.48
Uttar Pradesh	2.84	0.45	-1.57	-1.00	-3.84	5.27	3.60	3.08	4.01	-1.26
West Bengal	3.94	3.15	3.06	2.63	-1.31	5.11	4.09	4.19	3.69	-1.42
Total: GCS	**1.62**	**0.40**	**-0.72**	**-1.02**	**-2.63**	**4.10**	**3.19**	**2.15**	**1.90**	**-2.21**
Arunachal Pradesh	0.27	-6.23	-20.44	-18.57	-18.84	13.54	8.80	-3.14	0.24	-13.29
Assam	0.56	-2.61	-3.47	-3.66	-4.22	3.92	-0.62	-1.12	-1.12	-5.04
Himachal Pradesh	5.02	-0.36	-0.67	-2.66	-7.68	7.85	2.83	3.25	1.73	-6.12
Jammu & Kashmir	-2.32	-1.49	-1.96	-3.42	-1.10	6.86	9.96	6.65	8.38	1.52
Manipur	-2.00	-7.98	-8.39	-21.31	-19.31	9.84	5.36	8.89	-1.79	-11.63
Meghalaya	0.86	-1.15	-3.37	-2.47	-3.33	5.39	2.83	1.07	2.82	-2.58
Mizoram	-4.33	-2.43	-8.43	-3.99	0.34	9.59	14.71	6.40	11.91	2.32
Nagaland	-2.90	-3.65	-8.62	-5.89	-2.99	4.08	5.41	2.44	5.52	1.44
Sikkim	-10.54	-10.75	-11.06	-14.91	-4.37	11.58	8.13	4.68	2.73	-8.85
Tripura	-4.75	-6.74	-8.27	-8.04	-3.29	2.90	1.17	-1.28	0.14	-2.75
Uttarakhand	4.01	0.28	-3.02	-1.87	-5.88	9.19	7.18	2.98	5.12	-4.07
Total: SCS	**0.63**	**-2.17**	**-3.78**	**-4.35**	**-4.98**	**6.30**	**3.86**	**2.01**	**2.46**	**-3.84**
All States	**1.56**	**0.24**	**-0.90**	**-1.20**	**-2.76**	**4.24**	**3.23**	**2.14**	**1.93**	**-2.31**

Notes: 1. The fiscal indicators presented in Tables 4.11 to 4.14 are based on non-comparable estimates of GSDP and do not tally with those given in Chapter 9 which are based on comparable estimates of GSDP.

2. The ratios presented in Tables 4.11 to 4.14 are relative to GSDP of states and therefore do not match with those in Tables 4.7 and 4.8, which are relative to GDP. The aggregate ratios given in Tables 4.11 to 4.14 can be converted into ratios with reference to GDP by multiplying them with the conversion factors of 0.8024, 0.7930, 0.7889 and 0.7821 for the years 2004-05, 2005-06, 2006-07 and 2007-08, respectively.

3. GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

of GSDP in 2007-08, as compared to 10 in 2004-05. Fiscal correction in special category states is characterised by large year-to-year variations, both within and across states, because of the low and fluctuating nature of GSDP in these states.

4.45 Figures 4.2 and 4.3 decompose the correction in the revenue deficit-GSDP ratios of general category and special category states, respectively. Correction is decomposed into increase in own revenue, increase in central transfers, and decrease in revenue expenditure. In the general category there are wide variations across states in the extent of correction achieved through improvement in own revenue and compression of revenue expenditure. However, in the majority of states, the correction is revenue-led, with major corrections coming from central transfers. There was no revenue expenditure compression in special category states, with the exception of Assam, Sikkim

Figure 4.2: Reduction (+) in Revenue Deficits in General Category States : 2007-08 over 2004-05

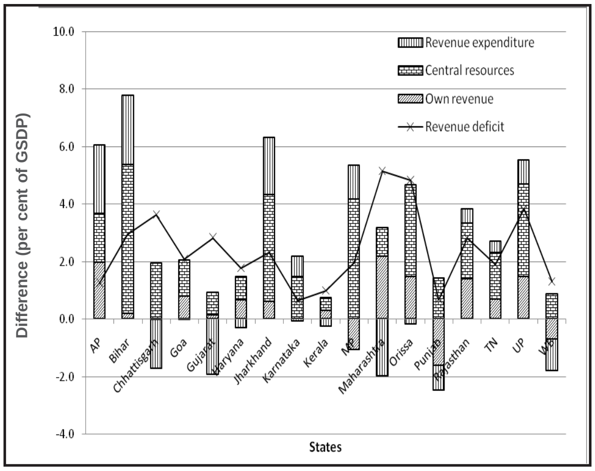


Figure 4.3: Reduction (+) in Revenue Deficit in Special Category States: 2007-08 over 2004-05

