FISCAL TRANSFERS AND BORROWING

Disparities among States in the Indian Federation

Dissertation submitted in partial fulfillment of the requirements for the Degree of Master of Philosophy in Applied Economics of the Jawaharlal Nehru University

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M.Phil Programme in Applied Economics

2010-12

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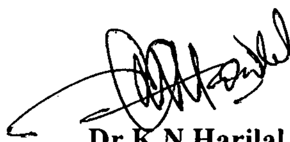
Thiruvananthapuram

June, 2012

I hereby affirm that the work for this dissertation, ***"Fiscal Transfers and Borrowing: Disparities among States in the Indian Federation"***, being submitted as part of the requirements for award of the degree of Master of Philosophy in Applied Economics of the Jawaharlal Nehru University, was carried out entirely by myself. I also affirm that it was not part of any other programme of study and has not been submitted to any other University for the award of any Degree.

June, 2012 **Siamlal T.A.**

Certified that this study is the bona fide work of *Siamlal T.A*, carried out under our supervision at the Centre for Development Studies.



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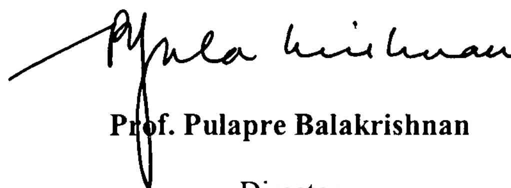

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Dr. B. R. Ambedkar

ACKNOWLEDGEMENTS

In accomplishing this work, I owe much to my supervisor, Dr.K.N.Harilal. His valuable guidance, support and encouragement always helped me to do the work in the right direction. I would like to express my sincere gratitude and indebtedness to him for showing commitment and care towards me and my work.

I am greatly benefited from the course work of the M.Phil programme and the K.N.Raj library of the centre. It sharpened my understanding of the society, economy and people. It is my pleasure to acknowledge my indebtedness to all the teachers at CDS. With gratitude, I remember the encouragement and support given by Dr. M.Parameswaran in crucial times.

My teachers at M.A.College, especially Dr.Raju Abraham always motivated and supported me. To them I owe a deep debt of gratitude.

The life in CDS gifted me a lot of happy moments. I wish to thank all the community members for that. I remember my friends and classmates Izudheen, Rahul, Sammer, Raju, Kavitha, Maria, Sajitha, Chinju, Saritha, Nikitha, Deepak, Pinak, Santhosh, Amit, Soumy, Nutan, Midhun,Beena,Vijayasurian, Saravanan, Shyjan sir, Hari sir for their love and support towards me. I also acknowledge the help I received from CDS administration, staffs of library, canteen and computer centre.

Last but not least, I remember my family members who always stood behind me.

Siamlal T.A.

Abstract of the Dissertation

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The present study ,which is contextualized in the centre state financial relations, focuses on the federal fiscal transfers and borrowing space of states and analyses whether it is equitable and helping the poor states to meet their fiscal needs. An enquiry in to the pattern of expenditure of states in Indian federation reveals that there exist wide disparities among them. Expenditure in different sectors and sub sectors shows disparities between high income and low income states in per capita terms. This is a serious issue in an era of economic reforms as it accelerates the already existing regional disparities and lead to differences in the quality of life of the masses in the federation. These disparities has its roots in the differences in revenue generating capacity of states and the fiscal responsibilities assigned on them, and the resultant fiscal imbalances. The states need enough resources to correct these fiscal imbalances and the national government has the obligation to provide that to the states. India has constitutionally defined-Finance Commission transfers- and other forms of measures-Planning Commission transfers- to correct the fiscal imbalances. When we analyze whether the fiscal transfers made by centre to the states are capable of offsetting the fiscal disabilities of poor states, we realize that it is inadequate and fails to achieve the goal of equalization due to many factors.

Apart from the transfers, the states depend on the borrowings to raise resources to finance their responsibilities. Analysis of the borrowings by the states reveals that it is inequitable and insufficient to help the poor states. The borrowing regime is regressive and not favoring the poor states. The low income states are able to collect only less from different sources of borrowing whether it is market borrowing, loans from centre, loans from banks and financial institutions etc. A change in the sources of borrowing is visible i.e., states are borrowing mainly from the market in recent years and the importance of loans from centre is gradually declining, which was a main source earlier. Leaving the states to borrow mainly from market can be of consequences. The market will provide finance by assessing the income levels of the states and fix interest on the basis of that. The interest payments by the poor states are very high even though they are borrowing less, when compared to the richer states. Besides all these, there exist Fiscal Responsibility and Budget Management Act (FRBMA) which is restricting the states' borrowing or fiscal deficit. There are arguments for the introduction of state specific deficit targets as the common target prevents the fiscally strong states to raise more resources. But the question raised by the study is that whether this will accentuate the already existing disparities among states. The regressive borrowing regime may nullify the progressiveness in the transfer mechanism. These things adversely affect the fiscal position of poor states and lead to disparities in development and living standards of people in different states. This affects regional equality and thereby the social fabric, political stability and economic development of the federation.

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Chapter 1

Introduction

The initiation of economic reforms in India in the early nineties has resulted in a paradigm shift in the economic policies. The earlier focus on planned economic development, primacy of the public sector, location of public sector undertaking to address regional imbalances and regulation of industry and trade through a system of licensing and permits gave way to market–oriented economic policies. Thus the focus shifted from public investment to promoting private investment. With public investment constituting only around 20 per cent of the aggregate investment[1] in the country, there is a drastic shift in the role of the states from undertaking direct investments to that of facilitating investments (Commission on Centre-State Relations, 2010). Providing of the enabling environment and other facilities to attract private investments became essential in the new circumstances, as the private investment tends to move to the places where the enabling environment is better. Here those regions or states that fail to provide infrastructure- both social and physical- may lag behind. It can act as a serious source for inter-state inequality in the overall development and standard of living of the people.

So the new circumstances resulted from the economic reforms, demands a greater role for the states in the provision of greater infrastructure facilities and enabling environment. Each state has to make greater expenditure than their counterparts in order to attract private investments. Otherwise the states that fail to provide these facilities may lag behind. The states in India play an increasingly important role in devising and implementing policies to stimulate economic growth and promote human development (World Bank, 2005). But the expenditure responsibilities and the revenue raising capacities are arranged in a peculiar way that major taxes are assigned to the centre -most of the broad based taxes- and the sub national governments[2] are entrusted to make most of the expenditures that directly touches the life of the masses. Actually the central government has a comparative advantage in raising revenues where as sub national governments are better placed to provide public services efficiently corresponding to varying preferences of people of different jurisdictions (Breton, 1987, 1995). This creates vertical imbalances in the federation and the states which need much resource to create infrastructure

[1] In the Eleventh plan, the share of public sector outlay estimated to be 21.9 per cent.

[2] It means the State governments in this context.

facilities will face scarcity of it. Apart from the vertical imbalances in the federation, the differences or the mismatch between revenues and expenditures of government units within a level of government creates horizontal imbalances. This leads to differences between state governments in their ability to generate revenues and standards of physical and social infrastructures provided. So the preconditions for successful intergovernmental competition-competitive equality and cost-benefit appropriablity - will not exist to create a competitive environment (Rao and Singh, 2005).

Indian Constitution recognizes the fact that states' tax powers are inadequate to meet their expenditure needs and thus, provides for federal fiscal transfers[3] which include both tax sharing and a system of grants to offset the fiscal gap arising from the fiscal imbalances. Apart from the constitutionally mandated Finance Commission transfers, there is transfer of resources through the Planning Commission to assist state's plan expenditure and to implement various Centrally Sponsored and Central Sector Schemes. The design of these fiscal transfers is one of the most complex aspects of the fiscal federalism and the transfer mechanisms are under increasing stress in terms of their ability to deal with vertical and horizontal gaps (Vaidya, 2012) due to many factors. If the federal fiscal transfer mechanism is unable to adequately deal with the fiscal imbalances in the federation, then the sub national governments will increasingly depend on the borrowings to finance their expenditures. Provision of enabling environment to attract private investments by the creation of infrastructure facilities-human and physical- requires heavy investments and this capital expenditures cannot be financed by the current revenues including fiscal transfers and own revenues. So the states have to depend on borrowing. If they don't borrow, they have to postpone the investments which will result in their lagging behind in this era of competition.

In this context, this thesis attempts to enquire how Indian state governments are making their expenditure and whether there exist any differences between states in their expenditure. It also tries to analyze whether the fiscal transfers are successful in offsetting the fiscal disabilities of the poor states and the borrowing regime of the states is equitable enough to help the poor states to raise adequate resources to finance their responsibilities.

[3] We use the terms federal fiscal transfers and intergovernmental transfers interchangeably.

1.1 Fiscal Federalism

The federal form of democratic government consists of two coexisting sovereign levels of government- one at the national and the other at the sub national level. This multi level system of financial responsibilities is a more realistic situation in the world today. We can call this decentralized fiscal system as fiscal federalism. Fiscal federalism is considered as an optimal institutional framework for the provision of public services. Alexis de Toqeville observed that, "the federal system was created with an intention of combining the different advantages which result from the magnitude and littleness of nations" (1945, Vol. I, p.163). The advantages from the magnitude and littleness can be realized only when the functions of different levels of governments and various units within each of the levels are clearly specified. Then only a federation can reap the economies of scale in the provision of services and advantages of a large common market, while retaining the individual identities of sub national governments. This requires clear identification and assigning of the public services to various governments and jurisdictions within each level of government depending on their comparative advantage in terms of their capacity and willingness to respond to diverse preferences in the provision of public services (Rao, 2010). We can see that the central government has comparative advantage in the performance of the distribution and stabilization functions. At the same time it is the state governments' decentralized decision making that is found to be the most efficient in performing a significant portion of the allocation function. As a result both sovereign jurisdictions have basic economic justification for the coexistence and thus for federation.

What distinguishes a federation and fiscal decentralization is that, a federal system is the one in which entire set of powers- legislative, fiscal and regulatory- are divided in the Constitution between different levels of government. The important thing is that the permanency in the assignments and the powers given to lower level governments cannot be extinguished by the higher level governments (Breton, 2000). The checks and balances to protect the federal system are inherent in that system whereas decentralization doesn't have that.

There are political and economic theories of federalism[4]. The political theories extend support to the federalism on the basis of enhancing freedom and the representation of constituents in their

[4] For a detailed discussion on theories of federalism, see Rao and Singh (2005).

government. India is a possible example for this. There are other arguments such as safeguarding group identities (language, religion, ethnicity etc), ensuring security and stability through bargains etc. The economic theories of federalism focus on creating multilevel public sector governance systems to improve efficiency. The traditional analysis or the first generation theories of economic federalism (Qian and Weinghast, 1997; Oates, 2005) implicitly assume that governments are 'benevolent' and as 'custodians of public interest', they seek to maximize social welfare. They demonstrate the superiority of the decentralized system over the centralized provision of public services. The new approaches to fiscal federalism or the second generation theories consider the assumption of benevolent governments unrealistic and consider that agents within the governments (bureaucrats and politicians) have their own objective functions operating within the constellation of incentives and constraints depending on the given fiscal and political institutions (Oates, 2008). They model the inter-governmental behaviour in terms of principal-agent relationship, underline the importance of hard budget constraints and focus on the importance of competition – both vertically between different levels of government and horizontally among different units within the same level to enhance efficiency in the delivery of public services (Rao, 2010).

1.2 The Rationale for Federal Fiscal Transfers

Generally the federal fiscal transfers are advanced for (i) offsetting the fiscal imbalances or to close the fiscal gaps; (ii) establishing horizontal equity across the federation; and (iii) offset inter-jurisdictional cost and benefit spillovers or for merit good reasons.

The assignments according to the comparative advantages in the federation results in the vertical imbalances, as all the broad based taxes are assigned to the centre and most expenditure functions are assigned to the sub national governments. The redistribution and stabilization functions are considered to be the functions of central government and so all the broad based and redistributive taxes, money supply function and borrowing powers are assigned to the centre. On the contrary the allocation function which involves the spending is assigned to the sub national governments as they can cater the diversified preferences in a better manner on a comparative basis. The fiscal transfers are meant to offset the imbalances arising from this.

The argument for intergovernmental transfers on equity grounds has been made either in terms of ensuring horizontal equity of individuals residing in the states across the country, or simply to ensure inter-regional equity (Musgrave, 1962). There is the need for general purpose transfers to offset the fiscal disabilities arising from lower than prescribed revenue capacity and higher unit cost of providing public services. Such differences in the revenue raising capacity and unit cost of providing public services among the sub national jurisdictions create different 'fiscal residuum' or net fiscal benefits[5] (Buchanan, 1950).The problem is aggravated when there are origin based taxes and similar other factors that alter the net fiscal benefits in different sub national jurisdictions (Boadway and Flatters, 1982). It means that residents in the richer states will get higher benefits from the public services compared to the poor states for the same tax rate payment. These differences in the fiscal benefits will be equalized automatically if there is perfect mobility of people across jurisdictions. This is because the people will migrate from the places where the net fiscal benefits are lower to those regions where it is higher. If the property market is well developed, then these fiscal differentials will be capitalized in to property values even when there is no perfect mobility of people across jurisdictions (Oates, 1969). But in most of the developing countries the property market is under developed and there will be no perfect mobility of people. So the only solution here is the intergovernmental transfers to offset the fiscal disabilities of the states.

Transfers are also made to ensure that the people are provided with basic services of minimum standards with significant inter-jurisdictional externalities. There are some services which must be available to all at minimum specified standards which include minimum standards of education, health care, water supply and sanitation. Feldstein (1975) calls them as 'categorical equity 'goods as these goods have nation- wide externalities and yet the sub national governments have a comparative advantage in providing them.

There are debates on the efficiency consequences of the equalizing transfers. The issue whether the horizontal equalization transfers are efficiency enhancing or involve efficiency cost is an unsettled debate. There are arguments that these transfers are growth enhancing (Buchanan 1950, Boadway and Flatters, 1982).Buchanan's argument is that equitable transfers are also efficiency

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[5] Net fiscal benefits in a state are measured as per capita expenditure incurred by the states minus per capita taxes collected by it.

enhancing because, as capital-labour ratio in the poorer regions is lower, the productivity of capital is high and transfer of capital to these regions would lead to higher productivity and income. The competitive federalism literature also advances support for transfers to create a level playing field by enabling poorer jurisdictions to compete effectively with fiscally stronger ones. There are other views which show tradeoff between equalization and growth. The income levels in poorer regions are low mainly because of lower productivity and transfer of capital to these regions will entail lower productivity and income. So there is a tradeoff between equity and efficiency (Scott, 1950). Despite these arguments, whether or not there is equity-growth tradeoff in the case of equalizing transfers remains theoretically unresolved and remains an empirical issue (Rao, 2010). The transfers can help to realize the growth potential of the locality by creating the necessary infrastructure or it may actually be used to impart skills to labour, enhance productivity and accelerate mobility of labour from regions having surpluses. The economic rationale for the transfers gives us an idea about the purpose fiscal transfers in a federation.

1.3 Statement of the Problem

As we discussed earlier, the economic reforms necessitated a transition from a plan economy to market economy which envisages a greater role for the sub national levels of governments or more specifically for the states governments. But all the Indian states are not equally equipped to access the opportunities provided by the market. There are significant differences between states in the levels of development achieved, market penetration, governance capacity, resource endowments etc. So the questions arises in this context is that how each state governments make expenditure for the creation of infrastructure facilities, both human and physical, that will help them to attract private investments. It is important to know whether the poor states are able to make adequate expenditure in critical areas, so that they can effectively compete with other states.

It is well known that in the Indian federation the expenditure responsibilities are more for the states whereas revenue raising capacity is higher for the centre, which generates vertical imbalances. This aggravates the problem of horizontal imbalances which arises from the differences in the revenue raising capacity and unit cost of providing services between different states governments. This kind of differences in the capacity to generate revenues and unit cost of providing services can make differences between states in the standards of physical and social

infrastructures provided. So in an era of competition, the poor states which lack adequate infrastructure facilities and the enabling environment to attract the private investments may lag behind.

But the federal fiscal transfers through various channels such as the Finance Commission and Planning Commission are meant to solve the fiscal imbalances. So the real concern is that if the transfer mechanism is adequate enough to offset the fiscal disabilities of the poor states and successful in creating a level playing field to enable the states to access the market opportunities from an equal footing. Apart from that the complexities in the transfer mechanism and the inadequacy of the own revenues and even the transfers generate the need to borrow for financing the large investments in order to create better enabling facilities and environment that attract private investments. Whether the borrowing regime helps the poor states to raise adequate resources equitably for their expenditure needs, is a real question that arises in this context.

1.4 Objectives of the Study

1. To examine the expenditure pattern of states in India.

2. To examine whether the fiscal transfers made by centre to the states are capable of offsetting the fiscal disabilities of poor states,

3. To analyze whether borrowing by the states are sufficient to finance their needs, especially that of the backward states,

1.5 Data Sources and Methodology

The study is based on secondary data and the main source is the 'Handbook of Statistics on State Government Finances, 2010' published by RBI, which provides state wise data on major fiscal indicators from 1980-81 to 2009-10 (BE) and on the transactions in the revenue and capital accounts from 1990-91.The data on receipts (revenue and capital) and expenditure of state governments is obtained by RBI from the data present in the Budget documents of state governments over the years. But the data provided by RBI on the outstanding liabilities of states are based on the data from the Combined Finance and Revenue Accounts of Union and State Governments in India,(CAG ,GOI), Ministry of Finance(GOI), Reserve Bank records, Budget documents of state Governments and Finance Accounts of Union Government(CAG,GOI).

We have selected major fourteen Indian states (non-special category states) for our study. The data of newly created states like Uttarakhand, Chhattisgarh, and Jharkhand added to the data of Utter Pradesh, Madhya Pradesh, and Bihar respectively, for the sake of comparison. The states are divided into high income, middle income and low income categories based on their per capita income. The 'high income states' includes states like Gujarat, Haryana, Maharashtra, and Punjab whereas the 'middle income states' category is comprised of Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and West Bengal. The 'lower income states' category consist of the states like Bihar, Madhya Pradesh, Orissa, Rajasthan, and Utter Pradesh. The period of the study is from 1990 to 2010 i.e., the two decades of economic reforms.

1.6 Chapter Scheme

First is the introduction chapter that gives an idea of the broader context in which the present study is situated along with the objectives, data and methodology of the study. The chapter 2 looks into the expenditure pattern of the fourteen major states in India and disparities among them. An analysis of the fiscal transfers in India is provided in the chapter 3. It tries to analyze whether the transfer mechanism in India is adequate enough to offset the fiscal disabilities of poor states and presents the reasons for the transfer mechanism's inadequacy to achieve the same. Chapter 4 is an enquiry into the borrowing regime of states to see if it is equitable and helps the poor states to raise adequate resources to finance their needs. The fifth chapter summarizes the thesis and draws conclusions.

Chapter 2

Expenditure Pattern of States in India

2.1: Introduction:

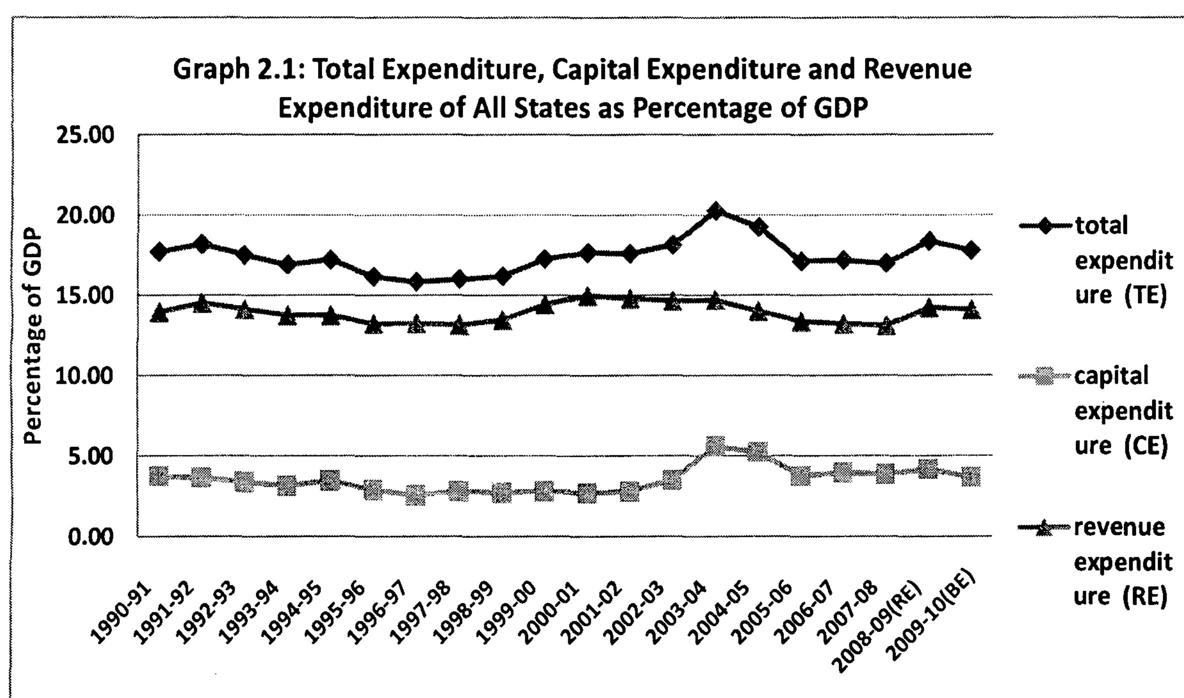
A detailed analysis of the expenditure pattern of states in India, during the two decades of economic reforms- from 1990 to 2010- is undertaken in this chapter. The striking feature of this era is the greater role cast on the states in economic development. With the major portion of investment envisaged to come from the private sector in the five year plans and public investment constituting less than 20 percent of the aggregate investment in the country, there is a paradigm shift in the role of states from undertaking direct investments to that of facilitating necessary enabling conditions and adequate infrastructure –both physical and human- to attract private investments (Commission on Centre-State Relations, 2010).

In this context, an enquiry in to the levels of expenditure made by different states is of great importance because the creation of the adequate infrastructure –physical and human –that attracts the private investments depends on the expenditure made by each state on each item of expenditure. If there is any disparities between states in the expenditure made by them, that will get reflected as the differences in the infrastructure and enabling conditions across states. As the states that have taken proactive measures and having better infrastructure facilities may attract private investment, those states that fails to attract this kind of private investment will lag behind. This will result in increasing inequalities in economic growth and accentuate disparities across states. In a country like India where there already exist disparities between states and regions due to lot of reasons like differences in resource endowments, institutions, colonial rule, population, its own history etc, this will easily get translated in to differences in the economic opportunities, income levels etc and most importantly the quality of life of the people in the respective states. So the analysis of expenditure decisions is of great importance.

This chapter is organized in the following manner. Section 2 analyses the expenditure pattern of all states in India. Section 2.3 gives an analysis of the expenditure pattern of individual states and an interstate comparison of expenditure by states in different sectors and sub-sectors. Section 2.4 provides a brief summary of this chapter.

2.2: Trends in Expenditure of All States:

An analysis of expenditure by all states in major items of expenditure is undertaken here, like total expenditure, capital expenditure, revenue expenditure, social sector expenditure, committed expenditure, capital outlay. We add up the expenditure in revenue and capital account to get the total expenditure. The trends visible from the total expenditure of all states points to interesting patterns.

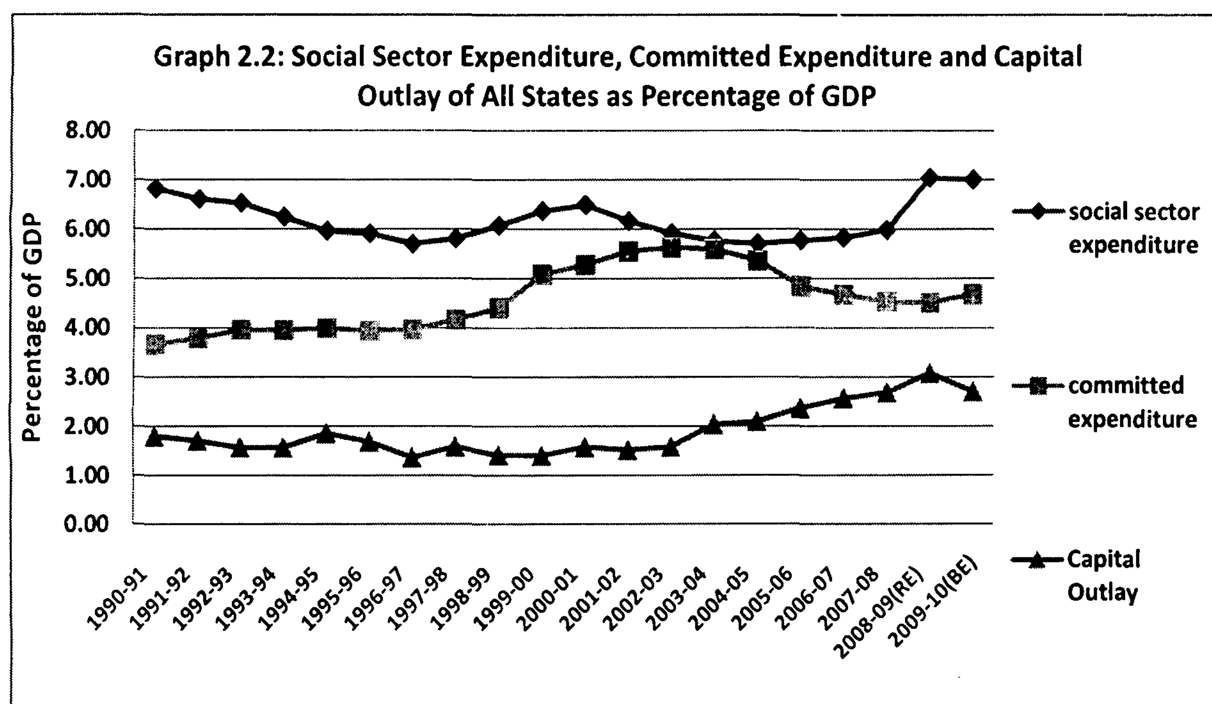


Source: Handbook of Statistics on State Government Finances 2010, RBI

The total expenditure of all states as a percentage of GDP shows a declining trend from 1991-92 till 1996-97, driven by a fall in both capital and revenue expenditure (Graph 2.1). But after that it started to increase till 2003-04. This increase was initially due to an increase in revenue expenditure and latter by the increase in capital expenditure. From 2003-04, the total expenditure began to fall, may be due to the enactment of FRBM legislation (Fiscal Responsibility and Budget Management Act)[1] in the Parliament, which stresses the need to

[1] Indian Parliament passed the Fiscal Responsibility and Budget Management Act (FRBMA) in August 2003 which imposes stringent fiscal discipline on the central government. The salient features of this act were the following.(a) elimination of Revenue Deficit by March 2009 (b) reduction of Fiscal Deficit to an amount equivalent to 3 % of GDP by March 2008.As the Eleventh Finance Commission started to link the resource transfers and other benefits from centre to fiscal consolidation by states, they were under

reduce deficit and fiscal deficit. The deficits can be reduced either by augmenting the revenue or by reducing the expenditure. Here, what we can see is a curtailment in the expenditure rather than augmenting the revenue (Chandrasekhar, 2011). It is important to note that it was a period when capital expenditure was increasing while revenue expenditure was declining. There was the unusual phenomenon of cash balances with state government even when many important sectors of these states needed substantial expenditures. This cash surplus was an outcome of mechanical constraints imposed by the FRBM laws (Isaac and Ramakumar, 2006). The restrictions seems to have worked for some time, but from 2007-08 the total expenditure began to increase again, may be due to fiscal stimulus adopted to counter the financial crisis, more allocation for social sector expenditure for an inclusive growth etc. Here the increase was mainly driven by an increase in revenue expenditure.



Source: Handbook of Statistics on State Government Finances 2010, RBI

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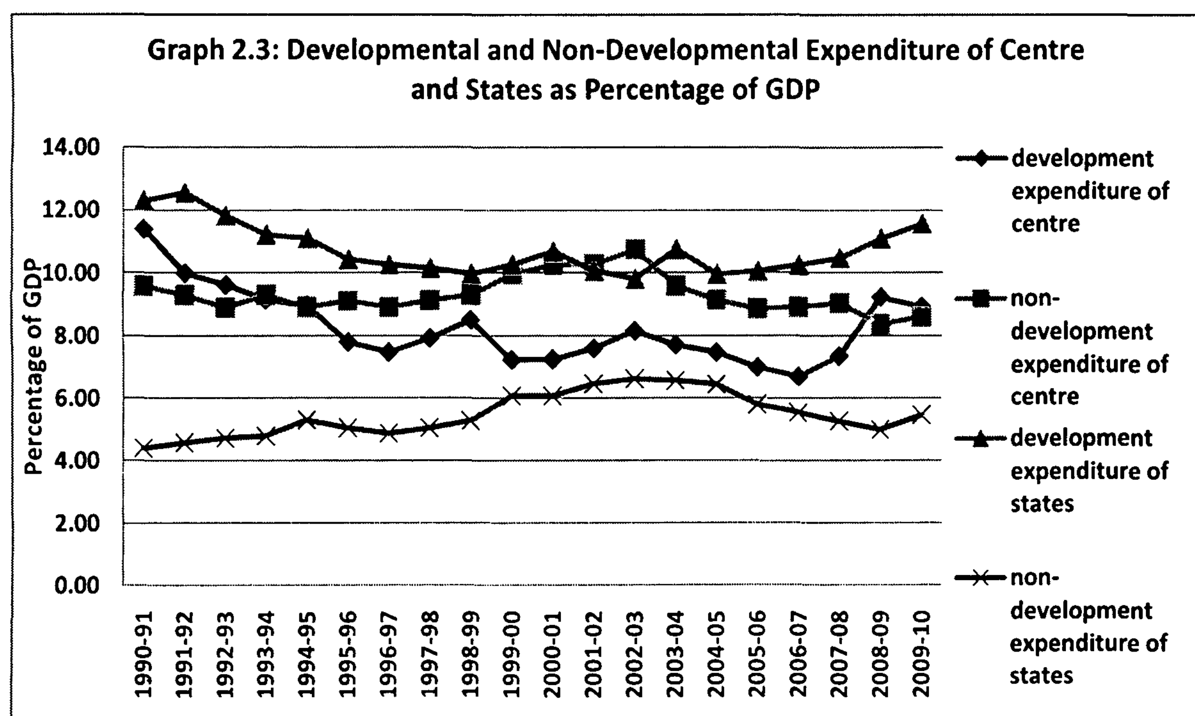
compulsion to pass the FRBM legislation First state that passed FRBM was Karnataka, in August 2002. Now all the states passed the legislation. The main elements of FRBM acts of states were the following (a) 2 to 3 per cent target for fiscal deficit to be achieved by 2005-06 to 2010-11(b) elimination of revenue deficit by around the same time (c) limits to overall liabilities to be incurred (d) limits to state government guarantees on debt€ formulation of a medium-term fiscal plan to reach these targets etc(Isaac Thomas and Ramakumar, 2006). For a detailed discussion on the enactment of the FRBM legislation in India and its impact on expenditure of states, see Isaac and Ramakumar (2006), Mohanty and Sigh (2007).

Graph 2.2 shows the social sector expenditure, committed expenditure and capital outlay of all states in India. Here the social sector expenditure includes expenditure on social services, rural development and food storage and warehousing under revenue expenditure, capital outlay[2] and loans and advances by the state governments. The objectives of social sector expenditure are (a) to achieve the social development by improving the social development indicators, such as education, health and nutritional standards of the general population, and (b) to alleviate poverty by implementing employment oriented programmes (Dev and Sreedevi, 2012). It is visible that the social sector expenditure as percent of GDP initially declined till 1996-97, then increased. But after 2000-01 it gradually declined. After 2004-05 it started to increase and showed a sharp rise in 2007-08. Whereas the committed expenditure –which is composed of expenditure on administrative services, interest payments and pensions- started to decline from the year 2003-04 after a continuous increase from 1990-91. The capital outlay of all states as percentage of GDP gradually increased over time, with slight fluctuations.



Source: Handbook of Statistics on State Government Finances 2010, RBI

[2] Capital outlay includes total developmental and non-developmental expenditure in the capital account. Here the developmental expenditure is composed of expenditure on social services like education, medical and public health, family welfare etc and expenditure on economic services like agriculture and allied activities, rural development etc.

It is the states which are spending in most of the items of expenditure that touches the life of the people. If we see the developmental and non-developmental expenditure of centre and states, it is evident that the state's expenditure on developmental activities is higher than that of centre, whereas it is the non-developmental expenditure that is higher in the case of centre (Graph 2.3). In 2000-01, 57 percent of India's total expenditure was financed by the states, as was 97 percent of irrigation maintenance, 39 percent of road maintenance, 90 percent of public health expenditure and 86 percent of public education expenditure (World Bank, 2005).The development expenditure of both centre and states are declining from 1990-91, but after 200405, it shows improvement in the case of states, whereas a declining trend continued till 2006-07 in the case of centre.

2.3: State-wise Comparison of Expenditure

In this section we compare the expenditure made by the major fourteen states in India, on different sectors and sub sectors. The expenditure made by them can be classified broadly as revenue expenditure and capital expenditure; both together constitute the total expenditure of states. The major sectors of expenditure are developmental and non- developmental expenditure. The sub sectors include the expenditure on social services and economic services in the case of development expenditure. In this analysis, development expenditure is an addition of the social and economic services in revenue and capital account including the loans for development purposes. The total non-developmental expenditure includes the expenditure on administrative services, interest payments, pensions, fiscal services etc in the revenue account and other non-developmental expenditure in the capital account. The social services, a major component of development expenditure are comprised of expenditure on education, medical and public health, family welfare, urban development etc in revenue and capital account. Expenditure on economic services includes sub sectors like revenue and capital expenditure on agriculture and allied activities, rural development, energy, industry and minerals, transport and communications etc. A state wise comparison of expenditure by different states in different sectors and sub-sectors reveals interesting facts.

Table 2.1: Per capita Aggregate Expenditure (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	1333	1896	2168	2761	4090	5632	5222	6549	7130	9324	9997
Haryana	1471	1753	3908	4221	4460	4619	4904	6433	8423	11098	13191
Maharashtra	1378	1743	2400	2888	3404	4632	4796	7151	7236	9498	10932
Punjab	1690	2035	3489	3374	4764	5995	7019	8271	10091	12279	13193
Middle Income States											
Andhra	998	1329	1784	2254	2976	3726	4455	5971	7019	10953	12141
Karnataka	1114	1550	1863	2428	2933	3775	4495	6235	7836	9414	10496
Kerala	1165	1481	1973	2565	3349	4151	5280	6199	6962	9760	10578
Tamil Nadu	1192	1723	1971	2591	3275	3956	4788	6518	7852	10331	11061
West Bengal	894	959	1291	1747	2231	3385	3410	4020	4835	7312	8074
Low Income States											
Bihar	726	883	947	1011	1263	1696	2460	2729	3570	5343	5606
M.P.	901	1132	1314	1765	2076	2363	3118	4547	4743	6790	7653
Orissa	971	1216	1496	1832	2456	3081	3562	4171	4975	7912	8194
Rajasthan	1084	1408	1778	2205	2769	3266	3736	4819	5115	6734	7576
U.P.	888	1133	1410	1469	1932	2221	2634	3534	4338	6008	6668
SD	264.9	355.1	824.8	817.5	990.5	1228.5	1219.2	1557.4	1859.2	2102.6	2398.0
Mean	1128.9	1445.6	1985.2	2365.1	2998.5	3749.7	4277.1	5510.5	6437.6	8768.4	9668.6
CV	0.23	0.25	0.42	0.35	0.33	0.33	0.29	0.28	0.29	0.24	0.25
Max/Min	2.3	2.3	4.1	4.2	3.8	3.5	2.9	3.0	2.8	2.3	2.4

Source: Handbook of Statistics on State Government Finances 2010, RBI

The aggregate expenditure of major 14 states in India, which is composed of expenditure in revenue and capital accounts, shows wide disparities (Table 2.1). The coefficient of variation in per capita aggregate expenditure increased from 0.23 in 1990-91 to 0.33 in 2000-01. It reached 0.25 in 2009-10, showing a disparity position worse than 1990-91. If we see the expenditure pattern of each state, we realize that the expenditure made by high income states like Gujarat, Haryana, Maharashtra, and Punjab was consistently above the average of all the 14 states. On the other hand, the expenditure of low income states like Bihar, Madhya Pradesh, Orissa, Rajasthan, and Utter Pradesh was much below the average of all states in all the years. The per capita expenditure made by Haryana and Punjab was more than double the expenditure by a poor state like Bihar. Expenditure position of middle income states is better, as all of them except West Bengal are spending more than the average in almost all the years. These disparities in the expenditure of states in their different activities will have serious implications on the quality of services provided by them. This will get reflected in the quality of life the people in different states.

Table 2.2: Per capita Capital Expenditure (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	338	422	446	509	761	1064	1063	1989	1813	2364	2035
Haryana	285	342	361	573	812	997	575	1352	1405	2115	2693
Maharashtra	258	307	625	480	523	528	685	2128	1379	2218	2152
Punjab	437	380	680	278	1120	1019	1017	1495	2975	2276	1988
Middle Income States											
Andhra	163	265	422	259	680	669	1078	2006	1884	2745	2937
Karnataka	226	329	335	361	481	572	982	1696	1893	2107	2376
Kerala	190	240	295	373	437	401	688	950	702	1242	1429
Tamil Nadu	176	213	310	393	360	435	709	1970	1978	1951	2153
West Bengal	134	142	230	358	378	587	560	642	826	1167	1215
Low Income States											
Bihar	155	134	91	124	161	260	518	743	920	1437	1314
M.P.	176	222	212	220	228	281	691	1621	1241	1627	1626
Orissa	274	269	284	346	518	619	873	922	919	1343	969
Rajasthan	286	299	354	511	530	459	785	1501	1108	1363	1533
U.P.	196	242	379	243	331	344	579	855	1108	1543	1554
SD	83.7	82.3	154.0	127.7	253.2	267.1	196.8	515.5	614.9	493.1	574.4
Mean	235.4	271.8	359.0	359.2	522.7	588.2	771.7	1419.3	1439.4	1821.1	1855.3
CV	0.36	0.30	0.43	0.36	0.48	0.45	0.26	0.36	0.43	0.27	0.31
Max/Min	3.3	3.1	7.5	4.6	7.0	4.1	2.1	3.3	4.2	2.4	3.0

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 2.2 shows that, there exist disparities between states in the capital expenditure also. Even though for few years, the per capita capital expenditure of some high income states turned below the average of all states, we can say that on the whole they are spending a higher amount in the items of capital expenditure account when compared to the low and middle income states. Among the low income states group, all the states are spending below the average of all the 14 states in most of the years. An exception in this group is Rajasthan which is spending above the average for initial few years. It is clear that in the middle income group, capital expenditure by Kerala and West Bengal was below the average of all states in almost all the years. Even though in the 90s capital expenditure by all the middle income states was not so good, states like Andhra Pradesh, Karnataka, Tamil Nadu started to spend above all states' average towards the end of the next decade, i.e., from 2004-05. We can see that the coefficient of variation in per capita capital expenditure increased from 0.36 in 1990-91 to 0.45 in 2000-01 and finally reached 0.31 in 2009-10. It will be worthwhile to mention that this fall in the coefficient of variation is not a continuous one, but it is fluctuating over time. The disparities in the capital expenditure is very

serious, as the expenditure made on this item directly influences the economic and development activities of a state, and thus contributes to the overall development of that state.

Table 2.3: Per capita Development Expenditure (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	991	1351	1562	1933	2924	4071	3025	3527	4564	6372	6425
Haryana	1024	1232	1866	2098	2823	2875	2848	3309	5870	7927	9369
Maharashtra	989	1216	1745	2036	2096	2971	2756	3760	4506	6548	7253
Punjab	1175	1245	1509	1827	2222	2856	2526	3147	4143	6109	5913
Middle Income States											
A.P.	726	961	1277	1542	1968	2436	2553	3144	4497	7944	8680
Karnataka	791	1095	1302	1702	1966	2481	2717	3518	5324	6205	7048
Kerala	755	910	1235	1606	2092	2259	2777	3063	3125	4811	5112
Tamil Nadu	853	1261	1403	1776	2022	2302	2599	3182	4425	6397	6546
West Bengal	606	587	837	1136	1352	1969	1532	1840	2246	4250	4170
Low Income States											
Bihar	487	558	562	587	730	1010	1430	1469	2425	3724	3766
M. P.	640	802	902	1226	1341	1480	1933	2733	3044	4664	5067
Orissa	667	830	991	1190	1472	1690	1720	1802	2452	4910	5174
Rajasthan	703	982	1192	1453	1767	1907	2016	2551	3137	4291	4877
U.P.	603	714	785	861	1062	1156	1305	1633	2511	3921	4004
SD	195.8	260.4	378.3	448.6	617.0	809.7	589.2	773.5	1172.5	1400.8	1700.5
Mean	786.4	981.8	1226.3	1498.0	1845.5	2247.3	2266.8	2762.6	3733.4	5576.7	5957.4
CV	0.25	0.27	0.31	0.30	0.33	0.36	0.26	0.28	0.31	0.25	0.29
Max/Min	2.41	2.42	3.32	3.57	4.01	4.03	2.32	2.56	2.61	2.13	2.49

Source: Handbook of Statistics on State Government Finances 2010, RBI

The development expenditure includes the expenditure on developmental items in both revenue and capital account and loans by states for developmental purposes. It is comprised of expenditure on social and economic services which directly touches the life of the people and development of the state. We can observe glaring disparities between states in the development expenditure made by them (Table 2.3). All the high income states are spending higher than all states' average throughout the period of analysis. On the contrary, all the low income states are spending an amount which is far below the all states' average in all the years. The States like Haryana is spending double the amount spend by a poor state, Bihar in 2009-10. The middle income states are also allocating fairly good amount for development expenditure, which is above the average of all the states in almost all the years. A major exception in this group is West Bengal, whose per capita expenditure on development purposes is below the all states' average.

Kerala's development expenditure from 2006-07 is also below the average of all states. The coefficient of variation in per capita development expenditure also shows wide disparities among states. It increased from 0.25 in 1990-91 to 0.36 in 2000-01 and finally reached 0.29 in 2009-10. This definitely points to the fact that the disparity condition in development expenditure in 2009-10 is worse than that of 1990-91. This can have serious impact on the development of the state and life of its people.

Table 2.4: Per capita Expenditure on Economic Services (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	573	836	886	1123	1648	2225	1553	1781	2359	3336	2992
Haryana	602	698	1146	1234	1655	1522	1421	1717	3581	4293	4686
Maharashtra	571	678	1070	1127	976	1353	1258	1975	2120	3268	4368
Punjab	719	708	896	1068	1027	1529	1152	1743	2423	3007	2662
Middle Income States											
A. P.	382	525	751	772	959	1283	1275	1622	2489	3948	4666
Karnataka	436	617	691	909	928	1183	1438	1980	3092	2920	3182
Kerala	290	388	503	685	976	883	1158	1228	1094	1634	1540
Tamil Nadu	375	631	673	816	773	882	1162	1254	2208	2707	2775
West Bengal	248	248	388	569	597	863	576	783	858	2080	1204
Low Income States											
Bihar	248	288	238	230	315	394	678	736	1247	1759	1708
M.P.	333	435	448	643	581	625	923	1695	1578	2349	2387
Orissa	381	440	510	575	669	695	730	731	1047	2110	2180
Rajasthan	330	512	578	665	684	632	731	1099	1318	1667	1836
U.P.	342	412	453	424	496	561	617	777	1227	1943	1804
SD	144.6	171.5	265.3	291.2	389.2	499.1	332.9	476.1	832.5	852.2	1156.9
Mean	416.4	529.8	659.3	774.4	877.4	1045.0	1048.0	1365.8	1902.8	2644.3	2713.7
CV	0.35	0.32	0.40	0.38	0.44	0.48	0.32	0.35	0.44	0.32	0.43
Max/Min	2.90	3.37	4.82	5.37	5.25	5.64	2.70	2.71	4.18	2.63	3.89

Source: Handbook of Statistics on State Government Finances 2010, RBI

The expenditure on economic services include, the expenditure on agriculture and allied activities, rural development, irrigation and flood control, energy, industry and minerals, transport and communications etc. This shows the importance of this item of expenditure in the economic development of a state. But when we see the per capita expenditure on economic services of different states, we realize that there also exist glaring inequalities between them (Table 2.4). Here also the per capita expenditure made by different states in different income groups follows a pattern which very well suits their income position. More clearly, the high income states are spending an amount which is higher than the average of all the 14 states during

the entire period whereas, the low income states are spending much below the all states' average in the economic services throughout the period of study. Among the middle income states, Andhra Pradesh, Karnataka and Tamil Nadu spend a fair amount on economic services. But Kerala and West Bengal spends below the average in most of the years. The coefficient of variation in per capita expenditure on economic services clearly shows that the disparity condition is getting worse as it increased from 0.35 in 1990-91 to 0.48 in 2000-01 and finally reached 0.43 in 2009-10. The maximum-minimum ratio also increased from 2.90 in 1999-91 to 3.89 in 2009-10.

Table 2.5: Per capita Social Sector Expenditure (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	486	583	747	893	1410	2006	1586	1900	2383	3272	3711
Haryana	476	566	737	877	1286	1708	1302	1558	2404	4065	4941
Maharashtra	485	692	806	1062	1281	1693	1595	2011	2698	3567	5460
Punjab	476	512	728	550	1327	1652	1211	1476	1806	3269	3346
Middle Income States											
A.P.	416	542	611	871	1210	1326	1449	1750	2311	4466	4288
Karnataka	412	558	725	917	1153	1448	1414	1778	2561	3598	4215
Kerala	510	608	790	1038	1471	1655	1972	2245	2161	3347	3738
Tamil Nadu	537	695	785	1045	1343	1557	1534	2124	2598	4142	4214
West Bengal	419	396	532	669	862	1218	1041	1168	1542	2410	3241
Low Income States											
Bihar	278	358	390	431	556	741	1015	968	1543	2453	2504
M.P.	372	446	544	710	895	1018	1205	1269	1839	2943	3315
Orissa	354	463	560	716	922	1134	1130	1207	1576	3281	3507
Rajasthan	428	531	695	870	1152	1349	1393	1641	2020	2993	3463
U.P.	342	391	404	491	643	734	831	1039	1416	2276	2508
SD	72.7	104.6	140.3	205.5	286.1	375.2	293.1	409.7	442.3	656.1	828.2
Mean	427.9	524.3	646.7	795.8	1107.9	1374.2	1334.2	1581.1	2061.3	3291.5	3746.7
CV	0.17	0.20	0.22	0.26	0.26	0.27	0.22	0.26	0.21	0.20	0.22
Max/Min	1.9	1.9	2.1	2.5	2.6	2.7	2.4	2.3	1.9	2.0	2.2

Source: Handbook of Statistics on State Government Finances 2010, RBI

As discussed earlier in section 2.2, social sector expenditure is vital for the socio-economic development of any state or society. So the expenditure made by any state on this, is of great importance. Persistence of inequality between states is clear in the social sector expenditure, as the coefficient of variation in per capita social sector expenditure increased from 0.17 in 1990-91 to 0.27 in 2000-01.Even though it decreased to 0.22 in 2009-10, it is definitely a worse situation

than 1990-91(Table 2.5). Per capita expenditure on social sector by high income states and middle income states are higher when compared to the low income states. Among high income states, all except Punjab spends higher than the average of all states, for almost all the years. A major exception to the better performance of middle income states is West Bengal which spends below the average throughout the period of analysis. All the low income states except Rajasthan spend below the average of all state's spending for all the years. This is a disturbing fact, as the disparity in the social sector expenditure may produce disparities in social sector development of states which leads to persistence of regional disparities.

Table 2.6: Per capita Expenditure on Education, Sports, Art and Culture (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	223	272	359	453	670	764	705	751	907	1083	1152
Haryana	204	263	311	409	647	673	674	749	999	1695	2212
Maharashtra	223	295	368	491	601	1034	908	1003	1186	1548	1770
Punjab	257	303	363	469	751	790	847	839	896	1447	1598
Middle Income States											
A.P.	154	201	243	278	386	496	525	597	757	1229	1343
Karnataka	180	241	307	393	526	670	667	794	1024	1518	1560
Kerala	274	317	454	531	627	832	929	1003	1188	1641	1847
Tamil Nadu	233	278	334	427	647	714	660	733	958	1430	1643
West Bengal	205	199	250	326	397	580	542	598	735	991	1409
Low Income States											
Bihar	145	153	187	240	267	401	457	422	646	918	1026
M.P.	147	169	201	263	340	378	371	439	594	968	1081
Orissa	147	196	249	313	422	491	511	524	637	1262	1503
Rajasthan	190	237	309	400	541	614	577	663	799	1166	1401
U.P.	155	180	195	250	354	377	399	461	652	831	1034
SD	42.9	53.4	77.9	96.0	150.0	191.7	177.7	190.1	198.6	283.9	339.9
Mean	195.5	236.0	295.0	374.5	512.5	629.4	626.7	684.0	855.7	1266.2	1469.9
CV	**0.22**	0.23	0.26	0.26	0.29	**0.30**	0.28	0.28	0.23	0.22	**0.23**
Max/Min	1.89	2.07	2.43	2.22	2.81	2.74	2.51	2.38	2.00	2.04	2.16

Source: Handbook of Statistics on State Government Finances 2010, RBI

The expenditure by a state in education and medical and public health is very critical for the human and overall development of that state. Studies have shown that public spending on education and health has a stronger impact on human development than the growth of per capita income (Chakraborty 2003, cited in Ramakumar 2008). So having a look at these items of expenditure of states will be of importance.