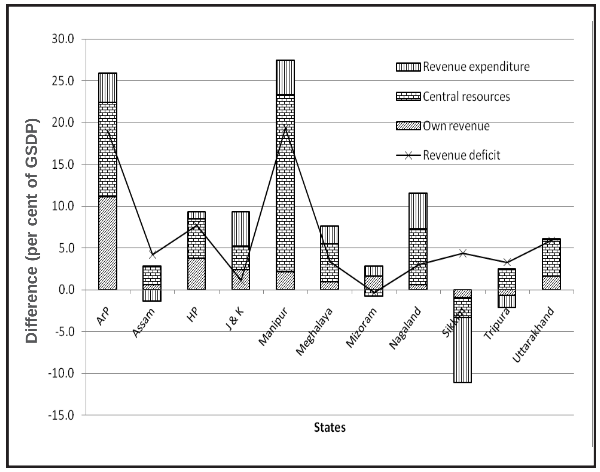


Table 4.12: Outstanding Debt Relative to GSDP: State-wise Position

(per cent of GSDP)

States	2004-05	2005-06	2006-07	2007-08	Difference (5-2)
1	2	3	4	5	6
Andhra Pradesh	35.30	33.70	32.18	31.16	-4.14
Bihar	58.02	58.01	49.61	48.49	-9.53
Chhattisgarh	27.31	24.11	22.00	18.95	-8.37
Goa	37.89	37.58	39.21	38.27	0.38
Gujarat	37.59	37.02	34.56	31.44	-6.15
Haryana	25.91	25.40	22.63	19.73	-6.18
Jharkhand	26.33	31.55	30.98	31.10	4.77
Karnataka	31.32	31.10	30.64	27.94	-3.39
Kerala	39.63	38.45	36.61	35.78	-3.85
Madhya Pradesh	41.23	42.27	41.56	38.81	-2.42
Maharashtra	30.91	32.11	30.34	26.70	-4.21
Orissa	50.53	48.98	43.30	37.29	-13.24
Punjab	46.89	45.25	39.97	39.47	-7.41
Rajasthan	51.28	51.28	47.93	46.29	-4.98
Tamil Nadu	27.25	27.15	25.25	22.14	-5.11
Uttar Pradesh	53.28	53.21	51.96	50.60	-2.68
West Bengal	50.01	47.88	44.35	42.82	-7.19
Total: GCS	**39.18**	**38.82**	**36.44**	**34.01**	**-5.17**
Arunachal Pradesh	62.29	80.09	69.73	68.13	5.84
Assam	33.40	32.22	31.13	29.87	-3.53
Himachal Pradesh	71.68	68.44	63.73	60.73	-10.94
Jammu and Kashmir	58.47	63.27	64.04	67.17	8.70
Manipur	67.48	77.09	78.37	79.40	11.92
Meghalaya	37.43	40.61	39.68	41.30	3.87
Mizoram	110.44	109.48	103.70	102.74	-7.69
Nagaland	52.62	56.30	55.71	54.00	1.38
Sikkim	69.10	73.82	71.70	76.33	7.24
Tripura	50.40	47.06	44.79	42.08	-8.31
Uttarakhand	115.79	112.11	103.21	94.13	-21.66
Total: SCS	**60.56**	**60.58**	**58.02**	**56.30**	**-4.26**
All States	**40.49**	**40.12**	**37.69**	**35.28**	**-5.21**

Note: GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

and Tripura. As in the case of the general category states, transfers from the Centre have played a major role in fiscal correction.