Table 2.6 shows the per capita expenditure of states on education, sports, art, culture etc. Throughout the two decades selected for this study, the states in the high income category are spending higher than the average of all states in this item. On the other hand almost all the low income states are spending below the average of all states, except Rajasthan for few years. Among the middle income states, all states except Andhra Pradesh and West Bengal are spending higher than the all states' average. Existence of disparity is very clear from the coefficient of variation in per capita expenditure on education etc, as it increased from 0.22 in 1990-91 to 0.30 in 2000-01 and finally reached 0.23 in 2009-10. The maximum-minimum ratio in this item of expenditure also increased from 1.89 in 1990-91 to 2.16 in 2009-10.

Table 2.7: Per capita Expenditure on Medical and Public Health (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	61	75	95	98	161	163	143	160	184	244	294
Haryana	53	73	87	85	135	133	138	150	185	315	388
Maharashtra	64	79	93	104	122	160	163	181	196	293	287
Punjab	84	104	110	121	207	253	233	219	242	411	376
Middle Income States											
A.P.	50	63	81	83	111	141	146	158	194	327	395
Karnataka	56	80	99	92	139	161	156	158	210	351	357
Kerala	77	81	118	125	156	189	221	249	306	403	434
Tamil Nadu	70	89	109	116	161	162	158	181	217	324	431
West Bengal	68	64	74	85	130	167	149	149	173	229	317
Low Income States											
Bihar	38	45	57	42	49	71	79	74	154	196	206
M.P.	43	51	65	65	97	102	111	124	156	225	250
Orissa	45	54	73	65	92	107	114	142	132	271	303
Rajasthan	59	77	101	104	135	140	132	154	184	264	330
U.P.	49	56	65	59	66	72	82	112	219	289	287
SD	13.3	16.3	19.0	24.7	41.2	47.5	43.6	42.7	42.7	64.2	67.3
Mean	58.4	70.8	87.5	89.0	125.7	144.3	144.7	157.9	196.6	295.9	332.6
CV	0.23	0.23	0.22	0.28	0.33	0.33	0.30	0.27	0.22	0.22	0.20
Max/Min	2.22	2.33	2.09	2.96	4.23	3.54	2.93	3.35	2.32	2.09	2.11

Source: Handbook of Statistics on State Government Finances 2010, RBI

An analysis of expenditure on medical and public health reveals interesting facts (Table 2.7). We can see that all the low income states are spending below the average of all the states in all the periods, except Rajasthan which showed better performance in initial years. Among the high income states, except the fact that Gujarat and Haryana spends below the average for few years, all the states exhibits relatively better expenditure on medical and public health. In the middle

income category, states like Karnataka, Kerala and Tamil Nadu is spending above the average whereas the expenditure by Andhra Pradesh and West Bengal is below the average for many years. The coefficient of variation in per capita expenditure on medical and public health increased from 0.23 in 1990-91 to 0.33 in 2000-01 and it turned 0.20 in 2009-10. Still we can observe disparities between states in this item of expenditure.

Primary education and basic health and nutrition represent important aspects of any country's development and it is widely accepted that India's performance on these fronts has been worse (Dreze and Sen. 1995). Following the all India trends, the different Indian states also shows wide disparities in these items of expenditures, which can lead to the differences in human development in the states.

2.4: Summary:

Our analysis of expenditure by fourteen major Indian states shows the existence of wide disparities across them. In all the sectors and sub sectors of expenditure like total expenditure, capital expenditure, developmental expenditure, social sector expenditure, expenditure on education and medical and public health, this trend is visible. The coefficient of variation in the per capita expenditure of almost all the sectors shows an increase towards the end of 1990s. But in the initial years of 2000s it reduced a little or more correctly witnessed some fluctuations, and reached a disparity situation worse than 1990-91, towards the end of the decade. In almost all the sectors the low income states like Bihar, Madhya Pradesh, Orissa, Rajasthan, and Utter Pradesh are spending much below the average of all the fourteen states, whereas the rich states like Gujarat, Haryana, Maharashtra, and Punjab are spending higher than the all states' average. Middle income states like Kerala, Andhra Pradesh, Karnataka, and Tamil Nadu exhibits relatively better performance and a major exception among the group is West Bengal.

The disparities in the expenditure by states in different sectors are of serious consequences. It can affect the economic and social development of the people and of the state itself, as it can cause inequalities in the access to basic social and economic services. The globalizing environment needs creation of better infrastructure - physical and human- facilities and if it is not provided by a poor state, the economic activities and investments will flow to the rich states that provide all these enabling conditions. As a result the poor states will lag behind and this will lead to

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differences in economic activities and development across states. This will easily get turned to differences in economic opportunities, employment, income levels, and human development and will pose serious threats to the stability of the federation.

Chapter 3

Federal Fiscal Transfers in India

3.1 Introduction:

In the previous chapter we saw the existence of wide disparities between states in their expenditure on major sectors. A major reason for these disparities is the differences in the revenue raising capacity of sub national governments and cost and demand pressures they may face when meeting the assigned expenditure responsibilities, which is also known as horizontal imbalances. The problem is getting worsened when according to the comparative advantage; all the broad based taxes are assigned to the centre while substantial and growing expenditure responsibilities are devolved to the sub national levels and finally result in vertical imbalances. Here, the transfer mechanism has an important role to resolve these imbalances by offsetting the fiscal disabilities of states or sub national governments and reducing disparities between them. In this context, it will be beneficial to see whether the transfer mechanism in India is capable of offsetting the fiscal disabilities of states, especially that of the poor ones.

The theoretical literature gives rationale for the federal fiscal transfers on horizontal equity grounds or merit good reasons. More precisely, the transfers are to be made for (a) offsetting fiscal imbalances or closing the fiscal gap, (b) establishing horizontal equity across the federation, and (c) offsetting inter-jurisdictional cost and benefit spillovers or for merit good reasons (Rao and Singh, 2005). Transfers given on the horizontal equity grounds-general purpose transfers- are meant to offset the fiscal disabilities arising from lower than prescribed revenue capacity and higher unit cost of providing public services. It will ensure horizontal equity of individuals residing in the states across the country, or simply ensure inter-regional equity (Musgrave, 1962). Differences in the revenue generating potential and unit cost of providing public services among the sub national governments may cause different net fiscal benefits[1] (Buchanan, 1950) and create inequity. The problem is aggravated when there are origin based taxes and similar other factors that change the net fiscal benefits in different sub national jurisdictions (Boadway and Flatters, 1982). If perfect mobility of people across jurisdictions is possible, then the fiscal differentials will get equalized, as people will migrate from places where

[1] Net fiscal benefits in a state are measured as per capita expenditure incurred by the states minus per capita taxes collected by it.

the net fiscal benefits are lower to those places where it is higher. If there is a well developed property market, these fiscal differentials will be capitalized into property values, even if there is no perfect mobility (Oates, 1969). In the developing countries, both the developed property market and perfect mobility may be absent. So the sole way to offset the fiscal disabilities arising from low revenue capacity and high unit cost of providing public services is the intergovernmental transfers.

Transfers based on merit good reasons are meant for specific purposes and to ensure that every state spends the prescribed minimum outlay on meritorious services with significant inter-state spillovers (Rao, 2010b). There are services which must be available at minimum specified standards to all the people and these include minimum standards of education, healthcare, water supply, sanitation etc. It is also called as 'categorical equity' goods because these services have nationwide externalities and yet, sub national governments have a comparative advantage in providing them (Feldstein, 1975). Here intergovernmental transfers are necessary to compensate the spillovers and to ensure minimum levels of these services to all. Competitive federalism literature also suggest transfers as it will create a level playing field by enabling poor jurisdictions to compete effectively with fiscally stronger ones (Breton, 1987).

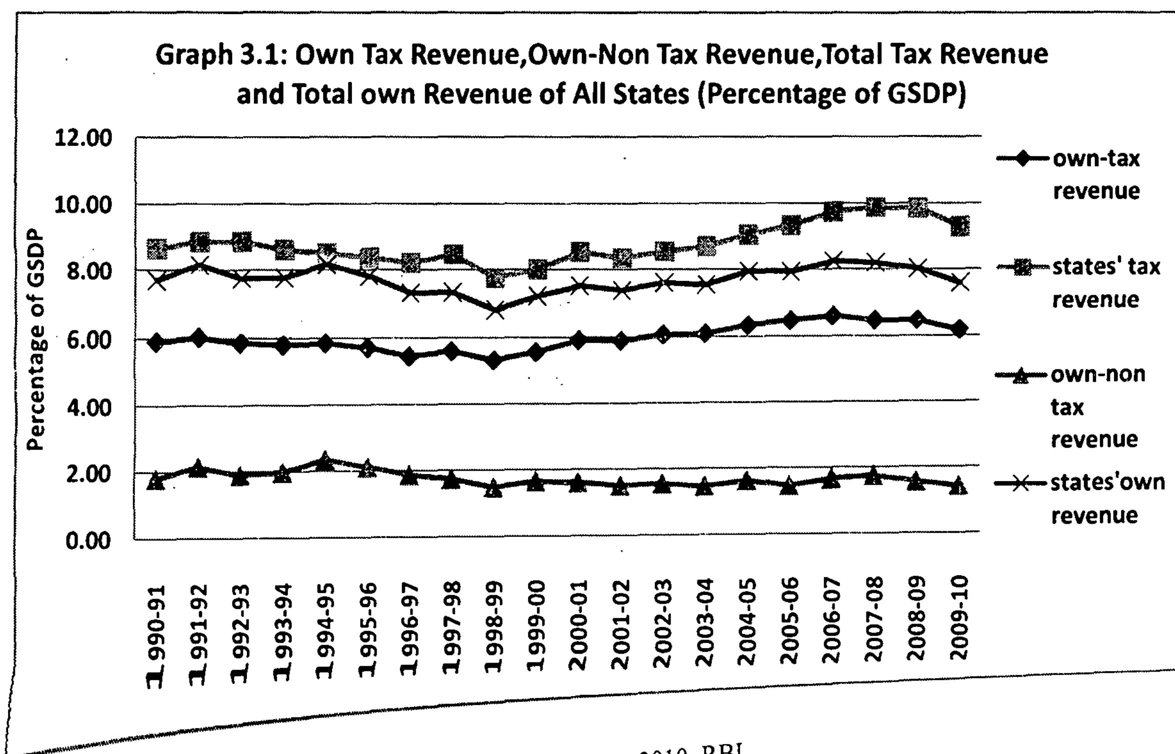
The plan of the chapter is as follows. Section 3.2 looks in to the revenue position of major fourteen states in India. A discussion on the federal fiscal transfers in India and its channels is provided in section 3.3. In section 3.4, an analysis of fiscal transfers to the individual states is given. Section 3.5 gives an account on the extent of equalization in the Indian federalism. An enquiry into the reasons for the failure of transfer mechanism to offset the fiscal disabilities of poor states is undertaken in section3.6. Summary of this chapter is given in section 3.7.

3.2 Revenue Position of the States

The revenue side of the state governments should be strong enough to make substantial expenditure in important sectors which contribute to the development of the state. But in India, the tax assignments and expenditure responsibilities of the states reveals that even when they are responsible for making expenditure on majority of the items that touches the life of the people directly, their revenue raising ability is limited. Apart from this there are differences in the

revenue raising capacity and cost of providing services across states. Both of these things will get reflected in the own revenue position of the states.

Graph 3.1 represents the overall revenue position of all the states in the Indian Union. It gives an account on the trends in the own tax revenue, own non-tax revenue, total tax revenue and total own revenue of all states in the two decades after the economic reforms. Own tax revenue is collected from the own tax sources of a state, whereas the own non-tax revenue is accruing from the sources other than taxes. States' own revenue include its own tax revenue and own non-tax revenue. By states' tax revenue, we mean a combination of states' own tax revenue and its share in central taxes. A general trend visible from the graph is that, all the items stated above declined till 1998-99, but after that it began to increase except own non-tax revenue which remained almost constant. The increase in states' own revenue and own tax revenue continued till 2006-07, after which it started to decline whereas such a decline is visible in the case of states' tax revenue only from 2008-09.



Source: Handbook of Statistics on State Government Finances 2010, RBI

3.2.1 State-wise Comparison of Own Revenue Position

Own tax revenue shows how much revenue, a state can collect from its economy through taxes. A state wise comparison of per capita own tax revenue reveals that own tax revenue of high income and middle income states are much higher than that of the low income states (Table 3.1). For instance, Haryana's own tax revenue is five times higher than that of Bihar in 2009-10. In the 90s, the coefficients of variation in per capita own tax revenue shows an increasing trend. It increased from 0.43 in 1990-91 to 0.49 in 2000-01. In the next decade, after showing some fluctuations it reached 0.45 in 2009-10, which shows a worse disparity situation in the own tax revenue of the states than 1990-91. The per capita own tax revenue of high income states like Gujarat, Haryana, Maharashtra and Punjab are higher than the average own tax revenue of all states in all periods whereas that of poor states like Bihar, Madhya Pradesh, Orissa, Rajasthan and Utter Pradesh is very much lower than the average in all the years. Among the middle income states, a major exception for their relatively better performance is West Bengal whose per capita own tax revenue is below the average since 1990.

Table 3.1: Per capita Own Tax Revenue (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	585	821	1083	1332	1625	1875	1847	2432	3359	4273	4431
Haryana	656	858	1067	1155	1621	2174	2572	3314	4687	5917	5955
Maharashtra	655	816	1133	1353	1595	2165	2317	3012	3826	4639	4654
Punjab	642	850	1208	1223	1418	2080	2312	2736	3460	4321	5199
Middle Income States											
Andhra	402	501	605	677	1079	1398	1635	2058	2964	4339	4889
Karnataka	522	676	902	1169	1368	1736	1949	2926	4142	4998	5624
Kerala	462	640	927	1259	1468	1853	2273	2741	3590	4714	5351
Tamil Nadu	563	736	1006	1343	1586	1988	2277	3020	4264	5222	5795
West Bengal	317	376	519	571	621	749	867	1191	1372	1865	2217
Low Income States											
Bihar	133	178	203	242	277	294	450	495	596	924	1066
M. P.	268	345	405	553	664	801	1026	1281	1744	2210	2471
Orissa	213	237	277	390	423	609	771	1097	1560	1935	2049
Rajasthan	279	385	487	628	762	990	1084	1403	1864	2345	2550
U.P.	229	273	326	402	486	663	774	925	1325	1614	1818
SD	183.0	248.5	355.6	415.6	509.3	672.3	727.5	947.3	1316.8	1619.7	1729.4
Mean	423.2	549.5	725.0	878.3	1070.9	1383.9	1582.5	2044.9	2768.1	3522.5	3862.1
CV	0.43	0.45	0.49	0.47	0.48	0.49	0.46	0.46	0.48	0.46	0.45

Source: Handbook of Statistics on State Government Finances 2010, RBI

An analysis of own non-tax revenue of states also shows a picture similar to that of their own tax revenue. Table 3.2 which presents the per capita own non-tax revenue, reveals that all the low income and middle income states has a low own non-tax revenue in almost all the years. But the revenue collected by the rich states from the own non-tax sources are higher than the average of all states in most of the years. It can be seen that the per capita own non-tax revenue of a rich state like Punjab is six times higher than that of Bihar, a poor state in the year 2009-10. This disparity is well represented by the coefficient of variation in per capita own non-tax revenue, which increased from 0.63 in 1990-91 to 0.81 in 2000-01. It became 0.67 in 2009-10.

Table 3.2: Per capita Own Non-Tax Revenue (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	98	275	340	345	590	694	775	580	900	766	848
Haryana	313	273	1964	1689	789	726	838	1133	1969	1579	1464
Maharashtra	230	240	348	434	401	614	459	405	717	969	1268
Punjab	127	159	932	870	655	1247	1634	2111	1525	2534	2009
Middle Income States											
Andhra	118	160	219	225	250	363	457	476	804	1019	1556
Karnataka	116	175	178	272	290	319	239	814	728	331	366
Kerala	72	95	131	166	176	208	211	250	282	384	429
Tamil Nadu	69	108	133	149	191	277	295	344	526	854	511
West Bengal	32	36	48	56	50	154	80	162	147	614	311
Low Income States											
Bihar	89	89	108	114	119	81	114	142	162	213	288
M. P.	129	213	228	266	232	252	313	664	462	561	715
Orissa	64	121	190	140	159	191	258	353	666	660	560
Rajasthan	188	223	274	274	262	315	272	358	551	595	805
U. P.	56	100	126	84	91	118	128	176	373	450	347
SD	76.1	74.4	505.7	432.6	224.4	319.9	413.3	522.3	506.2	601.3	545.7
Mean	121.5	161.8	372.8	363.1	303.8	397.1	433.9	569.2	700.8	823.5	819.7
CV	0.63	0.46	1.36	1.19	0.74	0.81	0.95	0.92	0.72	0.73	0.67
Max/Min	9.6	7.7	41.3	30.1	15.8	15.5	20.3	14.9	13.4	11.9	7.0

Source: Handbook of Statistics on State Government Finances 2010, RBI

It can be said that state's own revenue, which comprises of own tax and own non-tax revenue of states, shows the economic strength of a state, as this is the revenue resulting from its economic activities and doesn't include any kind of transfer from any source. Table 3.3 also shows the existence of disparities between states in their own revenue. The coefficient of variation in per capita state's own revenue increased from 0.42 in 1990-91 to 0.52 in 2000-01. From that year it

showed a decline and reached 0.44 in 2009-10. But the disparity situation in 2009-10 is worse than 1990-91. We can see that own revenue of high income states like Gujarat, Haryana etc are much greater than the average of all states in all the periods, where as it is much lower than the average in the case of poor income states like Bihar, U.P. etc. For example own revenue of Haryana is five times bigger than that of Bihar in 2009-10. Middle income states also have much better own revenue position except West Bengal throughout the period of analysis and Andhra Pradesh for few years. The maximum- minimum ratio also increased from 4.4 in 1990-91 to 5.5 in 2009-10.

Table 3.3: Per capita States Own Revenue (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	683	1096	1423	1677	2215	2569	2622	3011	4259	5039	5279
Haryana	970	1131	3031	2844	2410	2900	3410	4447	6657	7496	7418
Maharashtra	885	1056	1481	1787	1996	2779	2776	3417	4543	5608	5922
Punjab	768	1010	2140	2092	2073	3327	3946	4847	4985	6855	7208
Middle Income States											
Andhra	519	661	824	902	1330	1762	2093	2534	3768	5358	6445
Karnataka	637	851	1080	1441	1657	2055	2188	3740	4870	5329	5990
Kerala	534	735	1058	1425	1644	2061	2484	2991	3872	5098	5780
Tamil Nadu	631	844	1139	1492	1776	2265	2572	3364	4789	6076	6307
West Bengal	349	412	566	627	671	903	947	1353	1519	2479	2528
Low Income States											
Bihar	223	267	311	356	396	374	565	636	759	1137	1353
M .P.	397	557	633	819	896	1054	1340	1945	2206	2771	3186
Orissa	277	357	468	530	581	800	1029	1450	2225	2595	2609
Rajasthan	467	607	761	902	1024	1305	1356	1761	2415	2940	3355
U.P.	286	373	453	487	576	780	902	1101	1698	2064	2165
SD	230.6	295.3	744.2	710.5	681.7	924.7	1020.3	1284.6	1681.0	1968.2	2052.8
Mean	544.7	711.3	1097.8	1241.4	1374.7	1781.0	2016.4	2614.1	3468.9	4346.0	4681.8
CV	0.42	0.42	0.68	0.57	0.50	0.52	0.51	0.49	0.48	0.45	0.44
Max/Min	4.4	4.2	9.7	8.0	6.1	8.9	7.0	7.6	8.8	6.6	5.5

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 3.4 represents the fiscal autonomy ratios of states or the percentage of state's own revenue to their revenue expenditure. It is clear that the ratio is higher for the richer states throughout the two decades of analysis. For instance, it was 39.01 percent in 1990-91 for Bihar. It decreased to 26.08 percent in 2000-01 and further increased to 31.53 percent in 2009-10. Whereas for a rich state like Haryana the ratio was 81.79 in 1990-91 which became 80.09 percent and 70.67 percent

in 2000-01 and 2009-10 respectively. It means that rich states uses mostly their own revenue to meet their current expenditure, where as it is not the case with poor states. They have to depend on other sources to carry out their expenditure responsibilities. Here the coefficient of variation also increased from 0.24 in 1990-91 to 0.30 in 2000-01 and finally it reached 0.26 in 2009-10. It shows persistence of disparity between states in the fiscal autonomy.

Table 3.4: Percentage of State's Own Revenue to Revenue Expenditure (Fiscal Autonomy Ratio)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	68.67	74.30	82.60	74.46	66.53	56.24	63.04	66.04	80.10	72.39	66.31
Haryana	81.79	80.16	85.48	77.97	66.08	80.09	78.76	87.53	94.85	83.44	70.67
Maharashtra	78.98	73.56	83.43	74.21	69.26	67.70	67.52	68.03	77.57	77.03	67.45
Punjab	61.35	61.00	76.17	67.57	56.88	66.85	65.75	71.54	70.05	68.53	64.33
Middle Income States											
Andhra	62.20	62.14	60.51	45.21	57.88	57.63	61.97	63.92	73.40	65.27	70.03
Karnataka	71.75	69.76	70.71	69.70	67.60	64.15	62.28	82.40	81.95	72.94	73.78
Kerala	54.83	59.25	63.07	65.01	56.44	54.97	54.09	56.98	61.85	59.85	63.18
Tamil Nadu	62.15	55.89	68.57	67.88	60.93	64.33	63.08	73.97	81.52	72.50	70.80
West Bengal	45.89	50.44	53.36	45.14	36.23	32.27	33.25	40.04	37.89	40.34	36.85
Low Income States											
Bihar	39.01	35.65	36.36	40.13	35.94	26.08	29.07	32.04	28.62	29.10	31.53
M. P.	54.74	61.30	57.45	53.04	48.47	50.62	55.20	66.48	62.98	53.66	52.86
Orissa	39.71	37.72	38.58	35.65	29.99	32.51	38.27	44.64	54.86	39.50	36.11
Rajasthan	58.53	54.81	53.40	53.23	45.72	46.48	45.97	53.05	60.27	54.73	55.51
U.P.	41.30	41.82	43.95	39.70	35.99	41.58	43.91	41.10	52.58	46.22	42.34
SD	13.84	13.64	16.31	14.77	13.60	15.65	14.40	16.58	18.14	16.25	14.78
Mean	58.64	58.41	62.40	57.78	52.42	52.96	54.44	60.55	65.61	59.68	57.27
CV	0.24	0.23	0.26	0.26	0.26	0.30	0.26	0.27	0.28	0.27	0.26
Max/Min	2.10	2.25	2.35	2.19	2.31	3.07	2.71	2.73	3.31	2.87	2.34

Source: Handbook of Statistics on State Government Finances 2010, RBI

The analysis we made so far reveals the facts that are very crucial. The own resources of the states, especially that of the poor states are not adequate, to perform the responsibilities assigned on them. There exist wide disparities among states in the own tax, own non-tax and total own revenues. Both these issues can create serious fiscal disabilities and fiscal imbalances among states which will finally result in disparities-economic, social, human etc- between them. This is detrimental to the stability and development of the federation. This is a situation that is faced by most of the federations of the world. There are mechanisms to solve this issue, i.e. mainly in the form of transfer of resources from the national government to the sub-national governments. In

India also, we have constitutionally defined and other forms of measures to correct the fiscal imbalances[2]-both vertical and horizontal- in the form of transfer of resources from centre to states.

3.3 Channels of Federal Fiscal Transfers in India:

An important characteristic of the transfer mechanism in India is the existence of multiple channels which govern the transfer of resources from centre to the states. First of all, there is Finance Commission, appointed by the President of India (once every five years or earlier as needed), which determines the overall share of the states in the central taxes as well as its allocation among different states and recommends grants to the states in need of assistance from the Consolidated Fund of India. Apart from the Finance Commission, there is the Planning Commission which recommends on the magnitude of grants and loans to be provided to the states for financing their plan expenditure. In addition to these two channels, there are Central Sector Schemes and Centrally Sponsored Schemes, designed by the various central government ministries in consultation with the Planning Commission, in which centre's funds are transferred to the states for implementing the schemes. A detailed discussion on each channel of the fiscal transfers are necessary, to have a clear idea on the flow of resources from the centre to the states (Jha, et.al. 2011).

3.3.1 Finance Commission Transfers

As we mentioned earlier, the President of India appoints the Finance Commission under Article 280 of the Constitution, every five years or earlier as deemed necessary. As per the Constitution the Commission is required to make recommendations on the following:

(a) The distribution between the union and the states of the proceeds of shareable taxes and allocation between the states of the state's share of divisible taxes;
(b) The principles that should govern grants-in-aid of revenues of the states out of the Consolidated Fund of India and the amount to be paid to the states in need of assistance.

[2] In a federation there can be two types of fiscal imbalances, i.e., between different units of federation which is known as vertical imbalances and among different regions of the federation, commonly known as horizontal imbalances. Vertical imbalance arises as the duties and fiscal powers of different levels of the governments are not in harmony. Horizontal imbalance has its roots in the differential capacities and needs of the states constituting the federation

(c) The measures needed to augment the Consolidated Fund of a state to supplement the resources of panchayats (rural local governments) in the states on the basis of recommendations made by the State Finance Commissions;

(d) The measures needed to augment the Consolidated Fund of a state to supplement the resources of municipalities on the basis of recommendations made by the State Finance Commissions.

(e) Any other matter referred to the Commission in the interest of sound finance. (Rao,2005)

Under Article 281, every recommendation made by the Finance Commission together with an explanatory memorandum as to the action taken thereon is required to be laid before each House of Parliament. All the taxes and duties referred to in the Union List with the exception of duties referred to in Articles 268 and 269 and surcharges referred to in Article 271 and any cesses levied for specific purposes, shall be distributed between the Union and the States under Article 270. Article 268 refers to duties levied by the Union but collected and appropriated by the States. These are such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List. Under Article 269, taxes on the sale of goods and taxes on the consignment of goods shall be collected by the Government of India but shall be assigned to States. There are two Articles governing the grants-in-aid from the Union to the States. Article 275 (1) provides for grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance and different sums may be fixed for different States. Grants under Article 275 are charged on the Consolidated Fund of India. Under Article 282, the Union or a State can make any grants for any public purpose, not withstanding that the purpose is not one with respect to which Parliament or the Legislature of a State, as the case may be, may make laws. Unlike the grants under Article 275 which can be dispensed only on the recommendations of the Finance Commission and are charged, grants under Article 282 can be made with no such restriction and are voted (Commission on Centre-State Relations,2010).

The approach of the Finance Commission in determining federal fiscal transfers consist of (i) assessment of overall budgetary requirements of the centre and states to determine the volume of resources available for transfer with the centre and required by individual states and during the period of recommendation; (ii) projecting of states' own revenues and non-plan expenditures; (iii) distributing assigned taxes, broadly on the basis of origin; (iv) distributing shareable taxes-

the personal income tax and Union excise duties between the Centre and states and among the states based on a formula, and (v) filling the gap between projected expenditures and revenues after tax devolution with grants. This is known as 'gap filling' approach.

Up to the Seventh Finance Commission, distinct distribution formulae were used to determine the income tax shares and Union excise duties, under two separate Articles of Constitution. They are Article 270, under which income tax sharing was mandatory and Article 272 under which income sharing of Union excise duties was at the discretion of the centre. From the Eighth Finance Commission period, a process of convergence between two sets of formulae started. A full convergence was arrived at with the recommendations of the Eleventh Finance Commission, after the 80th Amendment based on the recommendation of the Tenth Finance Commission.

Table 3.5 Sharing of Income Tax and Union Excise Duties: Eighth to Tenth Finance Commission

A. Sharing of 90 per cent of divisible pool of Income Tax and specified portion of divisible pool of Union Excise Duties according to Common Criteria					
Finance Commission	Population	Distance	Inverse Income	Poverty Ratio	Index of Backwardness
Eighth	25	50	25	-	-
Ninth (1st Report)	25	50	12.5	12.5	-
Ninth (2nd Report) Income Tax	25	50	12.5	-	12.5
Ninth(2nd Report) Union Excise Duties	29.94	40.12	14.97	-	14.97
	-	-	Area	Index of Infrastructure	Tax Effort
Tenth	20	60	5	5	10
B1. Income Tax: Sharing of Balance Amount					
Eighth and Ninth Finance Commissions: Sharing of 10 per cent of divisible pool of income tax: According to assessment/contribution. Tenth Finance Commission: The balance 10 per cent was also distributed according to criteria given in Part A of the Table.					
B2. Union Excise Duties: Sharing of Balance of Divisible Amount					
Eighth and Ninth Finance Commissions (First Report): 5 percentage points out of 45 per cent of Union Excise Duties, which formed the States' share, according to assessed deficits.					
Ninth Finance Commission (Second Report): 7.425 percentage points out of 45 per cent according to assessed deficits.					
Tenth Finance Commission: 7.5 percentage points out of 47.5 per cent according to assessed deficits.					

Source: Report of the Commission on Centre State Relations, 2010, volume iii.

With Eighth Finance Commission, major changes occurred in the tax devolution. First there was a move towards unifying the formula for inter-state distribution of both income tax and Union excise duties. Secondly, a portion of Union excise duties was kept aside for distribution according to 'assessed deficits'. There was a large portion of the shareable part of revenues, both for income tax and Union excise duties, which was subjected to common unified criteria. Table 3.5 shows the unified formulae used by Eighth, Ninth and Tenth Finance Commissions. The weight given to the factor of population has ranged between 20-29.94 percent for different commissions. Two core criteria, which have been used by the Finance Commissions for horizontal equity, providing higher per capita transfer to lower per capita fiscal capacity states, are distance and inverse income formulae. Eighth Finance Commission gave combined weight of 75 per cent to these two criteria. In the case of the Ninth Finance Commission (Second Report), the combined weight given to these two criteria was 62.5 per cent for income tax. Here an additional equity related criteria was used in the form of the index of backwardness, with a weight of 12.5 per cent, replacing the index of poverty used in First Report with same weight. The weight of these three equity related criteria added to about 70 per cent in the case of Union excise duties. The tenth Finance Commission retained only distance criteria from this with 60 per cent weight, and introduced other criteria like area, index of infrastructure and tax effort.

The sharing of portions that were kept out of the unified formula was done as follows. In the case of income tax, 10 per cent of the share recommended for the states was to be shared on the basis of assessment of income tax (Eighth and Ninth Finance Commissions). In the case of Union excise duties, a portion of the shareable proceeds for devolution was kept aside for distribution among states on the basis of assessed deficits. The share kept aside for this purpose also gradually increased. It was 5 percentage points out of 45 per cent of the shareable proceeds of Union excise duties, which formed the states' share, in the case of Eighth Commission and the First Report of the Ninth Commission. It was raised to 7.425 percentage points in the case of the Second Report of the Ninth Commission and subsequently to 7.5 percentage points out of 47.5 per cent of the shareable proceeds of the Union excise duties by the Tenth Commission.

Under the new provisions following the 80th Constitutional Amendment, only one set of shares is to be determined replacing four distinct sets, which were needed prior to relating respectively to (i) portions of income tax and Union excise duties subjected to common criteria; (ii) portion of

devolution according to assessed deficits; (iii) grant in lieu of tax on railway passenger fares; and (iv) additional excise duties in lieu of sales tax on cotton textiles, tobacco and sugar. The criteria followed by the Tenth Finance Commission (Alternative Scheme), and the subsequent Commissions relate to this generalized sharing arrangements. These criteria jointly reflect four considerations: (i) vertical transfers, (ii) horizontal equity, (iii) incentives for efficiency, and (iv) cost disadvantages (Commission on Centre-State Relations, 2010).

Table 3.6 Criteria and Relative Weights for Determining Inter se Shares of States

Criterion	Weights (Per cent) 11th Finance Commission	Weights (Per cent) 12th Finance Commission	Weights (Per cent) 13th Finance Commission
Population	10	25	25
Income Per Capita (Distance Method)*	62.5	50	47.5
Area	7.5	10	10
Index of Infrastructure	7.5	-	-
Tax Effort**	5	7.5	-
Fiscal Discipline***	7.5	7.5	17.5

Source: Report of the Commission on Centre State Relations, 2010, volume iii.

*Note: *The distance method is given by: $(Y_h-Y_i)P_i/S\ (Y_h-Y_i)P_i$ where, where, Y_i and Y_h represent per capita SDP of the ith and the highest income State respectively and P_i is the population of the ith State.*

*** Tax Effort (h) is estimated as $(h) = (T_i / Y_i) / 0.5\ (1/Y_i)$ where, T_i is the per capita tax revenue collected by the ith State and Y_i is the per capita State domestic product of the ith State.*

**** estimated as the improvement in the ratio of own revenue of a State to its revenue expenditures divided by a similar ratio for all States averaged for the period 1966-99 over 1991-1993.*

Table 3.6 presents the different criteria and related weights followed by the Eleventh, Twelfth and Thirteenth Finance Commissions. It is evident that the weight given for the income per capita criterion is reducing. The Eleventh Finance Commission assigned 62.5 per cent weight for this criterion while it reduced to 50 per cent and 47.5 per cent during the Twelfth and Thirteenth Finance Commission periods respectively. The criterion of population received a weight of 10 per cent in the Eleventh Finance Commission awards whereas it increased to 25 per cent in the Twelfth Finance Commission award. Thirteenth Finance Commission retained that weight. The Eleventh Finance Commission used an index of tax effort and an index of fiscal discipline, with a combined weight of 12.5 per cent. The Twelfth Finance Commission gave a combined weight

of 15 per cent to these two criteria. But the 13th Finance Commission dropped the tax effort criterion and increased the weight of fiscal disciple criterion to 17.5 per cent. In the index of fiscal discipline, the improvement is measured by considering the ratio of the measure of fiscal discipline in a reference period in comparison to a base period. Cost variations were also brought into consideration through the criteria based on area and index of infrastructure: larger the area (per crore populations), higher the per capita cost; similarly, lower the index of infrastructure, higher is the per capita cost. Thus, the three main considerations in the selection of criteria used by the Eleventh, and Twelfth Finance Commissions relate to: (i) resource deficiency, (ii) higher cost of providing services, and (iii) fiscal discipline.

Under Article 275, the main unconditional grant is the 'revenue gap' grant. The Finance commissions make an assessment of the expenditures of each state on revenue account (non-plan or total) and the state's own revenues. After determining the tax devolution, grants-in-aid are determined as residual. It is the difference between the assessed expenditure and sum of the projected own revenues and share in central taxes. So the 'revenue gap' grants under the Finance Commission are supposed to finance that part of expenditure, which is not covered by the sum of own revenues and share in central taxes.

3.3.2 Planning Commission Transfers

Planning Commission is another mechanism through which resource transfer is taking place. It oversees grants meant for developmental expenditures of the states or it is meant for plan revenue and plan capital expenditure side of states' budgets. The plan assistance to states is comprised of grants and loans. Prior to 1969, its distribution was scheme based and both the quantum of transfers and its loan-grant components were discretionary. But since 1969, the plan assistance distributed on the basis of 'Gadgil formula' approved by National Development Council (NDC). The original formula has been subjected to changes from time to time and the present version is the NDC revised formula (1991). According to the formula, 30 per cent of funds available for distribution is kept apart for special category states and remaining 70 per cent for non-special category states. Assistance for special category states is given on the basis of plan projects formulated by them and it consist of 90 percent of transfer in the form of grants and remaining 10 per cent as loans. The 70 per cent of the funds meant for non-special category

states are distributed on the basis of different criteria with different weights. The NDC revised formula of 1991 assigned 60 per cent weight to population, 25 per cent to per capita SDP, 2.5 per cent each for tax effort, fiscal management and achievement of national objectives, and remaining 7.5 per cent to social problems of states (Table 3.7). Of the 25 per cent weight assigned to per capita SDP, 20 percentage points worth is allotted only to the states with less than average per capita SDP on the basis of the 'inverse formula' and the remaining is assigned to all the states according to the 'distance formula'. These transfers to the non-special category states consisted of grants and loans in the ratio of 30:70.

Table 3.7 Gadgil Formula: Alternative Versions

Criteria	Modified Gadgil Formula (1980)	NDC Revised Formula (1990)	NDC Revised Formula (1991)
A. Special Category States (10)	30% share of 10 States excluding North Eastern	30% share of 10 States including North Eastern	30% share of 10 States excluding North Eastern
B. Non-Special Category States (15)			
i) Population (1971)	60	55	60
(ii) Per Capita Income, Of which	20	25	25
a. According to the 'deviation' method covering only the below the national average	20	20	20
b. According to the 'distance' method covering all the fifteen states	-	5	5
(iii) Performance, of which	10	5	7.5
a. Tax effort	10	-	2.5
b. Fiscal management	-	5	2.5
c. National objectives	-	-	2.5
(iv) Special problems	10	15	7.5
Total	100	100	100

Source: Report of the Commission on Centre State Relations, 2010, volume iii.

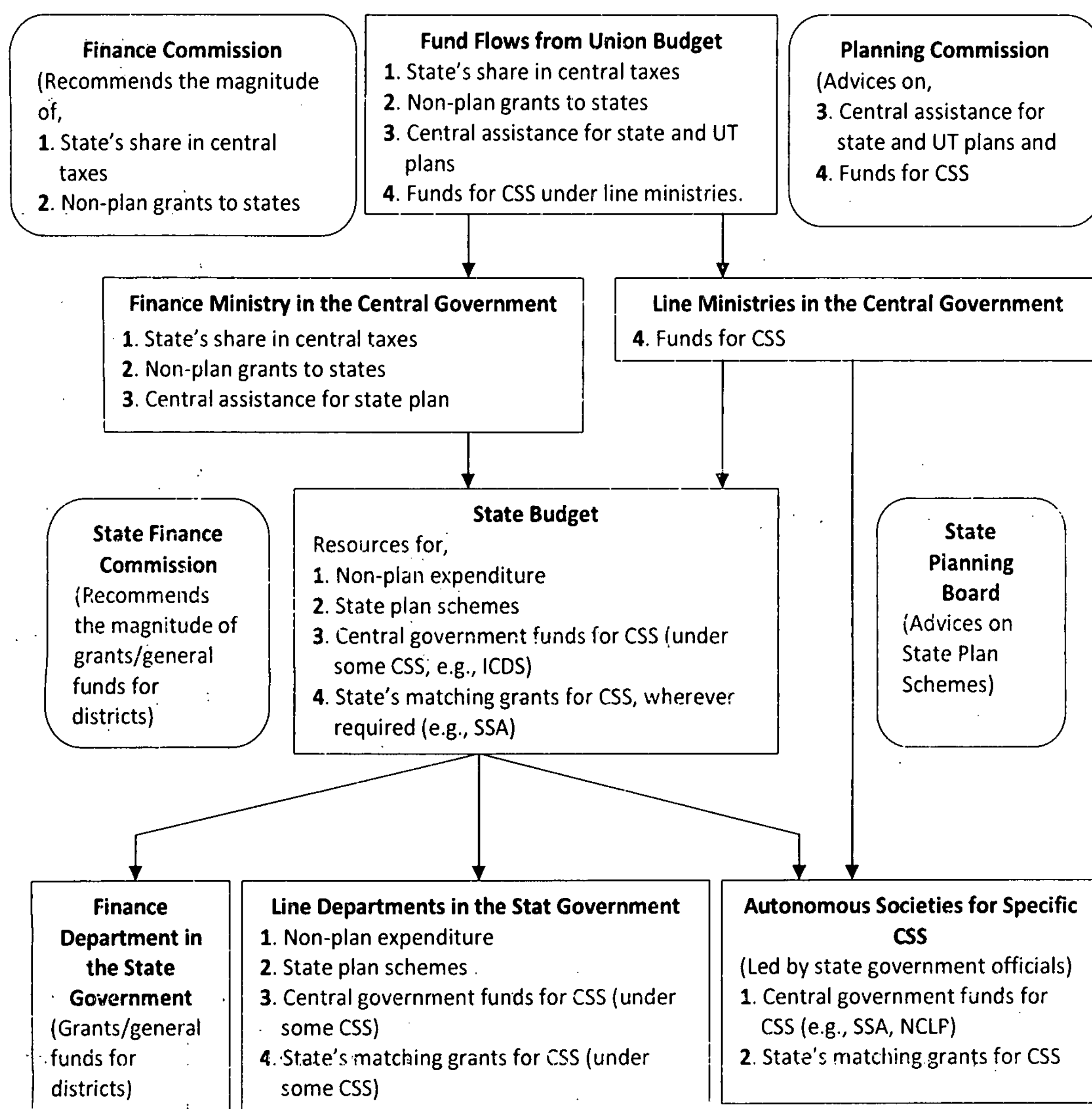
Notes: 1. Fiscal management is assessed as the difference between states' own total plan resources estimated at the time of finalizing Annual Plans and their actual performance, considering latest five years. 2. Under the criterion of the performance in respect of certain programmes of national priorities the approved formula covers four objectives, viz.: (i) population control; (ii) elimination of illiteracy; (iii) on-time completion of externally aided projects; and (iv) success in land reforms.

3.3.3 Assistance for central Sector and Centrally Sponsored Schemes

The assistance for central sector and centrally sponsored schemes are discretionary in nature, as it is not based on the Finance Commission recommendations or Gadgil formula. These are designed by various central ministries in consultation with the Planning Commission. The justification for the initiation of such programmes is that, they are financing the activities which have a high degree of interstate spillovers or are in the nature of merit goods. The Central sector schemes are entirely funded by the centre and the states merely implement these programmes (e.g., the Mahatma Gandhi National Rural Employment Guarantee Scheme (MNREGS), Integrated Child Development Scheme (ICDS), etc). On the other hand the schemes which are partly funded by the centre with states contributing a matching share of funds towards the schemes (e.g., Sarva Siksha Abhiyan (SSA), the Total Sanitation Campaign (TSC), etc.). Generally both these kind of schemes are used to be called centrally sponsored schemes.

The figure 3.2 clearly depicts how the funds are flowing from Union budget to states. In accordance with the recommendations from Finance Commission on states' share in central taxes and non-plan grants, and Planning Commission's advice on central assistance for state and UT plan and centrally sponsored schemes; funds will flow to states' budget through Finance ministry and other line ministries in the central government. Finance ministry is responsible for the transfer of state's share in central taxes, non-plan grants and central assistance for states plan, while funds for centrally sponsored schemes goes through central line ministries. The resources with state budget, i.e., funds for non-plan expenditure, state plan schemes, centrally sponsored schemes and states' matching grants for some of the centrally sponsored schemes, will flow to the next tier like Finance and other line departments in the state government, autonomous societies for specific centrally sponsored schemes etc, in accordance with the advice from State Planning Board on state plan schemes and recommendations from State Finance Commission on the magnitude of grants and general funds for districts.

Figure 3.2 Flows of Funds from Union Budget to State



Source: Das (2007)

3.4: Transfer of Resources from Centre to the States

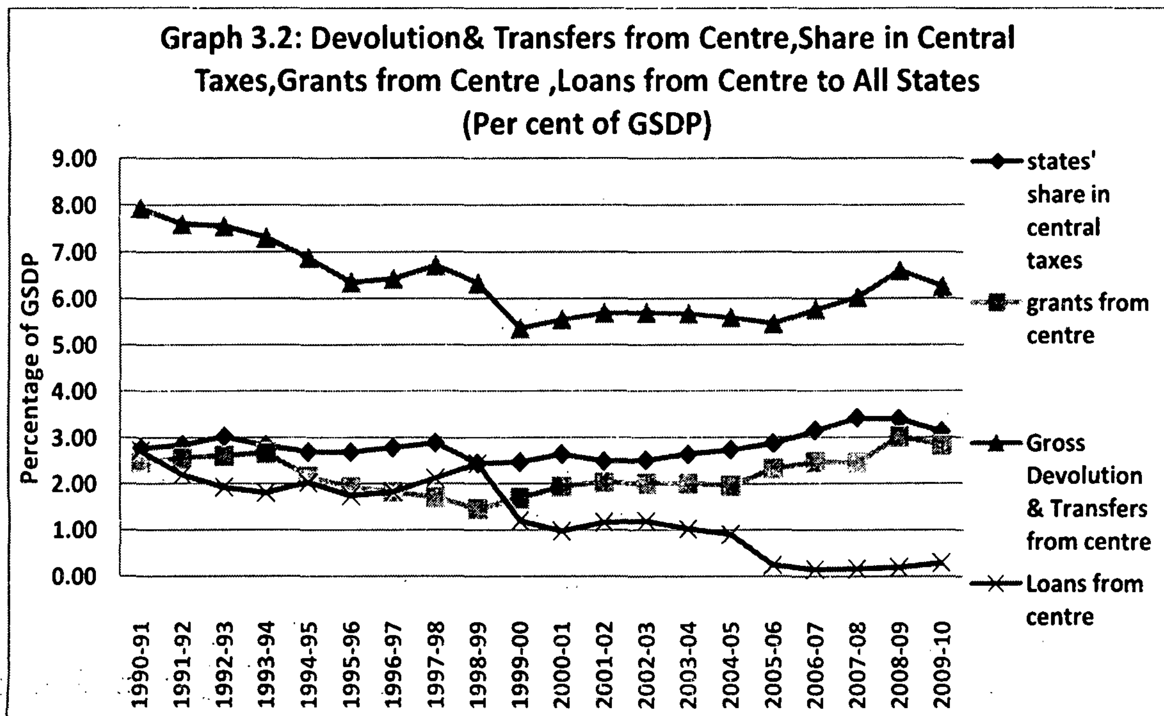
Of the total transfers from the centre to states, the Finance Commission transfers occupies a predominant position accounting for more than 60 per cent during all the periods since Eighth Finance Commission (Table 3.8). It increased from 60.13 per cent in the Eighth Finance Commission period to 68.03 per cent during Twelfth Finance Commission. Among the Finance

Commission transfers the share of states in the central taxes showed a decline from Tenth Finance Commission onwards. It declined from 62.06 per cent in the Tenth Finance Commission period to 56.48 per cent in Twelfth Finance Commission period. On the other hand the grants by Finance Commission showed an increase from 6.65 per cent in Eight Finance Commission award period to 11.55 per cent in Twelfth Finance Commission period. It can be observed that the share of plan grants declined from 35.80 per cent in 1984-89 to 28.55 per cent in 2005-10 period. There has been an increase in the share of plan grants to over 30 per cent of total transfers because of higher transfers through Centrally Sponsored Schemes. There has been a marginal increase in the share of non-plan grants in the total transfers in the recent years. Total transfers as a percentage of GDP was almost stagnant during the Eighth and Ninth Finance Commission period, and it declined to 4.09 per cent in the Tenth Finance Commission period. After that it showed an increase and during Twelfth Finance Commission period, 5.21 per cent of GDP transferred to the states.

Table 3.8 Percentage Composition of Revenue Transfers from the Centre to States

Period	Finance Commission Transfers			Other Transfers			Total Transfers (4+7)	Transfers as percentage of GDP
	Share in Central Taxes	Grants	Total Finance Commission Transfers	Plan Grants	Non-plan Grants	Total other Transfers (5+6)		
1	2	3	4	5	6	7	8	9
Eighth(1984-89)	53.48	6.65	60.13	35.80	4.07	39.87	100	4.83
Ninth (1989-95)	52.98	8.48	61.46	35.91	2.63	38.54	100	4.89
Tenth (1995-2000)	62.06	6.55	68.61	29.52	1.87	31.39	100	4.09
Eleventh (2000-05)	58.38	11.00	69.38	28.65	1.97	30.62	100	4.16
Twelfth (2005-10)	56.48	11.55	68.03	28.55	3.43	31.97	100	5.21
200506	57.00	14.95	71.94	25.36	2.70	28.06	100	4.69
2006-07	57.93	13.47	71.40	25.54	3.05	28.60	100	5.11
2007-08	58.82	10.21	69.02	27.69	3.29	30.98	100	5.46
2008-09(RE)	56.04	9.69	65.74	30.92	3.34	34.26	100	5.37
2009-10(BE)	53.62	11.22	64.84	30.88	4.28	35.16	100	5.23

Source: Report of the Commission on Centre State Relations, 2010, volume iii.



Source: Handbook of Statistics on State Government Finances 2010, RBI

Graph 3.2 represents the Gross Devolution and Transfer (GDT) of resources to all the states from centre as a percentage of GDP. The gross devolution and transfers (GDT) comprises of (a) state's share in central taxes (b) grants from the centre, and (c) gross loans from the centre. The GDT to the states witnessed a declining trend from 1990-91 to 1999-2000. It declined from around 8 per cent of GDP to 5.2 per cent of the GDP in this period. After that it remained almost stagnant till 2005-06. From 2005-06 onwards it started to increase, but suffered a setback in 2008-09. The grants from centre to all the states showed a decline from 1993-94 till the period 1998-99, after a slight improvement in the initial years of 1990s. But from 1998-99, it started to increase till 2008-09, after which it declined slightly. The sates' share in central taxes did not show much fluctuation, may be due to the fact that its devolution is based on certain criteria. We can see that despite slight decline in the end of 1990s, it remained at around 3 per cent of GDP in most of the years. Loans from the centre, another component of the GDT, declined up to the year 1995-96 and increased for a short span of time. But in the year 1999-2000 it declined sharply, may be due to the separation of collections in the small savings from the central loans to the states. Up to the year 2004-05 it remained stagnant, but after that it started to decline. It can be seen that from 2005-06, loan component from the centre is almost negligible. This is mainly due to the

recommendation of the Twelfth Finance Commission, regarding the termination of central loans to states from 2005-06.