4.46 The debt-GSDP ratio represents the final outcome of all the budgetary transactions, particularly the borrowings contracted to finance fiscal deficits over the years, and is an important indicator of fiscal correction. In consonance with the reduction in fiscal deficits there was reduction in the debt-GSDP ratio of the general category states by over 5 percentage points of GSDP in 2007-08 over 2004-05 (Table 4.12). In seven out of the 17 general category states, debt-GSDP ratio exceeded 40 per cent in 2004-05 as compared to the group average of 39.18 per cent. By 2007-08, the number of such states had come down to four, viz., Bihar, Rajasthan, Uttar Pradesh and West Bengal. Among these, Uttar Pradesh, and West Bengal have fiscal deficits exceeding 3 per cent of GSDP. Bihar, though a revenue surplus state, had the highest debt-GSDP ratio in 2004-05. All the states except Goa and Jharkhand managed to bring about reduction in their debt-GSDP ratio. FC-XII recommended that the debt-GSDP ratio be brought down to 28 per cent over a period of time so as to be consistent with the fiscal deficit target.

4.47 Though the aggregate debt-GSDP ratio of the special category states in 2007-08 was lower as compared to the 2004-05 level, the debt position of six of the 11 states, which had registered a revenue

Table 4.13: Own Tax Revenues: Comparative Performance of States

	Average OTR/ GSDP				(*per cent*)	Buoyancy
States	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**Difference (5-2)**	**1998-08**
1	2	3	4	5	6	7
Andhra Pradesh	7.72	8.14	8.89	9.21	1.49	1.327
Bihar	4.57	4.44	4.08	4.84	0.27	0.685
Chhattisgarh	7.20	7.36	7.85	7.34	0.13	1.128
Goa	7.46	8.21	8.89	8.27	0.81	1.348
Gujarat	6.85	7.14	7.25	7.13	0.28	0.944
Haryana	7.95	8.53	8.64	7.87	-0.07	1.199
Jharkhand	4.64	5.01	5.09	5.00	0.35	1.76
Karnataka	10.73	11.09	12.38	12.07	1.35	1.593
Kerala	8.13	7.86	8.38	8.42	0.29	1.097
Madhya Pradesh	7.25	7.84	8.17	8.43	1.19	1.321
Maharashtra	7.90	7.66	7.87	8.22	0.32	1.168
Orissa	5.85	6.37	6.65	6.64	0.79	1.608
Punjab	7.13	8.19	7.31	7.20	0.07	1.455
Rajasthan	7.18	7.63	7.82	7.97	0.79	1.571
Tamil Nadu	9.57	10.16	10.57	10.20	0.64	1.376
Uttar Pradesh	6.36	6.74	7.37	7.25	0.89	1.534
West Bengal	4.76	4.43	4.29	4.24	-0.51	1.145
Total: GCS	**7.35**	**7.59**	**7.88**	**7.89**	**0.53**	**1.322**
Arunachal Pradesh	1.76	2.13	2.30	2.45	0.69	2.398
Assam	5.16	5.59	5.46	4.77	-0.40	1.628
Himachal Pradesh	5.43	5.88	5.84	6.12	0.70	1.362
Jammu & Kashmir	5.57	6.13	6.20	8.05	2.48	1.952
Manipur	1.78	1.88	2.28	2.59	0.80	1.991
Meghalaya	3.58	4.00	4.38	4.20	0.62	1.591
Mizoram	1.61	2.04	2.27	2.36	0.75	2.779
Nagaland	1.46	1.86	1.86	1.83	0.36	1.441
Sikkim	5.48	5.43	6.12	6.36	0.88	1.542
Tripura	2.89	3.15	3.32	3.29	0.41	1.572
Uttarakhand	6.09	6.82	8.46	8.05	1.96	2.316
Total: SCS	**4.88**	**5.36**	**5.64**	**5.68**	**0.80**	**1.916**
All States	**7.20**	**7.46**	**7.75**	**7.76**	**0.56**	**1.343**

Note: GCS: General Category States; SCS: Special Category States.
Source: Basic data from State Finance Accounts

surplus in all three years since 2005-06, worsened by 2007-08. The debt-GSDP ratio of special category states continues to remain at a much higher level than that of the general category states. Low levels and fluctuating nature of GSDP growth partly explains the high debt-GSDP ratios in some of these states.