Table 3.9: Per capita Gross Devolution and Transfer of Resources from the Centre to States (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	355	509	581	761	1110	1112	1101	1132	1434	2017	2033
Haryana	377	431	528	703	960	576	718	651	1053	1526	1948
Maharashtra	394	440	504	784	975	547	481	796	1438	2139	2320
Punjab	806	935	876	1076	1454	922	706	809	1468	1826	1838
Middle Income States											
Andhra	412	535	651	876	1013	1069	1219	1340	1753	3243	3346
Karnataka	336	478	642	725	861	997	1120	1380	1927	2181	2506
Kerala	435	571	735	734	903	848	1197	1590	1657	2574	3014
Tamil Nadu	420	569	710	740	842	875	882	1271	1542	2491	2766
West Bengal	428	477	644	810	1253	1130	1156	1235	1585	2269	2360
Low Income States											
Bihar	399	520	559	652	857	936	1306	1577	2010	3098	3516
M.P.	380	482	547	674	821	1021	1200	1466	2023	3028	3337
Orissa	607	686	788	919	1131	1442	1898	2035	2602	4514	4325
Rajasthan	513	611	762	918	1016	1158	1187	1447	1749	2458	2559
U.P.	462	584	659	744	840	881	1028	1311	1854	2663	3070
SD	122.9	128.7	108.4	116.1	182.6	229.6	334.9	362.4	365.8	740.4	698.8
Mean	451.7	559.0	656.1	794.0	1002.6	965.3	1085.6	1288.6	1721.2	2573.5	2781.2
CV	0.27	0.23	0.17	0.15	0.18	0.24	0.31	0.28	0.21	0.29	0.25
Max/Min	2.4	2.2	1.7	1.7	1.8	2.6	3.9	3.1	2.5	3.0	2.4

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 3.9 shows the gross devolution and transfer (GDT) of resources made by the centre to the states in per capita terms. It is evident that, on the whole GDT favors the poor states, whose own revenues are very low, compared to the rich and middle income states. If we take the specific periods of analysis, it is clear that in the 90s the GDT was favoring many of the rich and middle income states also. For instance, till 1998-99 a rich state like Punjab was receiving the highest amount of GDT than any other state. Similar was the case with other rich states. Many poor states like Bihar, Madhya Pradesh was receiving resources less than high and middle income states in 90s. This was probably due to the regressive nature of the central loans to the states. In the 90s these kinds of loans was favoring the richer states in per capita terms[3]. From 2000-01 on

[3] A detailed discussion on the central loans and its regressive nature are given in the next chapter (pp.77).

wards we can see a change in the situation. The GDT is favoring the poor states much than the rich ones.

Table 3.10: Ratio of GDT to State's Total Expenditure (per cent)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	26.67	26.87	26.78	27.57	27.13	19.75	21.09	17.29	20.11	21.64	20.33
Haryana	25.62	24.56	13.51	16.65	21.52	12.47	14.64	10.12	12.51	13.75	14.77
Maharashtra	28.60	25.25	21.02	27.15	28.63	11.82	10.03	11.13	19.88	22.51	21.22
Punjab	47.68	45.96	25.10	31.89	30.52	15.39	10.06	9.78	14.55	14.87	13.93
Middle Income States											
A.P.	41.24	40.24	36.48	38.87	34.03	28.70	27.36	22.44	24.97	29.61	27.56
Karnataka	30.19	30.86	34.46	29.86	29.36	26.42	24.91	22.14	24.59	23.17	23.87
Kerala	37.38	38.55	37.25	28.62	26.96	20.42	22.67	25.65	23.80	26.37	28.50
Tamil Nadu	35.19	32.99	36.00	28.56	25.72	22.11	18.42	19.49	19.64	24.12	25.01
West Bengal	47.83	49.76	49.89	46.35	56.15	33.39	33.89	30.72	32.78	31.04	29.23
Low Income States											
Bihar	54.98	58.85	59.04	64.49	67.89	55.20	53.09	57.80	56.29	57.98	62.71
M.P.	42.19	42.56	41.61	38.20	39.56	43.21	38.48	32.25	42.65	44.60	43.60
Orissa	62.54	56.40	52.67	50.14	46.07	46.79	53.29	48.79	52.31	57.06	52.77
Rajasthan	47.34	43.37	42.83	41.64	36.68	35.44	31.78	30.03	34.20	36.49	33.77
U.P.	52.01	51.58	46.73	50.68	43.48	39.69	39.04	37.08	42.73	44.33	46.04
SD	11.34	11.32	12.73	12.55	12.99	13.43	14.00	14.16	13.82	14.24	14.51
Mean	41.39	40.56	37.38	37.19	36.69	29.34	28.48	26.76	30.07	31.97	31.67
CV	27.39	27.91	34.05	33.75	35.41	45.78	49.15	52.89	45.94	44.55	45.83
Max/Min	244.1	239.6	436.9	387.3	315.4	467.1	531.3	591.1	450.1	421.8	450.1

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 3.10 presents the dependency of states on gross devolution and transfer (GDT) of resources from centre to meet their expenditure. It shows that GDT from centre has an important position in the total expenditure of poor states, when compared to that of richer states. For example in 2009-10, 62.71 per cent of the total expenditure of Bihar was financed from gross devolution and transfer where as it was just 13.93 percent for Punjab. On the whole around 30-67 per cent of the total expenditure of the low income states is met from the GDT, but that of high and middle income states are around 10-30 per cent and 20-50 per cent respectively, throughout the two decades of the study. So there is a differing significance of transfers in the expenditure of rich and poor states (Kurien, 2008). One important change to be noted down is that, for almost all the income category states, the ratio is decreasing till 2004-05 and reached an all time

minimum level. But after that it showed some improvements. Like the per capita GDT, the per capita share in central taxes and per capita grants from centre also favors the poor states.

From the analysis it can be said that the transfer mechanism is favoring the poor states. The poor states get more resources when compared to that of rich states. It can be seen that the low income states are depending very much on the fiscal transfers to meet their responsibilities. But the real question is whether the transfer mechanism in India is successful in offsetting the fiscal disabilities of the states, especially that of the poor ones.

3.5: Extent of Equalization in India

We already learned that the intergovernmental transfers are necessary to offset the fiscal imbalances-both vertical and horizontal- which is detrimental to the development of the federation and quality of life of its people. These transfers are meant to equalize the basic services across all units of federation. Even though we could find some debate on the efficiency consequences of equalizing transfers, it can be said that such transfers are not only equitable; they are expected to promote efficiency as well[4]. But the strongest justification for such transfers comes from the Constitutional mandate, judicial requirements or societal desire rather than from economic theory (Sen, 2011).

In India there is no explicit constitutional requirement of equalization, even though many other nations have that[5]. But there are clear pointers to the equalization principle in the Directive Principles and in the provision regarding grants under Article 275 of the Constitution. Sen (2011) writes and we quote;

> "....in the Directive Principles, there is a clause [38(2)] inserted in 1979 that says, 'The State shall, in particular, strive to minimize the inequalities in income, and endeavor to eliminate inequalities in status, facilities and opportunities, not only among

[4] A brief discussion on theoretical basis of intergovernmental transfers is given in the first chapter. For a detailed discussion see Rao and Singh, 2005; Report of the Commission on Centre State Relations, Supplementary Vol.II, Research Studies.

[5] For example Canadian Constitution mandates federal government to ensure similar availability of public services to all citizens of country at similar tax costs. Similarly, Article 154R (5) of the Srilankan Constitution and 1971 California Supreme Court judgment in *Serrano Vs Priest* case in U.S.A., points to the need of equalization (Sen, 2011).

individuals but also *amongst groups of people residing in different areas*(emphasis by Sen) or engaged in different vocations'. This, if not equalization as such, is close to it".

Sen (2011) states that among the instruments for equalization in India, the financial intermediation by public sector or the expenditure of Union government does not have any equalizing impact. On the other hand, only Finance Commission transfers in the intergovernmental transfer mechanism have some equalizing impact. The transfer by Planning Commission, which is committed to the balanced regional development, also fails to bring equalization. The transfer system in India has not been successful in fulfilling overall objectives of offsetting revenue and cost disabilities of states and ensuring minimum standards of services provided (Rao and Singh,2005).

It is important to note that the objective of intergovernmental transfer mechanism is not to equalize incomes of different states but simply to offset their fiscal disabilities arising from lower revenue raising capacity and higher unit cost of providing services. The ultimate objective is to enable every state to provide comparable levels of public services at comparable tax rates. But in studies, the evaluation of equalization is attempted using income as the barometer because, it represents taxable capacity. An empirical analysis by Rao (2010a, 2010b) also found that despite the general criticism that the Finance Commissions' transfers are not designed to offset shortfalls in revenue capacity and high unit cost of providing public services, they are the most equalizing among the three channels of transfers such as Finance Commission transfers, Planning Commission transfers and Centrally Sponsored Schemes (CSS), where as the grants for state plan as well as CSS do not have significant equalization impact. The equalization that we have achieved is mainly due to the Finance Commission transfers, more precisely due to the progressive distribution of tax devolution.

3.6: Reasons for the Failure of Transfer Mechanism

It is clear that the federal fiscal arrangements in India are not adequate, to offset the fiscal disabilities of states and ensure minimum standards of services to the people. The reasons for its inadequacy emerge from the shortcomings within the federal fiscal arrangement and other problems outside these arrangements. The design and implementation of inter-governmental transfer schemes in India is criticized from various grounds. It is being argued that the existence

of multiple agencies with overlapping jurisdictions have jeopardized the overall objectives of transfers. The introduction of planned development strategy tended to limit the role of Finance Commission in making intergovernmental transfers, which is a statutory one. It has lead to restrict the Finance Commission to confine themselves to making transfer only to meet the non-plan requirements of the states even though the Constitution does not make any distinction between plan and non-plan sides of budget. This restriction on Finance Commission to confine themselves to non-plan side of the budget has led to many problems. Firstly, transfers made by Planning Commission and Central ministries constrain Finance Commission's ability to effect intended redistribution. Second, it prevented comprehensive periodic review and prevented a holistic view of state finances. Thirdly, the plan and non-plan distinction has made a spree of large sized plans leading to higher expenditures, and it results in inadequate provision for maintenance of existing assets. Finally there is enough confusion regarding the Constitutional validity of transfers given under Article 282 for plan purposes (Rao and Singh, 2005).

The meeting of plan and non-plan requirements of states separately by Planning Commission and Finance Commission has lead to a compartmentalization in the assessment of interdependent components of states' fiscal needs. The expenditure on completed plan schemes is classified as non-plan. For instance interest payments on plan loan and maintenance expenditure of an asset created under plan scheme is a non-plan item. This compartmentalized treatment of plan and non-plan has led to having large sized plans and inadequate provision for maintenance of assets created under previous plans and finally complexity in the expenditure decisions. The approach of the Finance Commission has been criticized because of the partial view of public finances of states implied by the exclusion of revenue expenditures in the plan account and all the capital expenditures from its purview. It is assumed that all states can raise necessary resources for these expenditures on their own, as supplemented by plan and other grants. But this assumption is false as these exclusions (of expenditures) badly affect the less developed states which have a high deficit in such expenditure items (Sen, 2011).

The approach adopted by the Finance Commission does not consider the economic objectives of transfer mechanism. None of the Finance Commissions assessed the overall resource position of the centre and the proportion of the resources required to meet its commitments on any objective basis, although the terms of reference explicitly required doing so. They merely make judgments

about the proportion of central taxes to be shared and they have found it difficult to evolve any objective criteria for evaluating the centre's needs. It is being argued that the Finance Commission transfers lack clear purpose. It is not designed to meet the major objective of unconditional transfers, i.e., offsetting fiscal disadvantages of the states arising from lower revenue generating capacity and higher unit cost of providing public services. The introduction backwardness factor in tax devolution criteria has effects on equalization, but the transfer system is not specifically targeted to fiscally disadvantaged states.

Finance Commission's methodology of projections of fiscal gaps has attracted criticisms. It is done by taking base year actual collections (or their estimates) of own revenues and non-plan revenue expenditures of the states, standardize them and project them using normative growth rates determined according to the fiscal restructuring plan. The gap estimated between projected revenue receipts and non-plan expenditures was first filled in by the tax devolution and the remaining gap is filled by grants. But the taking base year numbers, standardized non-plan expenditures did not take note of the differences in the existing level of services. The effect of the 'tyranny of base year' was to perpetuate the existing differences in expenditures on different public services. The poorer states with low resource base (even after the transfers), continued to have low gap and hence, low levels of transfers, relative to their fiscal disability. The relevant base should have been the 'fiscal capacity' and non-plan revenue expenditure 'needs' and not actual revenues and non-plan revenue expenditures (Rao 2010b).

The 'gap-filling' approach of the Finance Commission is criticized on the grounds that it leads to disincentives on fiscal management in states. It is being argued that the methodology has no incentive for greater tax effort or fiscal austerity as more transfers (grants) will be received by the states with larger gaps between revenues and non-plan expenditures. To a large extent, deterioration in state finances is attributed to the gap filling approach followed by the Finance Commissions.

An analysis of criteria for the distribution of resources reveals that, it was distributed on the basis of general economic indicators like population and backwardness, and not on the basis of fiscal disadvantages. Almost all the Finance Commissions assigned significant weight to the population, which broadly represents expenditure needs of the states. But they are mandated to use the population figures of 1971 to provide incentive to states for family planning. As a result

even the states with higher population growth due to immigration of people, and not just higher fertility are penalized (Rao and Singh, 2005). While the objective of basing transfers on general economic indicators was to keep the devolution package simple and transparent, the purpose was lost when Finance Commissions used a number of factors which included multiple variables and the same variable was used with different exponential powers as was done in the case of inverse and distance forms of per capita SDP.

It is being noticed that there are number of implicit and invisible ways in which the powerful states can distort resource transfers in their favor which will offset the effect of explicit transfers. The disbursal of institutional finance[6] has had a very pronounced regressive bias against low-income states and was in favour of high income states (George, 1988, George and Gulati, 1978). George further stated that bank finance and term-lending to industry were largely responsible for this regressive nature of Institutional finance and it wiped out the bias in the interstate distribution of transfers in favour of poor and middle income states, which ultimately led to overall distribution of total finance in favour of high income states and regional disparities. There was the lending by All- India Financial Institutions (AIFIs)[7], to the private sector at an interest below the market rates subsidized by the refinancing facility extended by the Reserve Bank of India, and the priority-sector lending by commercial banks for specified activities such as agriculture, small-scale enterprises, exports, rural development, industrial proportion etc. The distribution of resources from both these sources was disproportionately in favour of high income states (Rao and Singh, 2005, Rao et.al:, 1999). In 1999-2000, high income states with only 19 per cent of population received 35 per cent of priority-sector lending, and 43 per cent of

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[6]In George (1988) and George and Gulati (1978), the following items are included in the institutional finance category. The credit and investments of commercial banks, funds from Life Insurance Corporation (LIC), the term lending to industry (e.g. funds from Industrial Development Bank of India, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Industrial Reconstruction Corporation of India and Unit Trust of India), agricultural finance from Agricultural Refinance and Development Corporation, Rural electrification Finance and advances to Co-operative sector.

[7] The All- India Financial Institutions in Rao and Singh (2005) are the following. All- India Development Banks (Industrial Development Bank of India, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Small Industries Development Bank of India, Industrial Reconstruction Corporation of India, Shipping Credit and Investment Company of India Ltd), specialized financial institutions (Risk Capital and Technology Finance Corporation Ltd, Technology Development and Information Company of India LTD, Travel Finance Corporation of India Ltd), and investment institutions (LIC,UTI,GIC).

AIFIs' assistance whereas low income states with 44 per cent of the population received just 15 per cent and 22 per cent of the priority- sector lending and AIFIs' assistance respectively. These regressive implicit transfers also distort the efforts by the fiscal transfer mechanism to achieve equalization among states.

Studies have found that the states with greater bargaining power, represented by proxies such as degree of representation in the ruling party or coalition, alignment between the ruling party at the centre and a state, and representation of different states in the cabinet etc, tend to receive larger per capita transfers along with the population which adds the state's political importance due its size (Singh and Vasishtha, 2004). The effect of fiscal institutions in a federation is sensitive to the underlying political incentives (Khemani, 2002).

The proliferation of Centrally Sponsored Schemes (CSS), whose design and implementation is totally determined by the centre without adequate consultation with the state, is a serious problem in the federal fiscal transfer mechanism. The resources for CSS are acquired through taxes which should be a part of the common divisible pool of resources and it cannot be used at the discretion of centre. But the using of this reduces the quantum of resources in the common divisible pool. The excessive centralized and rigid nature of these schemes often make them not suited for meeting the specific needs of the states. This happens when the states also has to bear a part of the expenditure in some of the CSSs and it makes difficult for the states to make proper allocation of their own resources keeping their own priorities in view. Apart from these the conditions imposed through these programmes are viewed as an intrusion to the autonomy of states.

Even though a part of the CSS is funded by the centre, it has serious implications for the states in the form of higher expenditure commitments. For some CSS, there has been an increase in the share of states in the funding of scheme. In the case of Sarva Siksha Abhiyan (SSA), there has been an increase in the matching contribution from the states. The funding of centre is financed through the proceeds of education cess, whereas states finance their share through budgetary resources. In addition to this, it is the states which are responsible for the maintenance of the assets created under the CSSs. Even though the assets created under direct funding by centre to local bodies are required to be maintained by states owing to the inadequate financial capability

of local bodies to maintain that. The staff deployed for the implementation of CSS also adds financial burden to the states, as that responsibility also falls with them.

Table 3.11: Composition of Plan Transfers to States

Type of Plan assistance	2008-09(RE)	Share in Total Plan Assistance to States	2009-10(BE)	Share in Total Plan Assistance to States
1. Normal Plan assistance	16899	17.71	19111	19.06
2. Externally aided projects	11241	11.78	7500	7.48
3. Additional Central assistance	1293	1.36	1550	1.55
4. Special Central assistance	4602	4.82	4602	4.59
5. AIBP	7850	8.23	9700	9.67
6. JNNURM	10448	10.95	11619	11.59
7. Backward region grant	3890	4.08	4670	4.66
8. Others	17505	18.35	19735	19.68
Total State Plan (1 to 8)	73728	77.28	78487	78.28
Assistance for Central Plan and CSS	21678	22.72	21777	21.72
Total Plan assistance to States	95406	100	100267	100

Source: Report of the Commission on Centre State Relations, 2010, volume iii.

We can observe from the table 3.11 that, the share of normal plan assistance to states in the total plan assistance to them, which are given according to the modified Gadgil formula (1991), were 17.71 and 19.06 per cent respectively in 2008-09 and 2009-10. On the other hand the assistance to central plan and CSS was 22.72 per cent and 21.72 per cent respectively for the same period. The states have been demanding a reduction in the number of CSS and transfer of the resultant savings in the expenditure through normal plan assistance, which is not subjected to any discretion of centre. The states are seeking more flexibility in the implementation of CSS to suit the local needs and conditions. In the light of all these things, the Commission on Centre-State Relations (2010) recommended that the number of CSS should be restricted to flagship programmes of national and regional importance and there should be flexibility in the conditions governing the implementation of CSS to suit the specific situations and needs of the states.

Table 3.12: Gross Tax Revenue, Cesses and Surcharges

Finance Commission	Gross Tax Revenue of the Centre	Cesses and Surcharges	Cesses and Surcharges as percent of Gross Tax Revenue of Centre	Actual Tax Devolution (Rs. Crore)	Actual Tax Devolution as percent of Gross Tax Revenue of the Centre
Eighth (1984-89)	167119	8225	4.92	42009	25.14
Ninth (1989-95)	419250	16642	3.97	112569	26.85
Tenth (1995-2000)	694756	21474	3.09	182925	26.33
Eleventh (2000-05)	1148007	68203	5.94	305013	26.57
2000-01	188705	7502	3.98	51688	27.39
2001-02	186327	6541	3.51	52842	28.36
2002-03	215905	13987	6.48	56122	25.99
2003-04	253668	15598	6.15	65766	25.93
2004-05	303402	24574	8.1	78595	25.9
Twelfth (2005-10)	2663337	301944	11.34	691056	25.95
2005-06	357244	31557	8.83	94385	26.42
2006-07	461620	41343	8.96	120330	26.07
2007-08	575445	58179	10.11	151800	26.38
2008-09 (RE)	627949	83478	13.29	160179	25.51
2009-10 (BE)	641079	87387	13.63	164361	25.64

Source: Report of the Commission on Centre State Relations, 2010, volume iii.

Cesses and surcharges are not included in the divisible pool of revenues of the centre. So any increase in the cesses and surcharges means a corresponding reduction in the divisible pool of the revenue. Table 3.12 clearly shows that it is increasing over time. During the ninth Finance Commission period (1989-95), it was only 3.97 percent of the gross tax revenue of the centre. It increased to 5.94 percent in the eleventh Finance Commission period (2000-05). During the period of twelfth Finance Commission (20005-10), it almost doubled to 11.34 percent of the gross tax revenue of centre. If we take it on a yearly basis, we can see a sharp increase in the share of cesses and surcharges. In 2000-01 it was 3.98 percent of the gross tax revenue and it reached 13.63 percent in 2009-10 after a fourfold increase. So it is reducing the divisible pool of resources of the centre.

From the pre cited discussions, we learn that the transfer mechanism is not adequate enough to offset the fiscal disabilities of poor states, due to many reasons within and outside that mechanism.

3.7: Summary

As we saw, the necessity of transfers basically arises from the inadequacy of own revenues - including tax and non-tax revenues- of the states which is a result of the fiscal imbalances- both horizontal and vertical imbalances- in the federation. An analysis of own revenues of the states reveals that, there exist wide disparities between states in the case of own tax revenue, own non-tax revenue and own revenues of the states. The poor states are in a worst position. This further widens the existing horizontal imbalances in the federation.

There is compensatory mechanism to solve this issue, i.e., the fiscal transfers from the centre to the states. It can be seen that the fiscal transfers favours the low income states. But it has been found that the fiscal transfer mechanism is inadequate to offset the fiscal disabilities of the poor states and fails to achieve equalization. There are many reasons for this, which can be identified within and outside the transfer mechanism. To list a few, (a) there are multiple agencies with overlapping jurisdictions which jeopardize the transfer objectives (b) accommodating different interests complicated the transfer formula of Finance and Planning Commission (c) transfer mechanism is not targeted to achieve equalization and to ensure minimum service levels in the states (d) transfers lead to disincentive effects in the fiscal management of states (e) plan and non-plan categorization of state's budgets leads to complicated expenditure decisions (f) regressive nature of implicit transfers, like disbursal of institutional finance which include the priority lending by commercial banks and assistance from All India Financial Institutions (AIFIs) (g) proliferation of Centrally Sponsored Schemes(CSS) which leads to reduction in the divisible pool and normal plan assistance etc. All these problems prevent the transfer mechanism from achieving equalization and offsetting the fiscal disabilities of the poor states. This further widens the existing disparities between states which is harmful to the development of the federation.

Chapter 4

Borrowing of states

4.1: Introduction:

There is a growing worldwide tendency to decentralize the expenditures to the sub national governments, i.e., growing expenditure responsibilities are devolved to regional and local governments while retaining major revenue raising responsibilities with the national governments (Ter-Minassian, 1997). India too, is experiencing this phenomenon of worsening vertical imbalance. There are also horizontal imbalances, since the revenue generating capacity and unit cost of providing services of sub national governments varies. So the gap in the revenue and spending is usually met through intergovernmental transfers, borrowing by the sub national governments or a combination of both. From the previous chapter we came to realize that the federal fiscal transfer mechanism is not adequate enough to offset the fiscal disabilities of the states and fails to achieve a substantial equalizing impact. If the federal fiscal transfers are inadequate for the states to finance their activities, then they have to depend on borrowing. Ter-Minassian and Craig (1997) observed that "the growth of sub national debt is frequently a symptom of an inappropriate design of intergovernmental fiscal relations in the country in question, involving, for example large vertical or horizontal imbalances or a system of intergovernmental transfers lacking transparent criteria and conductive to ad hoc bargaining and ex post gap filling" (cited in Vaidya (2012)). A question that arises in this context, and that this chapter tries to analyze, is whether the borrowing by the states is equitable and sufficient enough to raise adequate resources to finance their expenditures.