Own Tax Revenues

4.48 There was an improvement in own tax revenues of all general category states with the exception of Haryana and West Bengal between 2004-05 and 2007-08 (Table 4.13). The improvement in tax-GSDP ratio was highest in Andhra Pradesh followed by Karnataka, Madhya Pradesh and Uttar Pradesh. The tax-GSDP ratios in the first two states were relatively higher in 2004-05 as compared to the average for general category states. Karnataka stands out with the highest tax-GSDP ratio of 12.07 in 2007-08 as compared to the average of 7.89 for the general category states as a whole. The improvement in states with low tax-GSDP ratios has been relatively less. While Bihar, with the lowest tax-GSDP ratio of 4.57 in 2004-05, improved its ratio marginally in 2007-08, the ratio in respect of West Bengal slipped by 0.51 percentage points to 4.24 in the same period.

Table. 4.14: States: Comparative Trends in Expenditure

(*per cent of GSDP*)

States	Revenue Expenditure					Capital Expenditure				
	2004-05	2005-06	2006-07	2007-08	Difference (5-2)	2004-05	2005-06	2006-07	2007-08	Difference (10-7)
1	2	3	4	5	6	7	8	9	10	11
Andhra Pradesh	14.88	14.79	15.39	17.27	2.40	2.57	3.25	3.68	4.09	1.51
Bihar	19.99	22.15	20.80	22.41	2.42	1.65	2.60	5.27	5.80	4.16
Chhattisgarh	15.85	13.54	13.70	14.15	-1.70	2.85	2.72	3.42	4.09	1.23
Goa	16.92	16.40	17.00	16.90	-0.02	3.71	4.35	4.31	4.19	0.48
Gujarat	12.85	11.59	11.48	10.93	-1.92	2.17	3.17	3.08	2.22	0.05
Haryana	12.18	11.88	12.94	11.88	-0.31	0.96	1.52	1.92	2.32	1.36
Jharkhand	13.59	15.43	14.46	15.58	1.99	2.60	3.34	2.33	3.72	1.12
Karnataka	16.64	16.69	17.76	17.36	0.72	3.12	3.47	4.54	4.02	0.90
Kerala	15.57	14.81	14.62	15.33	-0.25	0.62	0.66	0.63	0.91	0.29
Madhya Pradesh	16.80	17.68	17.44	17.97	1.16	4.61	5.69	4.03	4.79	0.18
Maharashtra	13.18	11.93	12.05	11.20	-1.98	2.03	2.30	1.98	1.99	-0.05
Orissa	17.32	17.32	17.30	17.16	-0.17	1.48	1.32	1.59	2.73	1.25
Punjab	17.65	16.59	15.03	16.77	-0.87	0.78	1.38	2.10	1.59	0.81
Rajasthan	16.97	16.60	16.81	17.48	0.51	2.97	3.32	3.24	3.93	0.96
Tamil Nadu	14.41	13.94	14.57	14.80	0.40	2.26	1.77	2.27	2.57	0.32
Uttar Pradesh	18.09	16.66	17.85	18.94	0.85	2.29	3.11	4.48	4.92	2.63
West Bengal	13.49	13.26	12.53	12.39	-1.11	0.88	0.70	0.74	0.87	-0.01
Total: GCS	**15.18**	**14.63**	**14.77**	**14.98**	**-0.20**	**2.12**	**2.50**	**2.78**	**2.94**	**0.83**
Arunachal Pradesh	52.91	57.15	55.79	56.43	3.52	13.14	15.00	17.22	18.81	5.67
Assam	19.47	18.22	17.97	18.09	-1.38	4.15	1.88	2.28	2.40	-1.75
Himachal Pradesh	25.11	25.39	26.96	25.93	0.82	2.84	3.22	3.91	4.42	1.59
Jammu and Kashmir	34.22	37.38	36.56	38.34	4.12	8.99	11.38	8.46	11.69	2.71
Manipur	36.15	39.57	45.19	40.19	4.04	11.41	12.16	16.23	19.42	8.01
Meghalaya	27.50	26.50	27.41	29.63	2.14	4.23	4.10	4.60	5.15	0.92
Mizoram	56.85	58.87	57.53	58.04	1.19	13.43	16.73	15.63	16.55	3.13
Nagaland	31.51	36.36	34.81	35.76	4.25	7.10	9.14	11.13	11.42	4.32
Sikkim	107.57	96.59	91.20	99.83	-7.74	22.07	18.89	15.77	17.66	-4.41
Tripura	26.31	25.48	24.14	24.83	-1.48	7.67	7.92	7.03	8.21	0.54
Uttarakhand	21.23	21.44	21.80	21.33	0.10	4.79	6.52	5.72	6.57	1.78
Total: SCS	**26.60**	**26.89**	**26.94**	**27.15**	**0.54**	**5.82**	**5.89**	**5.69**	**6.68**	**0.86**
Total All States	**15.88**	**15.36**	**15.47**	**15.67**	**-0.21**	**2.34**	**2.70**	**2.94**	**3.16**	**0.81**

Note: GCS: General Category States; SCS: Special Category States.