The economic reforms limited the role of the centre in directing investments to preferred sectors and regions. This factor along with unprecedented scale of urbanization resulted in a greater role for the states in creating enabling environment which includes provision of infrastructure facilities, education and health facilities etc, which will attract private investments to particular states. These require heavy investments from the part of state governments, which cannot be financed by the current revenues, owing to inadequate own revenue and transfer mechanisms. Resource gap will force the regional governments to postpone investment in key areas of development. Such states which postpone investment in critical areas will lag behind and disparities will get widened. But a prudent use of borrowings can be used to fill in the resource

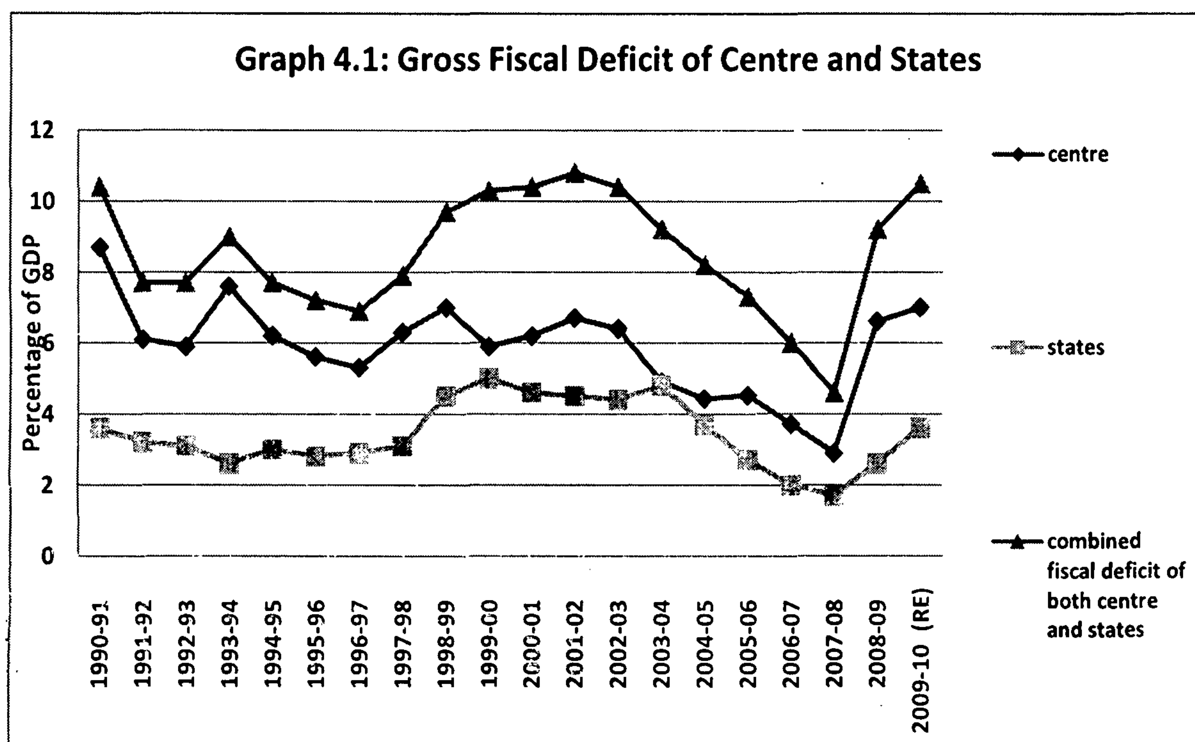
gap and make required investment provided the fiscal system leave enough space for it. It is also being argued that the sub national borrowing finances infrastructure more efficiently and equitably. As the future generations also benefits from the infrastructure investments, they should also bear the cost and the maturity of the debt should match the economic life of the assets that the debt is financing. Allowing sub national governments to access the financial market exposes sub nationals to market disciplines and reporting requirements and hence strengthening fiscal transparency, sound budget and financial management, and good governance (Liu and Waibel, 2008). But it should be noted that unregulated market borrowing is risky, particularly in an uncertain macroeconomic environment. The fiscal deficit itself may not be a problem if borrowing finances capital investments and economic growth, but in many countries sub national governments borrow heavily to finance current expenditure also. But such possibilities do not undermine the importance of a prudent borrowing system.

The chapter is presented in the following manner. The section 4.2 presents the debt position of states. A discussion on the sources of borrowing by the states is provided in the section 4.3. The section 4.4 looks into the composition of outstanding liabilities of state governments in India. An analysis of the borrowings of the major fourteen states from various sources is provided in section 4.5. In section 4.6, an interstate comparison of interest payments by the states is given. Section 4.7 summarizes the chapter.

4.2: Debt Position of States

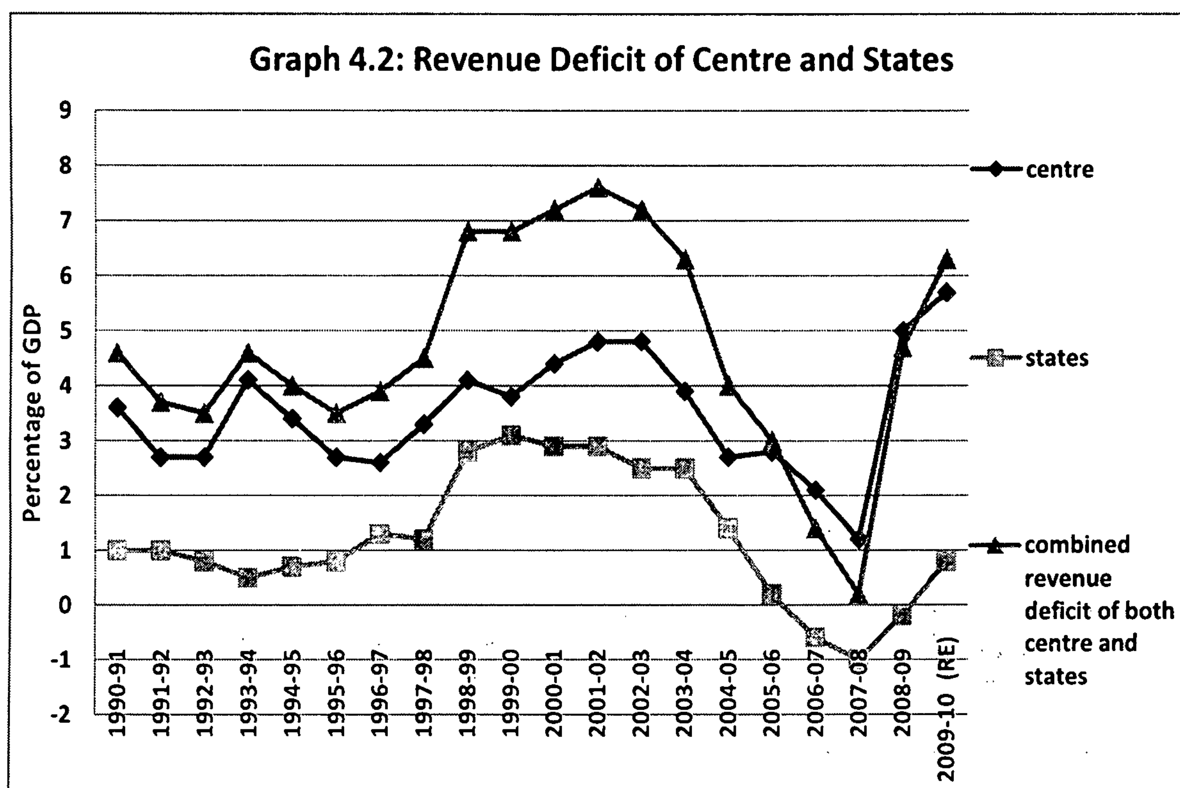
Gross fiscal deficit is the difference between aggregate disbursements (net of debt repayments) and recovery of loans, and revenue receipts plus non-debt capital receipts. Graph 4.1 gives a picture of fiscal deficit position of centre, all states and combined fiscal deficit of both centre and states. The fiscal deficit of the states witnessed an increasing trend from the year 1993-94, after a short declining phase. This increasing trend continued till the year 1999-2000, exhibiting a sharp increase from the year 1997-98.After remaining more or less same for few years, it showed a falling trend till 2007-08. From the year 2007-08, the fiscal deficit of states started to increase again. Like in the case of states, the fiscal deficit of centre also witnessed a steep fall in the beginning and it fluctuated between 5.5 -7 per cent of GDP till 2002-03. After that it started declining. But from 2007-08, it started to increase more steeply than states' fiscal deficit. The sharp decline in the fiscal deficit of both centre and states in the initial years of 2000s was mainly

due to the enactment of the Fiscal Responsibility and Budget Management Act (FRBMA) by centre and the states, which mandates the curtailment of their revenue and fiscal deficits. Combined fiscal deficit of centre and states shows a pattern similar to that of centre.



Source: Handbook of Statistics on State Government Finances 2010, RBI

Graph 4.2 shows the revenue deficit of centre, states and combined revenue deficit of centre and states. Revenue deficit is the difference between revenue expenditure and revenue receipts. Trends in revenue deficit are more or less similar to that of fiscal deficit. After a decline, revenue deficit of states started to increase from 1993-94 and reached a peak in 1999-2000. After that it started to decline gradually, which turned to a steep fall from the year 2003-04 and it became a surplus in 2005-06 and again turned deficit in 2009-10. Centre's revenue deficit was fluctuating around 2.5-4 per cent of GDP till 1999-2000, and it reached a peak in 2002-03. After a decline till the year 2007-08, it began to increase sharply. Combined revenue deficit of centre and states also follows a similar trend.



Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 4.1 shows the ratio of debt[1] to GSDP of states. The ratio is higher for the poor states when compared to the rich and middle income states. In the early years of 90s, this ratio was high for the poor states whereas it was comparatively low for the rich and middle income states. But by the end of 90s, it started to increase for almost all states and in the first half of the 2000s, it reached a maximum level. For instance, in 2002-03, the ratio was 62.09 per cent for Orissa. But after 2004-05 the ratio of debt to GSDP is decreasing in most of the states, mainly due to the FRBM Act. Amidst of this we can see that the ratio of debt to GSDP of rich and middle income states are also high in the closing periods of 2000s. This means that the middle and high income states are also borrowing highly during these days.

[1] Here debt means the outstanding liabilities of states. Outstanding liabilities are the cumulated form of each year's borrowing.

Table 4.1: Ratio of Debt to GSDP of States (per cent)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09	2009-10
High Income States											
Gujarat	25.13	22.68	19.43	18.81	22.60	38.49	38.98	37.72	34.62	32.24	31.77
Haryana	18.55	18.49	17.02	17.43	20.83	25.18	27.50	26.61	22.50	18.11	19.25
Maharashtra	18.65	17.35	16.27	16.43	20.32	26.80	30.04	32.24	31.06	26.32	24.98
Punjab	35.13	34.00	33.27	32.30	35.79	41.19	48.78	48.70	42.08	37.07	35.20
Middle Income States											
A.P.	22.02	22.44	21.13	21.43	23.55	28.89	33.53	35.61	32.62	29.52	31.02
Karnàtaka	22.40	19.18	19.75	18.58	18.89	23.35	29.80	28.39	28.22	25.26	25.72
Kerala	27.56	26.14	26.54	25.25	28.12	36.14	39.49	39.63	36.08	34.23	32.53
Tamil Nadu	18.90	19.96	18.41	18.05	18.31	23.53	28.12	27.66	24.76	24.89	25.09
West Bengal	23.31	23.87	24.09	25.41	27.53	38.22	46.62	46.48	46.93	42.01	40.87
Low Income States											
Bihar	30.73	32.43	30.60	31.16	31.43	42.97	48.71	45.03	42.32	36.58	36.27
M.P.	20.82	25.51	20.02	20.41	22.43	27.70	33.08	37.71	33.76	28.34	28.06
Orissa	36.79	34.91	33.20	37.46	37.88	55.87	62.09	51.60	45.17	33.34	32.21
Rajasthan	25.90	26.08	26.94	27.41	31.06	43.11	53.68	51.13	46.41	41.73	41.39
U.P.	30.84	32.30	31.87	31.49	35.59	44.49	49.44	53.71	52.64	47.24	44.47
SD	6.00	5.96	6.16	6.69	6.69	9.75	10.91	9.39	9.03	7.92	7.16
Mean	25.48	25.38	24.18	24.40	26.74	35.42	40.71	40.16	37.08	32.63	32.06
CV	23.54	23.48	25.48	27.42	25.03	27.53	26.79	23.37	24.36	24.27	22.34
Max/Min	198.3	201.2	204.5	228.0	206.8	239.2	225.7	201.8	233.9	260.8	231.0

Source: Handbook of Statistics on State Government Finances 2010, RBI

A trend visible from the table 4.2, which shows fiscal deficit of states as a percentage of their GSDP is that the fiscal deficit of almost all states shows a decline in the first half of the 90s, then started to increase in the latter half and reached to its peak in the early years of the next decade. But from 2004-05, it shows a decline and became surplus for some states in 2006-07. From 2008-09 fiscal deficits started to increase again. The fiscal deficit as percentage of GSDP of all the four high income states was above 3 per cent in 2009-10, whereas three middle income and four low income states had fiscal deficit above 3 per cent of GSDP in the same period.

Table 4.2: Fiscal deficit as Percentage of GSDP

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09	2009-10
High Income States											
Gujarat	5.59	2.54	1.93	2.61	5.07	7.19	4.30	4.60	2.15	3.07	3.20
Haryana	2.33	2.11	1.81	2.74	4.55	3.89	2.03	1.29	-0.91	2.03	4.08
Maharashtra	2.33	2.65	2.12	2.66	3.43	3.56	4.77	4.82	2.23	2.34	3.19
Punjab	6.17	4.47	4.77	3.03	6.20	5.23	5.35	4.18	3.62	4.14	5.02
Middle Income States											
A.P.	2.61	3.18	3.26	2.98	4.75	5.05	4.56	3.87	2.04	2.76	3.93
Karnataka	2.12	3.71	3.00	2.84	3.37	3.89	4.37	2.30	2.28	3.46	2.85
Kerala	4.42	2.86	3.17	3.16	4.89	5.34	5.75	4.04	2.64	3.33	2.61
Tamil Nadu	3.02	3.42	2.03	2.56	3.77	3.46	4.26	2.75	1.43	2.73	3.12
West Bengal	4.30	2.14	3.13	4.09	6.08	7.60	6.29	5.09	4.32	3.59	5.57
Low Income States											
Bihar	4.61	3.19	2.46	1.34	2.76	5.47	6.90	3.91	5.08	5.15	3.33
M.P.	2.73	1.95	2.33	2.46	4.21	2.54	4.22	5.14	1.38	2.86	2.98
Orissa	4.40	3.80	4.32	5.00	6.78	7.67	5.66	1.91	-0.87	1.92	3.98
Rajasthan	2.15	3.49	4.00	4.11	6.63	5.23	6.90	5.24	2.59	3.25	3.83
U.P.	4.79	4.55	4.43	4.11	6.67	5.26	4.61	5.57	3.05	4.89	4.71

Source: Handbook of Statistics on State Government Finances 2010, RBI

Revenue deficit as percentage of GSDP also follows a pattern similar to that of fiscal deficit (Table 4.3). We can see that in the second half of 90s revenue deficit increased and in the period 2000-01 and 2002-03 it reached to its maximum for most of the states. But from 2004-05, it started to decline and in 2006-07 and 2008-09, it turned surplus for many states. In 2009-10, deficit started to increase for some states .when all the high income states experienced this, many low and middle income states were having a surplus in the revenue account.

Table 4.3: Revenue Deficit as Percentage of GSDP

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	2.19	0.65	-0.39	0.65	2.58	5.67	2.52	2.13	-0.67	-0.08	1.03
Haryana	0.12	0.01	1.32	1.79	3.13	1.04	0.94	0.28	-1.22	-0.03	1.62
Maharashtra	0.08	0.75	-0.21	0.85	1.80	3.11	3.13	2.60	-0.16	-0.62	0.86
Punjab	2.70	2.27	1.98	2.81	4.31	3.13	4.56	3.51	1.44	2.30	3.24
Middle Income States											
A.P.	0.43	0.25	1.01	3.39	2.23	2.48	1.83	1.21	-1.01	-0.55	-0.59
Karnataka	0.30	0.46	0.59	0.84	1.31	1.72	2.19	-1.05	-2.02	-0.28	-0.39
Kerala	2.33	1.32	1.14	1.32	3.29	4.33	4.74	3.33	1.82	1.96	1.38
Tamil Nadu	1.48	2.98	0.57	1.15	2.71	2.34	3.07	0.35	-0.96	0.00	0.27
West Bengal	2.68	0.92	1.22	2.57	4.15	5.27	5.14	3.93	3.15	3.58	4.35
Low Income States											
Bihar	1.64	1.45	1.71	0.32	1.57	3.31	2.71	0.03	-0.86	-1.86	-2.45
M.P.	0.54	-0.64	0.31	1.85	2.93	1.00	1.07	-1.24	-3.02	-1.58	-0.83
Orissa	0.14	0.70	1.71	2.60	5.27	4.45	3.17	0.73	-2.38	-0.57	1.57
Rajasthan	-0.66	0.33	0.96	1.42	3.86	3.20	4.44	1.83	-0.42	0.14	0.64
U.P.	1.92	1.24	1.86	2.19	4.98	3.20	2.47	2.91	-1.69	-1.04	-0.25

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 4.4 gives the percentage of revenue deficit in the fiscal deficit of different states. This actually shows, to what extent a state's fiscal deficit is healthy. Percentage of revenue deficit in fiscal deficit of all states increased from 28.26 per cent in 1990-91 to 62.91 per cent in 2000-01. From 2002-03 it started to decline and became negative in 2006-07 and 2008-09. But in 2009-10, it turned positive i.e., 16.19 per cent. In the case of almost all the states, this ratio increased to a peak level by 1998-99 and till 2002-03 it stood at a high position. Even though it turned negative for most states from 2006-07, in 2009-10 it became positive for all the rich states and some of the middle and low income states. We can see that the ratio of revenue deficit in fiscal deficit was higher for the rich states, especially in 2000-01 and subsequent years. In 2009-10 this ratio was positive and high for all richer states, when many middle and low income states were still experiencing a negative trend. A high revenue deficit in the fiscal deficit means that, a larger portion of the current borrowing is used to meet the current expenditure.

Table 4.4: Percentage of Revenue Deficit in the Fiscal Deficit

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	39.10	25.55	-20.28	25.06	50.95	78.89	58.63	46.42	-31.33	-2.60	32.21
Haryana	5.18	0.45	73.08	65.42	68.75	26.84	46.57	21.39	134.86	-1.48	39.55
Maharashtra	3.41	28.19	-9.68	32.12	52.61	87.28	65.58	53.88	-7.01	-26.28	26.82
Punjab	43.80	50.80	41.57	92.63	69.57	59.84	85.30	84.02	39.90	55.60	64.53
Middle Income States											
A.P.	16.34	7.90	30.99	113.76	47.04	49.21	40.05	31.23	-49.74	-19.82	-14.90
Karnataka	14.13	12.27	19.56	29.78	39.04	44.13	50.10	-45.50	-88.57	-8.20	-13.55
Kerala	52.82	46.04	36.07	41.67	67.40	81.15	82.54	82.41	69.02	59.05	52.95
Tamil Nadu	49.11	87.25	27.81	45.15	71.95	67.69	71.95	12.62	-66.94	-0.09	8.66
West Bengal	62.36	43.14	39.03	62.85	68.31	69.42	81.70	77.24	72.90	99.87	78.05
Low Income States											
Bihar	35.49	45.53	69.52	24.24	56.79	60.63	39.28	0.72	-17.01	-36.13	-73.73
M.P.	19.73	-32.53	13.48	75.18	69.59	39.34	25.46	-24.12	-219.74	-55.31	-27.83
Orissa	3.25	18.38	39.69	51.87	77.67	57.95	55.97	38.21	274.73	-29.68	39.46
Rajasthan	-30.83	9.49	24.11	34.54	58.16	61.07	64.34	34.87	-16.07	4.32	16.73
U.P.	40.03	27.35	42.02	53.37	74.75	60.86	53.67	52.36	-55.20	-21.28	-5.36
All States	28.26	24.48	24.56	46.16	60.66	62.91	57.34	36.33	-32.07	-7.31	16.19

Source: Handbook of Statistics on State Government Finances 2010, RBI

4.3: Sources of Borrowing by the States

The state governments in India raise resources for their activities from various sources (figure 4.1). These sources include the following;

A. internal debt which includes(a) market borrowing, (b)loans from banks and financial institutions, (c)Ways and Means advances(WMA) from RBI, (d)special securities issued to NSSF

B. loans and advances from centre

C. provident funds etc

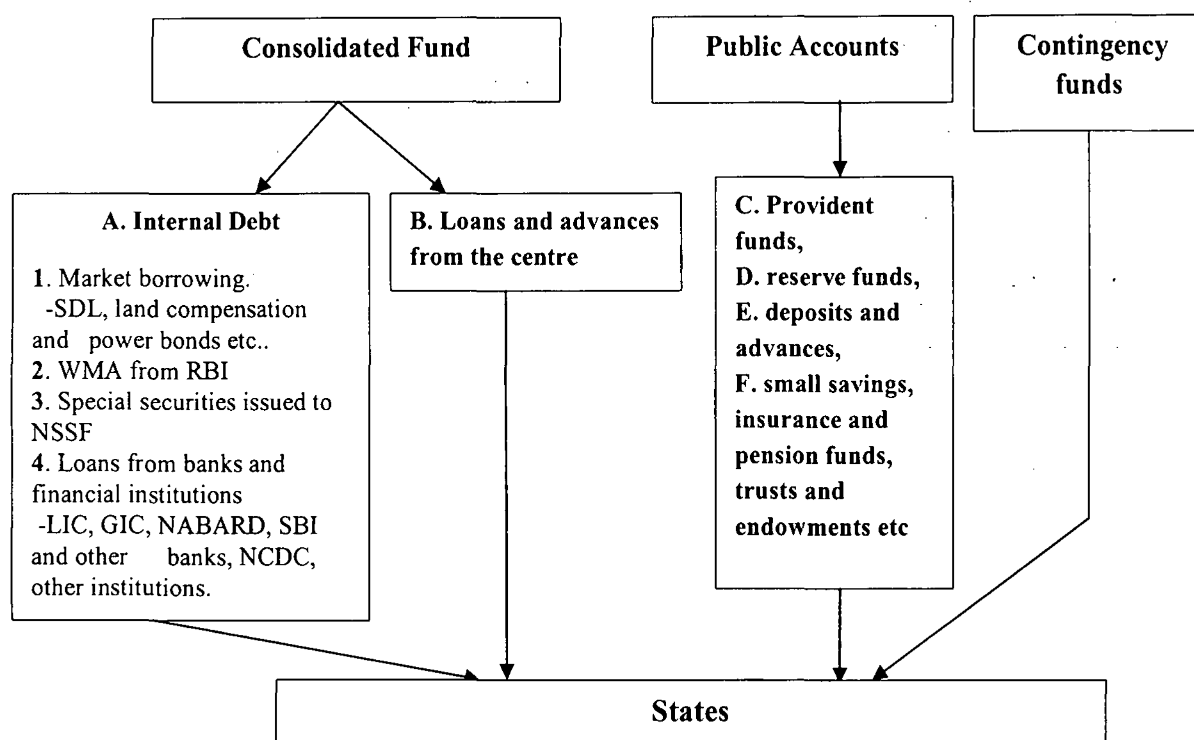
D. reserve funds

E. deposits and advances (net balance) and,

F. Contingency funds

The internal debt and the loans and advances from the centre are included in the Consolidated Fund whereas the borrowings from the provident funds, reserve funds, deposits and advances are included in the Public Accounts.

Figure 4.1: Sources of Borrowing by States



Source: Handbook of Statistics on State Government Finances 2010, RBI

Report of the Working Group on Compilation of State Government Liabilities (2005) suggests decomposition of total budgetary liabilities of states governments in four categories according to the international best practices, i.e., (i) Public Debt which would include open market borrowings, borrowings from banks and financial institutions, special securities issued to NSSF, bonds/debentures which are issued by the state government and loans from the central government (ii) Ways and Means advances and Overdrafts from RBI or any bank. (iii) Public Accounts which would include State Provident Funds, Small Savings, Insurance and Pension Funds, Reserve Funds and Deposits and Advances; and (iv) Contingency Fund. The RBI's compilation of the data on outstanding liabilities of states is similar to this. There are borrowings from the Consolidated Fund of India, Public Accounts along with contingency funds. A

discussion on the major sources of borrowing is carried out here to have a better idea of states borrowing patterns.