Source: Basic data from State Finance Accounts

4.49 All special category states improved their tax-GSDP ratios in 2007-08 relative to 2004-05, with the exception of Assam. There was considerable improvement in Own Tax Revenues in the states of Jammu & Kashmir and Uttarakhand. States in the special category improved their overall tax-GSDP ratio by 0.8 percentage point of GSDP in 2007-08 over 2004-05, which was higher than the aggregate improvement of 0.53 per cent of GSDP achieved by general category states.

Expenditure of States

4.50 Expenditure trends for states are presented in Table 4.14. The general category states witnessed a marginal reduction of 0.20 per cent of GSDP in their revenue expenditure in 2007-08 over the 2004-05 level. Reduction in revenue expenditure as a percentage of GSDP was observed in nine of the 17 states. Andhra Pradesh, Bihar and Jharkhand stand out for witnessing a significant increase in their revenue expenditure, ranging from 1.99 to 2.42 per cent of GSDP between 2004-05 and 2007-08. Reduction in interest burden following the DCRF seems to have aided the states in their effort to reduce revenue expenditure. In contrast, there was a marginal increase in the revenue expenditure of special category states during 2004-08. Revenue expenditure-GSDP ratio is much higher at 27.15 per cent in special category states as compared to 14.98 per cent in general category states in 2007-08. Assam, Sikkim and Tripura are the only three states in the special category to have reduced their revenue expenditure-GSDP ratios in 2007-08 compared to the 2004-05 levels.

4.51 Aided by improvement on the revenue account, there was overall improvement in the capital expenditure of general category states from 2.12 per cent of GSDP in 2004-05 to 2.94 per cent of GSDP in 2007-08. Only Maharashtra and West Bengal witnessed a marginal reduction in their capital expenditure-GSDP ratios between 2004-05 and 2007-08. The improvement was significant in the poorer states of Bihar and Uttar Pradesh. With the exception of Assam and Sikkim, all the special category states witnessed improvement in their capital expenditures. The improvement was significant in Arunachal Pradesh, Manipur, Mizoram and Nagaland. The capital expenditure–GSDP ratio in special category states is much higher than that in the general category states because of higher revenue surpluses in the former.

Summary

4.52 The comparative performance of states during 2004-08 may be summarised as below:

i) There was significant improvement on the revenue account, with the number of revenue-surplus general category states going up from four in 2004-05 to 14 in 2007-08. The only three states with revenue deficits in 2007-08 were Kerala, Punjab and West Bengal. Thus, in most general category states, elimination of the revenue deficit was achieved one year ahead of the target date. All special category states were in revenue surplus in 2007-08.

ii) Elimination of revenue deficit in all states (barring three) by 2007-08, meant that fiscal deficits were now incurred on account of capital expenditure. This marks the quality of fiscal correction achieved.

iii) Only five of the 17 general category states had fiscal deficits exceeding 3 per cent of GSDP in 2007-08, as compared to 11 in 2004-05. Among the 11 special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3 per cent of GSDP in 2007-08, as compared to 10 in 2004-05.

iv) In six of the 17 general category states, fiscal deficit was less than 2 per cent of GSDP, and in Maharashtra and Orissa, the fiscal account turned surplus in 2007-08. The borrowing limits prescribed for states in accordance with the correction path stipulated by FC-XII, were with reference to the GSDP paths as projected by FC-XII. States with higher GSDP growth than projected would, thereby, exhibit lower fiscal deficits as a percentage of their actual GSDP.

v) Corresponding to the declining path of fiscal deficits, the debt-GSDP ratios of states also declined over the period. There were only four general category states with debt-GSDP ratios exceeding 40 per cent in 2007-08, as compared to seven in 2004-05. However, the debt position of six of the 11 special category states worsened by 2007-08.