4.3.1: Market Borrowing

RBI, (2012) states that the scheme of market loans in the outstanding debt of states increased by almost three times over the past two decades, as market borrowings emerged as major source of financing their Gross Fiscal Deficit (GFD).It is the repayment capacity of the states that will be considered with prime importance in the market borrowing programme of the states, determined through a consultative process which includes the Planning Commission, the RBI and the state government. But the entire process is non-transparent and factors that determine the size of the market borrowing programme of states are not completely known to the parties outside the consultative process (Vaidya, 2012). RBI conducted the market borrowings of the state governments through a completely administered system (traditional tranche method) till 1998, whereby the market borrowings of all the states were generally completed during the year in two or more tranches through issuances of bonds with predetermined coupon and pre-notified amounts for each state. This was thought to be unfair to some states that are supposedly capable of borrowing on their own standing at a lower rate of interest. During 1998-99 the states were permitted to access the market individually (at their discretion) through the auction method (with a predetermined notified amount but without predetermined coupons) to raise between 5-35 per cent of the allocated market borrowings, or the tap method (with predetermined coupons but without a predetermined notified amount), thereby providing scope for better managed states to raise resources at market rates. Nonetheless, some states continued to prefer the traditional tranche method. In order to address the risk of under-subscription faced by some states, 'umbrella tranche' method was introduced during 2001-02. Under this method, borrowings for all states together are raised indicating a total targeted amount without notifying the amounts of individual states. The limit for utilizing the auction option was raised to 50 per cent in 2002-03, before the states were eventually allowed to raise their entire market borrowings through auctioning of State Development Loans (SDLs) from 2006-07. After having a system of fixed coupon spreads (raised from 25 basis points to 50 basis points in 2001), the complete switchover to the auction system enabled the market determination of spreads (RBI, 2012).

The cost minimization was the major objective of market borrowing of the states, as they will get the benefits of a lower interest cost on market borrowings. The interest rate on securities issued to the NSSF remained quite rigid and turned out to be higher than the weighted average interest rate on market borrowings. The interest rate on securities issued to the NSSF declined from 13.5 per cent in 1999-2000 to 9.5 per cent in 2003-04. Even though the interest rates on SDLs rose after 2005-06 due to market condition and enhanced market borrowings, the level remained much lower than that on securities issued to the NSSF. The weighted average interest rate on market borrowings declined from 11.9 per cent in 1999-2000 to 8.4 per cent in 2010-11.

Under Article 293 of the Constitution, state governments require the approval of the centre for borrowing from the market, if they are indebted to the Centre. Since a portion of the plan assistance to the states was in the form of loans, all the states needed approval from centre to borrow from the market. The centre has been setting the limits on the market borrowings of the states as part of the overall pattern of plan financing. The states have been complaining from time-to-time that their share in overall market borrowings has come down significantly. In 2008-09, the share of centre in the aggregate market borrowing were 75 per cent, where as that of states was 25 per cent. In the common memorandum submitted to Twelfth Finance Commission, states have contended that their share in market borrowings should be resorted to the level of 50 per cent as was prevalent in the fifties.

Since 2005-06 all issuances of SDLs have a shorter maturity period of 10 years. The shorter maturity period of market loans creates heavy repayment obligations in short span of time, i.e., the increase in market borrowings of the state governments in 2008-09 and 2009-10 could lead to large repayment obligations from 2017-18 onwards. The maturity profile of the outstanding stock of SDLs as at the end of March 2011 shows that the majority of SDLs (around 58.3per cent) were in the maturity category of 7 years and above; around 16.4 per cent were in the 5-7 years maturity category, while the remaining 25.3 per cent were to mature less than 5 years (RBI, 2012).

4.3.2: Special Securities Issued to National Small Savings Fund (NSSF)

Till 1998-99, small saving collections were being credited to the Consolidated Fund of India and the Centre was extending loans to a State against small saving collections in that State. In April

1999, the National Small Savings Fund (NSSF) was created in the Public Account with the Centre taking on the responsibility of servicing outstanding small saving deposits from the date NSSF became operational. The share of the States in net small saving collections was increased from 66.66 per cent to 75 per cent in April 1987 and further to 80 per cent from April 2000 following the requests of the State Governments. From April 2002 to March 2007, the entire net collections under small savings were being invested in securities issued by the State Governments. The mandatory sharing of net collections by the States was reduced to 80 per cent from 2007-08 with the States being given the option to borrow up to 100 per cent of net small saving collections. States' borrowings against net small saving collections are no more treated as loans from the Centre following the setting up of NSSF.

Now , with the transfer of small savings collections to NSSF from 1999-2000, loans from NSSF are no more treated as loans from the centre depriving them of the facility of relief offered on outstanding debt to the centre by successive Finance Commissions. In their responses, states have demanded that the Finance Commissions should take into account their entire loan burden, including the outstanding loans from the NSSF. The present repayment period of NSSF loans is 25 years. Here the centre has no control on the extent of loans raised as they depend on the contribution of residents of a state to various small savings schemes. Even though the centre has no control on the extent of loans, the responsibility to repay the investors in these schemes remains with the centre. Loans from NSSF carry an interest rate of 9.5 per cent per annum, which is considered by the states to be very high in relation to the cost of raising small savings by the centre.

4.3.3: Loans from Banks and Financial Institutions

The states in India borrow from the banks and financial institutions such as National Bank for Agriculture and Rural development (NABARD), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), State Bank of India (SBI) and other banks, National Co-operative Development Corporation (NCDC) etc. The states need approval from the centre to borrow from these sources, mainly to finance specific development projects. The interest rate charged by the financial institutions is decided through a negotiation process and in many cases it is high compared to other loans. These loans are in principle purely commercial transactions and lenders consider states as any other commercial borrower. Here the repayment

ability of the states will be the prime factor in the sanction and charging of interests. It is being argued that this type of loans have two advantages. Firstly, screening of the project will be under taken to know its suitability and then only it will be financed. Apart from this, progress of the project also will be monitored. Secondly, the financing of a project by a bank will serve as an indicator to the investors regarding the health of a state's finances. But the problem that arises here is that most of the major financial intermediaries are owned by the central government and this creates difficulty for the centre to credibly signal a non-refinancing commitment in the face of a default (Vaidya, 2012).

4.3.4: Loans and Advances from the Centre

It is a major source of borrowing for states. Large part of these loans emerged in the process of federal fiscal transfers from centre to the states through Planning Commission, as it comprised of both loans and grants. Prior to 1969, the loan-grant components were discretionary. But since 1969, it was distributed on the basis of Gadgil formula approved by National Development Council (NDC)[2]. According to the formula, funds for the special category states consist of 90 per cent grants and 10 per cent loans. On the other hand, 70 per cent of the fund transfer to the non-special category states took place in the form of loans and remaining 30 per cent as grants. Apart from this, there are ad hoc loans provided to states under special circumstances. This process has led to an accumulation of debt. These loans are not arising from a commercial relationship but from resource transfer between centre and states. The main problem is that the plan size which determines the size of loans from the centre has never been linked to sustainable levels of state debt. No state government can or does refuse to take these loans because it does not see itself in a position to repay the loans nor does the central government refuse to give loans to state governments whose financial position is weak (Vaidya, 2012).The servicing of these loans are partly done by using the grants or share in central taxes and thus the centre is taking back the funds transferred to states as interest and debt service. Interest rate is also high, but states cannot refuse these loans as the interest rates are administratively fixed and borrowings are actually formula based transfers.

[2] Original formula changed and the present version is known as the NDC revised formula (1991).

In order to ensure debt sustainability, various Finance Commissions (like Sixth, Tenth, Eleventh and twelfth Finance Commissions) introduced debt relief measures such as debt write offs. In view of the mounting interest burden and also to supplement the efforts of states in achieving fiscal management, the central government formulated the Debt Swap Scheme (DSS) allowing states to pre pay the high cost loans from central government, contracted at interest rates of 13 per cent and above, through the low cost borrowings such as small savings and market loans. Accordingly, these loans were swapped through additional market borrowings (allocated under the DSS in addition to the normal borrowing allocations of the States) and net small savings proceeds at the prevailing administered interest rates, over a period of three years ending in 2004-05. The total debt swapped during 2002-03 to 2004-05 amounted to Rs.1020.34 billion, of which Rs.535.66 billion (52.5 per cent) was swapped through additional market borrowings at interest rates below 6.5 per cent, i.e., at less than half the earlier cost.

The Twelfth Finance Commission recommended some major changes in the debt position of states such as the consolidation and rescheduling of outstanding central loans for a term of 20 years at a rate of interest of 7.5 per cent. It has been subjected to a state enacting a fiscal responsibility legislation, which aims at eliminating the revenue deficit to zero by 2008-09. The Commission also recommended a debt write off scheme, which is linked to a reduction in revenue deficit of states. There was a huge increase in debt relief compared to the earlier Finance Commissions' relief measures. Apart from this, the Commission recommended that the centre should not act as a financial intermediary for states and has encouraged them to borrow from the market directly. As a response to this recommendation, from 2005-06 onwards, the central assistance for state plans consist of only grant and the states are required to raise balance resources from the market. Termination of lending by centre has cast a burden on the states in terms of shorter duration of market borrowings. The central loans had a repayment period spread over 25 years with a moratorium of 5 years in repayment. On the other hand, the market loans have a repayment period of 10 years with a bullet repayment at the end of 10th year. This will result in bunching of repayment for the states.

4.3.5: Loans from State Provident Funds etc

This is a provident fund scheme for the state government employees where the state government does not contribute to the principal amount but pays cumulative interest. Here a portion of the

salary of the employees deducted as contribution towards Provident fund is credited to Public accounts. Employees are allowed to withdraw under specific rules and state government pays the employees a lump sum on retirement. In most of the states the receipts are more than disbursals. This surplus is used by the respective states governments to fund various expenditures. On an average the interest rate on these loans is about 10.5 per cent. Here the ability of states to repay the loans is not considered and centre has no control over the amount of loan (Vaidya, 2012).

4.4: Composition of Outstanding Liabilities of the States

Table 4.5 represents the composition of outstanding liabilities of all states over time. An interesting trend which is visible from the table is that the share of 'loans and advances from the centre', a major source of borrowing in 1990-91 is gradually declining. Its share declined from 57.37 per cent in 1990-91 to 45.20 per cent in 1999-2000, and in 2005-06, it witnessed a drastic decline to 13.68 per cent. It reached 9.55 per cent in 2009-10. The main reason behind this steep decline in central loans to states is the Twelfth Finance Commission's recommendation to discontinue such kind of loans[3].On the other hand, the internal liabilities emerged as a major source by 2009-10. Its share increased from 15.04 per cent in 1990-91 to 24.57 per cent in 1999-2000 and 65.08 per cent in 2009-10. The increase in internal liabilities was driven by the increase in its sub components such as, market borrowing and special securities issued to NSSF. Among these, market borrowings occupy an important position, which shows a continuous increasing trend since 1990-91. Share of market borrowings increased from 12.26per cent in 1990-91 to 32.77 per cent in 2009-10, without any decline. The share of special securities issued to NSSF[4] increased from 4.96 per cent in 1999-2000 to 32.44 per cent in 2007-08. But in 2009-10, it declined to 26.95 per cent. The share of loans from banks and financial institutions also increased from 1.96 per cent in 1990-91 to 6.51 per cent in 2002-03. But after that it seems to be declining slowly. Provident funds etc and deposits and advances are the two other important sources of borrowing for the states. The share of provident funds is above 10 per cent in all the periods and that of deposits and advances is close to 10 per cent. It is to be noted that share of both sources are declining slightly in the recent years. Reserve funds have its own importance in

[3] Twelfth Finance Commission recommended the discontinuation of central loans to states and from 2005-06, the central assistance for plans consist of only grants and the states are required to raise balance resources from the market.

[4] Before 1999-2000 NSSF collections was included in the loans from the centre to states.

the borrowing regime of states, as its share constitutes nearly 5 per cent of the total outstanding liabilities.

It is evident that the market borrowings emerged as a major source of borrowing for the state governments. During 2002-03 to 2004-05, the sharp increase in the share of market loans in the total debt of the states was attributable to Debt Swap Scheme (DSS) which was operational during the period. In the recent years, market loans increased due to four factors. First, there was a complete switchover to the auction route for market borrowings by the states from 2006-07 onwards. Second , the borrowing requirements of the states increased in 2008-09 due to higher gross fiscal deficit on account of the implementation of the Sixth Pay Commission award and fiscal stimulus expenditure undertaken to offset the impact of the global economic slowdown. Third, the smooth conduct of the market borrowing programme of the states at competitive rates encouraged the states to increase their access to the market. Fourth the market borrowing allocations were enhanced (2008-09 and 2009-10) due to shortfall in the net collections of small savings (RBI, 2012).

Table 4.5: Composition of Outstanding Liabilities of All States (per cent)

Items	1990-91	1993-94	1996-97	1999-2000	2002-03	2005-06	2007-08	2009-10(BE)
1.Internal liabilities, *of which*	15.04	16.46	17.96	24.57	41.46	60.88	62.06	65.08
a. Market borrowings	12.26	13.94	15.28	14.82	16.93	22.70	24.22	32.77
b. Loans from banks and FIs	1.96	1.83	1.79	3.36	6.51	6.26	5.38	5.26
c. WMA from RBI	0.82	0.70	0.89	1.44	0.32	0.04	0.02	0.10
d. Special Securities Issued to NSSF	0.00	0.00	0.00	4.96	17.70	31.88	32.44	26.95
2. Loans and advances from centre	57.37	53.82	51.13	45.20	31.68	13.68	10.92	9.55
3. Provident funds etc	13.16	14.89	15.42	15.80	14.45	12.27	12.19	12.11
4. Reserve funds	3.69	4.35	4.32	3.88	4.09	5.50	5.89	5.06
5. Deposits and advances(net balance)	9.96	10.12	11.00	10.24	8.27	7.55	8.78	8.04
6. Contingency funds	0.78	0.35	0.18	0.30	0.04	0.12	0.16	0.15
Total Outstanding Liabilities	100	100	100	100	100	100	100	100

Source: Handbook of Statistics on State Government Finances 2010, RBI

RBI (2012) attempts to summarize the evolution of state government finances since the 1990, in to four broad phases, *viz.*, (i) 1990-91 to 1997-98, (ii) 1998-99 to 2003-04, (iii) 2004-05 to 2006-07 and (iv) 2007-08 to 2011-12(BE). During the first phase (1990-91 to1997- 98), fiscal imbalances persisted, although the consolidated fiscal deficit-GDP ratio remained marginally below 3 per cent. The fiscal deficits of states were mainly financed through loans from the Centre and small savings collections earmarked for the states were also given through these loans. Market borrowings played a subordinate role and its share in the fiscal deficit of the states remained quite low. Consequently, the Reserve Bank completed the market borrowings of all the states in a combined manner, generally in two or more tranches through issuance of state Development Loans at pre-determined coupon and notified amounts for each State.

During the second phase (1998-99 to 2003- 04), the fiscal deficit-GDP ratio of the states reached a historical peak, crossing 4 per cent, due to higher expenditures related to the implementation of the Fifth Pay Commission award and deceleration in state government revenues due to economic slowdown. The National Small Savings Fund (NSSF) was established in 1999 to mobilize small savings and direct them to the Central and the State governments through investments in their special securities. Consequently, small savings collections, instead of being intermediated by the Centre, were channelized through NSSF's investments in special securities issued by the states for financing their fiscal deficits. During this phase, the NSSF's investments became the dominant source of financing fiscal deficit. The states were allowed to use the auction mode, although to a limited extent, for accessing market borrowings. By 2003-04, market borrowings emerged as a major a source of financing fiscal deficit of the States.

The third phase (2004-05 to 2006-07) saw operationalisation of fiscal rules by most of the States which led to a decline in their fiscal deficit-GSDP ratios. There was an increase in small saving collections during this phase and the states had to absorb the predominant share of small savings collections earmarked to them, regardless of the cost of borrowings. As a result, the states' dependence to market borrowings for financing fiscal deficits declined during this phase .By 2006-07, the states were allowed to raise market borrowings completely through the auction route so as to allow market determination of yields on their SDLs.

With market access for states switching completely to the auction-mode, market borrowings' importance increased in the financing of fiscal deficits during the fourth phase [2008-09 to 2011-

12(BE)]. Consequently, the states were able to meet the enhanced requirements during 2008-09 to 2009-10 for implementing the Sixth Pay Commission award and fiscal stimulus measures, particularly in the wake of shortfall in small savings collections. Even after the states reverted to fiscal correction from 2010-11 the importance of market borrowings continued, as small saving collections remained low. During this phase, market borrowings have emerged as a dominant source of financing and, on an average, accounted for around 65 per cent of gross fiscal deficit (GFD).

4.4.1: Interstate Comparison of Composition of Outstanding Liabilities

Table 4.6 which represents the composition of outstanding liabilities of fourteen major Indian states reveals interesting trends. The most important change visible in the composition of outstanding liabilities of all the states, whether it is high income, middle income or low income states, is that the share of loans and advances from the centre which was a major source of borrowing in the 1990-91 declined gradually and the internal sources comprised of market borrowing, loans from banks and other financial institutions, special securities issued to NSSF emerged as the major borrowing source for all the states. We can see some state specific or income group specific characteristics also in these changes.

It can be seen that in the period 1990-91, the share of internal debt was very low in the case of high income states compared to that of middle income and low income states. It was 9.3 per cent, 7.8 per cent, and 6 per cent for high income states like Gujarat, Maharashtra and Punjab respectively. It was the middle income states that borrowed highly from the internal sources than any other states. The share of middle income states like Andhra Pradesh, Karnataka, Kerala and Tamil Nadu were 21.6 per cent, 16.6 per cent, 22.9 per cent, 22.3 per cent respectively. It can be observed that the poor states also borrowed heavily from the internal sources at that time. But by 2009-10, the share of internal debt of high income states increased very much, compared to that of low income states. Many of these states' shares were around 70 per cent (for Gujarat it was 72.6 per cent, for Punjab 73.2 per cent). Even though the share of internal debt in poor states' outstanding liabilities increased by 2009-10, it was only around 60 per cent. For instance, it was 62.3 per cent for Bihar whereas 52.9 per cent in the case of Utter Pradesh. It is noteworthy that in 2009-10 also the middle income states are collecting considerable amount of resources from the

internal sources. 70.7 per cent and 79 per cent of the outstanding liabilities of West Bengal and Tamil Nadu respectively, consisted of internal debt.

Among the internal debt, market borrowing is the one item which needs a special attention as it is becoming the largest source of borrowing for all the states. Even though the special securities issued to NSSF also contribute heavily to the outstanding liabilities of states, its share is declining in the recent years. In the market borrowing we can see that in the 1990-91, its share in the total outstanding liabilities of high income states was very low. It was only 8.1 per cent, 6 per cent and 4.8 per cent in the case of richer states like Gujarat, Maharashtra, and Punjab respectively. On the other hand middle income and low income states borrowed highly from the market compared to richer states. 14.5per cent of the outstanding liabilities of Bihar and Utter Pradesh comprised of borrowings from the market. For Orissa it was 18.3 per cent. But by 2009-10, the share of market borrowing in the total outstanding liabilities of high and middle income states surpassed that of the low income states. For the high income and middle income states, it was around 30-35 per cent and 32-43 per cent respectively whereas in the case of poor states it was around 20-34 per cent. It was the middle income states that collected much resource from the market heavily followed by the high income states.

The share of special securities issued to NSSF in the total outstanding liabilities was highest for the richer states in all the periods. Among the middle income states, the share of special securities issued NSSF in the total outstanding liabilities was very high for West Bengal in 1990-91 (16.5per cent) and 2009-10 (39.4 per cent). In fact it was a state which depended heavily on special securities issued to NSSF.

The share of loans from banks and financial institutions in the outstanding liabilities of all high income and low income states are increasing throughout the period of analysis, except in the case of Punjab and Rajasthan. On the other hand, its share is declining after reaching a peak in 2000-01, for most of the middle income states except Kerala.

If we see the 'loans and advances from centre' component of the total outstanding liabilities of states, it is clear that it was the main source of borrowing for all the states in 1990-91 and even in 2000-01. We can see differences between states in their dependence on loans and advances from centre. The high income states depended heavily on this source to raise resources in 1990-91. For

instance, in the total outstanding liabilities of Punjab in 1990-91, the share of loans and advances from centre constituted 81.1 per cent. Its share was 63.8 per cent for Gujarat and 60.8 per cent for Maharashtra. On the other hand, share of loans and advances in outstanding liabilities of poor states like Madhya Pradesh, Orissa, Utter Pradesh, Bihar and Rajasthan were 47 per cent, 51.5 per cent, 50.7 per cent, 54.5 per cent, 52.5 per cent respectively. This is a serious issue, because the 70 per cent of the plan assistance under the Gadgil Formula, given to the non-special category states was in the form of loans. So we can assume that the richer states must have received more resources for their plan than the poor states. This was against the objective of equalization which is meant to be achieved by the fiscal transfers. This situation should be understood in the context of the findings made by many studies, that the Planning Commission transfers are less equalizing (Sen 2011, Rao 2005). By 2009-10, the share of loans and advances from centre declined drastically for all the states. But most of the middle income and low income states have more than 10 per cent of their outstanding liabilities in this category. For example the share of loans and advances form centre in the outstanding liabilities of Orissa and Madhya Pradesh constituted 21.8 per cent and 15.9 per cent respectively in 2009-10.

The sources like provident funds etc occupies an important position in the borrowing process of all the low income states and some of the middle income and high income states like Kerala, Karnataka, Haryana, Punjab etc. But the share of provident funds in the outstanding liabilities of most of the states shows a decline in 2009-10 compared to that in 2000-01. The deposits and advances (net) is also a major source of borrowing for all the states, irrespective of their income category. But the share of reserve funds in the outstanding liabilities of high income states are higher compared to that of middle and low income states.

Table 4.6: Composition of Outstanding Liabilities- An Interstate Comparison

High Income States												
Sources of Debt ↓ / States	Gujarat			Haryana			Maharashtra			Punjab		
Year	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10
1.Internal debt, *of which*	9.3	28.6	72.6	16.3	27.6	66.1	7.8	22.5	69.6	6.0	31.3	73.2
Market borrowing	8.1	9.0	32.4	12.6	12.0	29.4	6.0	7.7	30.8	4.8	8.4	35.2
Loans from Banks and Fis	1.2	3.0	4.0	3.6	6.6	7.5	1.8	1.8	3.4	1.1	8.7	7.2
Special securities issued to NSSF	-	14.5	36.2	-	8.8	25.5	-	13.0	35.5	-	13.1	30.8
2.Loans and advances from centre	63.8	42.1	8.3	53.3	40.2	6.2	60.8	40.0	4.7	81.1	47.8	5.2
3.provident funds etc	7.7	6.7	5.2	22.1	26.6	20.1	9.4	9.6	6.1	10.1	16.9	15.0
4.reserve funds	4.4	1.2	4.5	3.2	2.6	3.1	11.6	13.9	7.2	0.4	0.8	3.5
5.deposits and advances(net)	14.3	21.2	9.3	4.7	2.8	4.5	9.7	13.3	12.3	2.1	3.1	3.1
6.contigency funds	0.5	0.2	0.2	0.3	0.1	0.0	0.8	0.7	0.0	0.4	0.1	0.0
Total (Rs. Crore)	8078	42781	120759	3076	14650	40324	12878	67601	207810	7071	30763	67721

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 4.6: Composition of Outstanding Liabilities- An Interstate Comparison (Contd.)

Sources of Debt ↓ / States	Andhra Pradesh			Karnataka			Kerala			Tamil Nadu			West Bengal		
	Middle Income States														
Year	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10
1.Internal debt, *of which*	21.6	37.4	65.9	16.6	30.4	60.9	22.9	28.8	61.6	22.4	31.5	70.7	13.3	37.5	79.0
Market borrowing	19.6	21.8	42.6	14.8	17.8	32.1	17.9	17.1	33.2	16.8	16.8	38.9	11.9	10.6	34.6
Loans from Banks and FIs	2.0	7.5	3.9	1.8	4.7	3.4	2.9	5.6	8.2	2.5	7.3	6.2	1.4	7.9	5.0
Special securities issued to NSSF	-	7.0	19.4	-	7.9	25.3	-	3.9	20.2	-	6.7	25.6	-	16.5	39.4
2.Loans and advances from centre	53.6	42.2	13.5	51.0	40.5	13.1	43.5	25.4	10.4	46.8	37.5	10.1	68.2	42.1	8.1
3.Provident funds etc	8.5	8.2	6.8	14.2	16.3	14.2	28.3	38.8	23.2	10.9	16.8	9.2	7.6	6.7	4.3
4.Reserve funds	1.4	0.7	1.8	4.1	0.7	6.4	0.4	0.3	1.0	8.3	3.6	3.5	0.2	0.1	1.6
5.Deposits and advances(net)	14.4	11.4	12.0	13.2	12.0	5.5	4.6	6.5	3.8	10.7	10.2	6.2	10.5	13.6	7.0
6.Contigency funds	0.6	0.1	0.0	0.9	0.1	0.1	0.3	0.1	0.0	1.0	0.4	0.2	0.2	0.0	0.0
Total (Rs. Crore)	8150	41809	127581	5898	25301	76762	4983	26259	70761	7043	34541	95232	8857	54929	168684

Source: Handbook of Statistics on State Government Finances 2010, RBI

Table 4.6: Composition of Outstanding Liabilities- An Interstate Comparison (Contd.)