vi) With a few exceptions, the tax-GSDP ratios of all states improved over 2004-08, both in the general category and the special category, the exceptions being Haryana and West Bengal in the general category and Assam in the special category. The tax-GSDP ratio is the highest in Karnataka, followed by Tamil Nadu and Andhra Pradesh. Bihar and West Bengal are at the bottom of the list of general category states in terms of tax-GSDP ratios.

vii) There was only a marginal decline of 0.20 per centage points of GSDP in the aggregate revenue expenditures of general category states in 2004-08, with eight states witnessing an increase and nine states registering a decline. There was significant increase in revenue expenditure in Andhra Pradesh, Bihar and Jharkhand. Further, significant reduction in revenue expenditure took place in Chhattisgarh, Gujarat, Maharashtra and West Bengal. There was a marginal increase in revenue expenditure of special category states during 2004-08, with the exception of Assam, Sikkim, and Tripura, which saw a reduction in their revenue expenditure-GSDP ratios.

Trends in Inter-governmental Transfers

4.53 In India, resource transfers from the Centre to states, comprising statutory and non-statutory transfers take place through a multiplicity of channels. Statutory transfers in the form of share in central taxes and non-plan grants are based on the recommendations of the Finance Commissions. Non-statutory revenue transfers are in the form of plan grants from the Planning Commission, as well as plan and non-plan grants from the central ministries. The relative shares of these revenue transfers are presented in Annex 4.1.

4.54 Transfers through the Finance Commissions are predominant, accounting for over 68 per cent of total transfers in recent years. There has been an increase in the share of Finance Commission transfers from 60.13 per cent in the award period of FC-VIII to 68.03 per cent in the period covered by FC-XII. Within the Finance Commission transfers, there has been an increase in the share of grants, particularly in the periods covered by FC-XI and FC-XII. FC-XII felt that grants could be targeted better and that cost disabilities and distributive considerations could be addressed more effectively through grants than through tax devolutions. The Commission, accordingly, increased the share of grants in the transfers recommended by it.

4.55 The share of plan grants has been increasing since 2006-07 and the increase is more pronounced from 2007-08 onwards. This is on account of a shift in the composition of plan grants as well as higher transfers through CSS. Now, a substantial portion of plan grants dispensed to states is scheme-specific, and as a result, the share of formula-based normal central assistance in total plan grants has come down significantly. There has been an increase in the number of Centrally Sponsored Schemes, some of which are funded by the proceeds of cesses levied by the Union Government.

4.56 In recent years, plan grants have become more scheme-oriented, reverting in a way to the pre-1969 position of scheme-based transfers. There is a general consensus on reducing the number of CSS and moving towards predominance of formula-based transfers, but there has been no significant movement in this direction. It is our considered view that initiatives should be taken in this direction.

4.57 Multiplicity of transfer channels makes it necessary for the Finance Commission to look at overall transfers. For the first time FC-XI recommended an indicative ceiling of 37.5 per cent of Centre's gross revenue receipts as transfers to states from all channels. This was raised to 38 per cent by FC-XII. Trends in transfers to states as a proportion of the Centre's gross revenue receipts are presented in Annex 4.2.

Table 4.15: Share of the Centre in Combined Revenue Receipts Before and After Transfers

(*per cent*)

Commission	Share of the Centre in Combined Revenue Receipts			FC Transfers to States/ Combined Revenue Receipts	Total Transfers to States/ Combined Revenue Receipts
	Before Transfers	After FC Transfers	After Total Transfers		
FC-VIII	65.4	49.1	38.7	16.3	26.7
FC-IX	62.8	45.6	35.3	17.2	27.5
FC-X	60.8	44.1	36.3	16.7	24.5
FC-XI	58.5	40.4	33.3	18.1	25.2
FC-XII	62.6	42.4	35.7	20.2	26.9
2005-06	61.9	41.6	35.3	20.3	26.6
2006-07	62.5	41.9	35.4	20.6	27.1
2007-08	63.5	43.6	36.5	19.9	27.0

Notes: 1. For FC-XII the average is for three years (2005-08).
2. FC transfers to states include both tax devolution and grants.
3. Total transfers to states include tax devolution and grants by the Finance Commissions and other plan and non-plan grants from the Centre. These do not include tranfers outside the state budget.

Source: Basic data from Indian Public Finance Statistics and Union Finance Accounts (various years).

4.58 After the peak level of 40.33 per cent of gross revenue receipts of the Centre during the award period of FC-IX, central transfers dipped to around 35 per cent in the periods covered by FC-X and FC-XI. During the period covered by FC-XII, central transfers are estimated to be over 38 per cent of the Centre's gross revenue receipts. In 2008-09 and 2009-10, there is more than two percentage point increase in central transfers to states. Both Finance Commission grants and plan grants account for the variations in central transfers as a percentage of gross revenue receipts.

Vertical Imbalance

Revenue Receipts

4.59 The relative shares of the Centre and states in the combined revenue receipts as well as combined expenditure show the vertical imbalances in the Indian federation. The total transfers as a proportion of combined revenue receipts have remained stable since FC-VIII. There has been a slight upward drift in the share of Finance Commission transfers in combined revenue receipts over the period as a whole, because of an increase in the recommended share of the states in net central taxes by successive Finance Commissions (Table 4.15).

Expenditure

4.60 Table 4.16 presents the relative shares of the Centre and states in the combined revenue and total expenditures. The Centre's share in the combined revenue expenditure varied from 40.0 per cent to 46.1 per cent through the period covered by FC-I to FC-XII. Since the period covered by FC-VIII, there has been a remarkable stability in the relative shares of the the Centre and the states in the combined revenue expenditure with the share of the Centre fluctuating in the narrow range of 43 to 44 per cent. As far as combined total expenditure is concerned, the share of the Centre varied from 43.14 per cent to 50.51 per cent through the award periods of all the twelve Finance Commissions. The share of the Centre remained stable at around 43 per cent since the award period of FC-X.

4. 61 Figure 4.4 shows the year-wise variations in the shares of states in combined revenue and total expenditure.

Policy Implications

4.62 Putting fiscal correction back on track should be the priority of both the Centre and the states. With the moderation in international oil prices, commitments on account of arrears of pay following the recommendations of the Sixth CPC and farm loan waiver having been met and the economy showing signs of recovery, it should be possible to return to the path of fiscal correction at the earliest. There is improvement in the global economic outlook with a number of major economies coming out of recession. There are also indications of the global economic situation improving in the last quarter of 2009 and the improvement continuing through 2010. A calibrated exit strategy from the fiscal expansionary stance of 2008-09 and 2009-10 should be the main agenda for the government in 2010-11. The proposed introduction of GST is expected to reverse the temporary reduction in revenue following rate cuts effected as part of the fiscal stimulus. We are recommending a revised roadmap of fiscal correction for both the Centre and the states. The revised roadmap prescribes a combined debt-GDP ratio of 68 per cent for 2014-15. With the target of debt-GDP ratio for the Central Government set at 45 per cent in 2014-15, the target envisaged for all the states by implication is 25 per cent (the state and central ratios do not add up to the combined ratio because of the netting out of central loans to states). The roadmap also targets elimination of revenue deficit by the Centre and all the states individually by 2014-15 as detailed in Chapter 9.

4.16: Relative Shares of Centre and States in Revenue and Total Expenditures

Average for Finance Commission Periods	Relative Shares			
	Total Expenditure		Revenue Expenditure	
	Centre	States	Centre	States
FC-I	43.83	56.17	40.77	59.23
FC-II	49.47	50.53	41.83	58.17
FC-III	50.51	49.49	46.10	53.90
FC-IV	47.69	52.31	41.77	58.23
FC-V	43.14	56.86	40.00	60.00
FC-VI	47.35	52.65	44.19	55.81
FC-VII	44.79	55.21	41.98	58.02
FC-VIII	47.86	52.14	44.22	55.78
FC-IX	45.58	54.42	43.45	56.55
FC-X	43.35	56.65	43.18	56.82
FC-XI	43.77	56.23	44.03	55.97
FC-XII*	43.74	56.26	44.45	55.55
Overall Average	**45.92**	**54.08**	**43.00**	**57.00**

Note: * Average of three years (2005-08).

Source: Basic Data from Indian Public Finance Statistics (various years).

Figure 4.4: Relative Shares of States in Combined Revenue and Total Expenditure