Sources of Debt ↓ / States / Year	Low Income States														
States	**Bihar**			**Madhya Pradesh**			**Orissa**			**Rajasthan**			**Uttar Pradesh**		
Year	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10	1990-91	2000-01	2009-10
1.Internal debt, *of which*	15.6	27.8	62.3	10.6	27.1	61.3	21.2	32.7	41.0	18.4	33.3	63.2	17.5	26.9	52.9
Market borrowing	14.5	17.1	28.0	8.5	17.1	32.1	18.3	20.4	20.5	16.7	18.2	34.5	14.5	16.2	26.8
Loans from Banks and FIs	0.6	1.4	5.4	1.7	2.7	6.7	1.6	4.1	6.0	1.6	3.9	3.4	1.5	2.4	4.8
Special securities issued to NSSF	-	9.4	28.8	-	7.3	22.5	-	4.1	14.5	-	10.2	25.4	-	8.2	21.2
2.Loans and advances from centre	54.5	44.3	12.8	47.0	36.9	15.9	51.5	35.4	21.8	52.5	36.0	8.7	50.7	41.9	8.7
3.Provident funds etc	18.4	22.2	13.2	26.3	25.8	11.6	16.6	24.1	23.9	18.6	21.5	20.1	9.7	11.0	15.0
4.Reserve funds		-0.1	1.8	3.9	2.9	4.2	0.3	0.8	9.1	1.5	0.9	1.0	6.0	9.4	12.6
5.Deposits and advances(net)	9.7	4.9	9.4	11.8	7.3	6.8	10.1	6.4	4.0	8.5	8.2	6.9	14.4	11.8	10.6
6.Contigency funds	1.8	0.9	0.6	0.4	0.1	0.2	0.4	0.5	0.2	0.5	0.1	0.2	1.7	-1.0	0.2
Total (Rs. Crore)	10633	38390	86358	7777	29094	84810	5156	24220	48619	6580	35541	90972	19760	87204	239322

Source: Handbook of Statistics on State Government Finances 2010, RBI

4.5: Borrowing of States from Each Sources: An Inter-state Comparison

Table 4.7 represents the per capita net addition made to the total outstanding liabilities of each state in each year. It is same as the total borrowing by each state in a particular year. Interstate differences can be seen in the borrowings of states in every year.

Table 4.7: Per capita Net Addition to Total Outstanding Liabilities (Rs)

States	1991-92	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	313	276	357	474	1006	1806	1432	1722	1465	1505	2125
Haryana	242	260	354	460	1131	430	1051	1113	1018	1327	3005
Maharashtra	307	207	390	497	821	975	1178	1771	1406	1909	2360
Punjab	527	687	749	719	1726	1784	1804	1698	-51	2148	2342
Middle Income States											
Andhra	198	242	332	341	684	935	970	1302	898	1411	1966
Karnataka	83	198	244	344	551	827	886	809	1527	1376	1455
Kerala	293	292	565	522	914	1277	1500	1402	1344	1934	1708
Tamil Nadu	234	334	336	362	612	812	866	662	729	1605	1635
West Bengal	190	168	312	464	926	1396	1488	956	1155	1426	2297
Low Income States											
Bihar	134	205	219	224	372	563	548	547	396	464	529
M.P.	157	399	198	284	527	404	654	940	450	667	1001
Orissa	289	230	374	502	760	1015	736	831	575	400	1027
Rajasthan	245	229	396	537	967	733	1044	1166	807	1102	1056
U.P.	233	244	313	433	606	557	605	774	794	984	1283
SD	105.2	130.4	141.6	123.9	335.4	455.0	382.1	405.0	460.7	534.1	686.4
Mean	246.0	283.5	367.1	440.2	828.8	965.3	1054.4	1120.8	894.0	1304.3	1699.3
CV	0.43	0.46	0.39	0.28	0.40	0.47	0.36	0.36	0.52	0.41	0.40
Max/Min	6.3	4.1	3.8	3.2	4.6	4.5	3.3	3.2	-30.0	5.4	5.7

Source: Handbook of Statistics on State Government Finances 2010, RBI

The high income states like Gujarat, Maharashtra, Punjab and Haryana are borrowing an amount higher than the average borrowing of fourteen states in almost all the periods (Table 4.7). To be more precise, in the 1990s Gujarat and Haryana were two exceptions among them as they borrowed less than the average for few years. But in 2000s all the richer states except Haryana in the initial few years, borrowed higher than the all states' average. On the contrary, almost all the low income states borrowed less than the average borrowing of all states for all the periods except Orissa and Rajasthan, which borrowed higher than the average for few years in the 1990s. Haryana, a rich state borrowed an amount which is five times greater than the borrowing of

Bihar in 2009-10. Among the middle income states, all of them except Kerala borrowed less than the average of all states, throughout the 1990s and first half of 2000s. But in the latter half, almost all of them started to borrow an amount higher than the all states' average. The coefficient of variation in the net addition to outstanding liabilities of states shows the persistence of disparities between them. It increased from 0.43 in 1990-91 to 0.47 in 2000-01. In 2006-07 it become 0.52 showing a worst disparity situation among states, and finally reached 0.40 in 2009-10. We can see existence of disparities between states from this.

Table 4.8: Per capita Gross Market Borrowing (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	20	31	48	62	125	168	492	379	–	1507	1567
Haryana	33	45	62	79	122	120	350	463	–	1156	1626
Maharashtra	13	28	46	54	77	89	109	421	166	1645	1415
Punjab	18	23	80	109	162	154	462	721	376	1894	1843
Middle Income States											
Andhra	36	54	63	73	211	185	441	419	338	1327	1849
Karnataka	31	39	38	47	138	159	301	419	–	1289	1031
Kerala	52	73	98	123	187	182	385	511	652	1632	1602
Tamil Nadu	33	51	60	75	102	177	369	405	278	1452	1893
West Bengal	26	43	59	66	92	111	308	533	157	1425	1884
Low Income States											
Bihar	40	46	49	60	76	86	160	211	33	394	386
M. P.	23	26	49	61	79	91	193	247	160	489	697
Orissa	46	84	90	110	161	192	351	315	–	–	–
Rajasthan	37	51	66	87	194	221	413	399	241	985	1142
U.P.	33	45	53	66	129	92	235	236	188	686	712
SD	10.7	17.2	17.2	22.7	45.1	45.5	116.0	133.5	170.0	461.9	514.0
Mean	31.7	45.6	61.4	76.5	132.5	144.7	326.4	405.6	258.8	1221.6	1357.5
CV	0.34	0.38	0.28	0.30	0.34	0.31	0.36	0.33	0.66	0.38	0.38
Max/Min	3.9	3.7	2.6	2.6	2.8	2.6	4.5	3.4	19.5	4.8	4.9

Source: Handbook of Statistics on State Government Finances 2010, RBI

In the initial years of the first half of the 1990s, high income states were not borrowing much from the market (Table 4.8). But most of the middle income and low income states except west Bengal and Madhya Pradesh was borrowing an amount which is higher than average of borrowing made by all the fourteen states. If we take 1990s as a whole, it is clear that, barring the initial years, in all the periods the low income states was borrowing less than the average of all states except Orissa and Rajasthan. Among the high and middle income states Punjab (only

for few years) and Kerala was borrowing above the all states' average. But we can see that in the 2000s, the picture is changing altogether. The high income and middle income states started to borrow an amount higher than the average borrowing of all states, in almost all the periods. But the low income states was borrowing less than the average of all states in all the periods, except Rajasthan and Orissa for initial few years. The existence of disparity between states is evident from the coefficient of variation in the per capita gross market borrowing by them. It increased from 0.34 in 1990-91 to 0.36 in 2002-03. It increased further to 0.38 in 2009-10, which shows the disparity situation. The maximum-minimum ratio also increased from 3.9 in 1990-91 to 4.9 in 2009-10.

Table 4.9: Per capita Loans from the Centre (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	215	202	221	315	606	419	256	341	54	49	31
Haryana	172	151	233	287	523	161	115	132	9	15	244
Maharashtra	166	151	177	347	530	81	98	177	48	71	113
Punjab	592	597	551	679	1026	265	170	216	8	104	146
Middle Income States											
A.P.	120	150	217	227	410	250	330	233	39	142	298
Karnataka	103	146	257	216	306	207	288	283	116	70	179
Kerala	141	180	248	174	275	152	371	453	62	257	529
Tamil Nadu	135	172	259	220	269	175	146	196	50	185	320
West Bengal	167	135	256	334	703	195	316	197	73	61	71
Low Income States											
Bihar	117	107	118	144	291	171	177	231	0	1	112
M.P.	83	87	105	144	242	125	268	269	55	177	227
Orissa	193	138	182	204	418	317	662	374	191	348	300
Rajasthan	144	134	188	300	380	147	275	247	55	70	84
U.P.	145	137	215	208	349	154	189	161	21	27	54
SD	124.2	124.0	104.3	134.9	215.1	87.1	142.3	88.1	49.0	99.3	136.7
Mean	178.0	177.7	230.5	271.2	451.9	201.3	261.4	250.7	55.7	112.6	193.4
CV	0.70	0.70	0.45	0.50	0.48	0.43	0.54	0.35	0.88	0.88	0.71
Max/Min	7.2	6.8	5.3	4.7	4.2	5.1	6.8	3.4	762.5	539.0	16.9

Source: Handbook of Statistics on State Government Finances 2010, RBI

The table 4.9 which represents the per capita loans from the centre reveals the existence of interstate differences in borrowing from this source also. In the 1990s the high income states was getting much resources from the centre in the form of loans, compared to the poor and middle income states. Richer states were getting an amount greater than the average of all states, for

almost all the periods (90s), barring few years in the initial years for Haryana and Maharashtra. In the next decade, i.e., in 2000s the high income states was borrowing an amount lesser than the all states' average throughout the time period. On the other hand, among the low income group, states like Orissa and Rajasthan was receiving loans from centre which was greater than the average for all states in the 2000s. The middle income states like Karnataka, Kerala and Andhra Pradesh was receiving a higher amount as loans from centre in most of the years of 1990s. The coefficient of variation in per capita loans from centre changed from 0.70 in 1990-91 to 0.43 in 2000-01. It further increased to 0.88 in 2006-07 and finally reached 0.71 in 2009-10 showing the existence of disparities between states in the loans and advances received by them from the centre.

Table 4.10: Per capita Special Securities Issued to NSSF (Rs)

States	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	484	809	749	1097	1235	1649	1445	1050	164	18	87
Haryana	345	307	412	728	776	948	831	504	72	41	41
Maharashtra	457	511	565	652	1059	1550	1544	885	206	142	183
Punjab	735	990	573	1064	1348	1434	1322	1147	276	71	0
Middle Income States											
Andhra	153	237	150	345	278	795	569	513	48	121	120
Karnataka	185	201	277	369	504	799	714	461	68	52	86
Kerala	180	139	145	259	601	855	812	670	54	0	772
Tamil Nadu	165	208	238	349	596	923	951	616	81	9	30
West Bengal	534	620	722	1056	1100	1144	1273	968	89	230	683
Low Income States											
Bihar	173	190	197	254	294	297	117	302	105	138	124
M.P.	127	142	140	261	368	426	461	324	36	49	53
Orissa	108	168	135	165	269	351	368	279	43	38	62
Rajasthan	324	356	520	589	701	841	569	312	17	10	0
U.P.	196	231	241	317	373	440	419	352	111	72	135
SD	189.4	268.0	223.4	332.2	372.1	434.8	439.8	300.3	72.2	65.4	242.6
Mean	297.6	365.0	361.7	536.2	678.6	889.4	813.9	598.8	97.8	70.8	169.7
CV	0.64	0.73	0.62	0.62	0.55	0.49	0.54	0.50	0.74	0.92	1.43

Source: Handbook of Statistics on State Government Finances 2010, RBI

Disparities among states are visible in the 'special securities issued to NSSF' also. We can observe from the table 4.10 that the high income states were borrowing an amount higher than the middle income and low income states. All the states in the high income group were

borrowing higher than the average borrowing of all states. But all the low income and middle income states was borrowing less than the average of all states, with few exceptions in some years. Among the middle income states, a major exception to this trend is West Bengal, whose borrowing was always higher than the all states' average. Even though some other states in the low and middle income category also borrow above the average for few years, we can say that there are wide disparities among the states, especially between the low and high income states. We can also see that, the states' borrowing from this source is reducing from 2005-06 for all the states. The coefficient of variation in per capita special securities issued to NSSF also shows the existence of disparities. It increased from 0.64 in 1990-91 to 1.43 in 2009-10.

Table 4.11: Per capita Loans from Banks and Financial Institutions (Rs)

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	1	4	4	27	16	14	1	29	3	201	218
Haryana	19	12	-14	13	118	150	17	429	285	240	756
Maharashtra	20	6	14	5	9	50	86	-28	25	117	101
Punjab	3	4	160	20	225	300	651	70	109	168	166
Middle Income States											
Andhra	4	4	5	15	52	48	91	324	112	222	106
Karnataka	3	6	1	20	34	76	56	49	53	89	121
Kerala	12	24	23	28	70	141	181	186	209	281	277
Tamil Nadu	3	3	6	2	51	113	91	-29	149	195	215
West Bengal	1	1	1	2	3	5	4	2	2	3	3
Low Income States											
Bihar	1	1	2	1	2	38	41	28	103	70	108
M.P.	2	3	4	22	16	26	61	59	84	154	152
Orissa	4	2	5	2	13	27	57	40	57	161	179
Rajasthan	3	6	8	20	24	38	52	178	61	115	113
U.P.	8	-2	0	7	16	52	-12	125	102	124	181
SD	6.5	6.4	42.3	9.8	60.5	78.4	166.3	134.2	77.9	73.4	175.2
Mean	5.9	5.4	15.6	13.1	46.3	77.0	98.3	104.5	96.8	152.9	192.6
CV	1.1	1.2	2.7	0.7	1.3	1.0	1.7	1.3	0.8	0.5	0.9
Max/Min	31.3	-11.8	-11.5	36.1	105.1	62.0	-56.0	-14.7	122.7	95.7	291.9

Source: Handbook of Statistics on State Government Finances 2010, RBI

A trend similar to the other sources of borrowing is visible in the 'loans from banks and financial institutions' too. Disparities between states are evident from the table 4.11. Even though, many of the high income and middle income states are borrowing less than the all states' average for some years, in comparison to the low income states we can say that they are borrowing higher

than the average for majority of the period. On the other hand the low income states are borrowing less than the average, from this source in almost all the years. Major exceptions in the middle income category are West Bengal and Karnataka. The coefficient of variation also increased from 1.1 in 1990-91 to 1.7 in 2002-03 and finally reached 0.9 in 2009-10, which shows the persistence of disparities in the loans from banks and financial institutions.

4.6: Interest Payments: A State-wise Comparison

The states have to pay interest on the borrowings made by them. It creates burden on the states as they are bound to pay that interest and it takes away large amount of resources that could have been used for developmental activities. The burden of interest payments will be different for different states owing to their economic capacity along with other factors.

The burden of interest payments on the different states shows some peculiar trends (Table 4.12). Burden is very high for the low income states throughout the two decades of analysis. In the 1990s, all the states in the low income category had to spend more than 2 per cent of their GSDP to pay off their interest payments, except Madhya Pradesh in all the years and Rajasthan in 1990-91. But it was close to 2 per cent of their GSDP. Interestingly, in the same period most of the high income states' ratio of interest payments to GSDP was below 2 per cent, barring Punjab's high interest payment which was more than 3 per cent, in the second half of the decade. States belong to the middle category was also using a lesser portion of their GSDP to pay off the interests, when compared to the poor states.

In the initial years of 2000s, the interest payments of states reached a peak. More precisely in 2002-03 interest payments by most of the states irrespective of their income category reached a peak position. At this time also, the poor states was paying a higher portion of their GSDP as interests, than any other state. For instance, Orissa's interest payments crossed 5.81 per cent of their GSDP. Interest payments by Bihar and Rajasthan were 4.04 and 4.86 per cent respectively. On the contrary interest payments by states like Gujarat and Maharashtra were 3.50 and 2.38 per cent of their GSDP respectively. From 2004-05, the ratio of interest payments to GSDP for almost all the states started to decline. But in that declining phase also, this ratio for the poor states was more than or close to 3 per cent of their GSDP, whereas for many of high and middle income states, it was below 2 per cent. So the interest burden on the poor states is very high. This

is a serious issue as these states are borrowing less on a per capita basis when compared to the high and middle income states.

Table 4.12: Percentage of Interest Payments to GSDP

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	1.65	2.01	1.78	1.78	2.04	2.82	3.50	3.21	2.64	2.35	2.24
Haryana	1.46	1.63	1.65	1.78	2.03	2.56	2.68	2.39	1.74	1.29	1.43
Maharashtra	1.28	1.37	1.30	1.31	1.69	2.07	2.38	2.32	2.25	1.78	1.72
Punjab	1.65	1.47	3.32	3.38	3.80	3.14	4.18	4.12	3.43	2.93	2.78
Middle Income States											
A.P.	1.59	1.68	1.74	1.95	2.20	2.62	3.67	3.35	2.63	2.21	2.21
Karnataka	1.66	1.59	1.73	1.76	1.75	2.20	2.72	2.43	2.06	1.77	1.87
Kerala	1.89	2.12	2.35	2.26	2.35	3.11	3.39	3.28	2.89	2.54	2.44
Tamil Nadu	1.22	1.35	1.48	1.54	1.68	2.13	2.61	2.35	1.99	1.79	1.67
West Bengal	1.65	2.04	2.11	2.33	2.52	3.65	4.56	4.59	4.11	3.49	3.19
Low Income States											
Bihar	2.18	2.97	2.86	2.13	2.17	2.66	4.04	3.40	2.58	2.72	2.77
M.P.	1.37	1.65	1.80	1.76	1.87	2.57	2.78	3.20	2.56	2.09	2.00
Orissa	2.60	2.79	2.93	3.37	3.45	5.28	5.81	4.65	3.35	3.23	3.04
Rajasthan	1.96	2.24	2.35	2.54	2.89	4.05	4.86	4.41	3.72	3.10	3.07
U.P.	2.00	2.50	2.87	2.80	3.16	3.85	3.38	4.66	3.33	2.78	2.46
SD	0.37	0.52	0.63	0.64	0.68	0.89	0.99	0.89	0.70	0.65	0.57
Mean	1.73	1.96	2.16	2.19	2.40	3.05	3.61	3.45	2.80	2.43	2.35
CV	0.22	0.26	0.29	0.29	0.28	0.29	0.27	0.26	0.25	0.27	0.24
max/min	2.13	2.20	2.55	2.57	2.27	2.55	2.44	2.00	2.36	2.71	2.23

Source: Handbook of Statistics on State Government Finances 2010, RBI

It will be beneficial to see the patterns in the interest payments on the market borrowings by the states, as it emerged as a major source for raising resources by replacing centre's role in the borrowing. The share of interest payments on market borrowings in the total interest payments of all states shows an increasing trend throughout the two decades of analysis. Throughout the 1990s, the interest payments on market borrowings of middle income and low income states were high when compared to the high income states (4.13). During this time period, the middle income and low income states were collecting much resource from the market. But the interesting fact is that, towards the end of the decade 2000s, the high income states started to borrow more resources from the market, than the low income states. But the interest payment on market borrowing by them in this period was much lesser when compared to the low income

states. This is happening when the low income states are borrowing much less in per capita terms. From this we can understand that the state government bond market appear to be considering state's income levels rather than the status of the state's finances to determine the risk involved (Sen, 2011). It can certainly work against the interests of the low income states, when they are in a position to depend heavily on market to raise resources due to many reasons including centre's withdrawal from giving loans to the states. The middle income states are collecting heavily from the market and their interest payments on market borrowings is high throughout the period of analysis.

Table 4.13: Percentage of Interest Payments on Market Borrowings to Total Interest Payments

States	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09(RE)	2009-10(BE)
High Income States											
Gujarat	8.11	9.15	10.06	11.92	11.84	13.05	18.04	19.49	17.11	20.50	26.84
Haryana	15.14	14.65	15.00	14.66	15.04	13.49	12.14	15.79	18.47	15.79	28.41
Maharashtra	7.83	8.23	9.14	12.62	12.08	11.56	11.18	13.90	12.67	17.18	26.90
Punjab	8.32	8.84	4.13	6.66	7.89	12.77	10.71	14.58	17.68	23.49	30.38
Middle Income States											
Andhra	24.94	26.89	25.53	23.27	21.96	26.12	23.05	24.00	26.32	29.94	36.64
Karnataka	18.28	18.31	18.97	18.07	17.13	19.93	20.84	24.29	23.55	20.18	26.01
Kerala	23.61	23.49	22.63	24.44	26.15	23.20	22.46	22.83	23.31	28.61	30.90
Tamil Nadu	24.08	24.33	22.88	22.54	22.30	20.34	20.07	23.69	22.98	27.08	31.29
West Bengal	15.04	16.65	17.82	18.41	16.57	12.82	11.00	13.98	14.97	22.17	26.85
Low Income States											
Bihar	16.43	18.29	21.51	31.99	30.61	25.76	21.61	23.88	25.77	23.16	23.55
M.P.	11.81	13.28	14.39	18.44	20.68	20.59	21.61	20.59	21.92	22.19	24.46
Orissa	23.42	19.78	27.80	28.82	26.64	25.16	25.12	25.26	27.95	15.02	14.48
Rajasthan	19.11	19.70	21.01	20.24	19.75	21.17	21.31	23.19	23.23	25.66	32.31
U.P.	18.24	17.10	-	22.32	20.56	20.02	23.84	20.81	24.30	26.07	27.52
All states	15.51	15.86	13.63	19.18	18.38	18.55	18.78	20.10	20.81	23.36	28.11

Source: Handbook of Statistics on State Government Finances 2010, RBI

It has been found that, in the deregulated interest regime the structure of outstanding market loans of the state governments is highly skewed towards the high cost loans when compared to the centre (Chakraborty, 2005) and the state government bond market considers the financial strength or income levels to give loans. In this situation a fully market-based solution of debt

issue is likely to work against the poor states. Apart from that the centre's fiscal consolidation measures have contributed to sharp decline in vertical transfers and financial liberalization induced increase in interest rates has widened the resource gap of states through increase in interest outgo on the stock of debt (Chakraborty et.al., 2009). So the poor states are facing a situation of inadequate resources and large outgo of interest.

4.7. Fiscal Responsibility and Budget Management Act (FRBMA)

A major development in the management of public finances in the country was the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre and the States. It was the beginning of an era of rule based management of public finances in India. The finances of centre and states witnessed deterioration since the late eighties. In 2001-02 the combined fiscal deficit of centre and states reached 9.3 per cent of GDP while the combined revenue deficit increased to 6.9 per cent of GDP. Alarmed by the deteriorating fiscal situation, the Centre had enacted the FRBMA in 2003, which became operational from July 5, 2004. According to the Act, the main obligations of the Centre were the elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to no more than 3 per cent of GDP by 2008-09. The Twelfth Finance Commission recommended the Debt Consolidation and Relief Facility (DCRF) comprising consolidation of States' outstanding debt to the Centre and debt write-offs linked to the reduction of revenue deficit and containment of fiscal deficit at the 2004-05 level. Enactment of FRBMA by States was made a pre-condition to avail of the benefits under the DCRF. 21 states enacted FRBMA in 2005-06 period. The states like Karnataka, Kerala, Tamil Nadu, Punjab and Uttar Pradesh had enacted the legislation even before the stipulation by Twelfth Finance Commission. West Bengal and Sikkim enacted it recently. The legislations by states also mandate the elimination of revenue deficit and containment of fiscal deficit.

It is true that the enactment of FRBMA brought discipline in the management of public finances in India. But it is subjected to criticisms on various grounds. It has been argued that it lacks the flexibility to respond to an unexpected increase in government's expenditure. The Approach Paper to the 11th Five-Year Plan hinted that the first two years of the Plan could be vulnerable because of the possibility of a cyclical downturn, oil price hike and lack of flexibility in the FRBMA. The Paper further stated that there was a need to review the targets under the FRBMA, particularly those relating to the elimination of revenue deficit because of the shift in Plan

expenditure towards social sectors. FRBM Act has attracted other criticisms like fixing a limit on deficit without any logic and theoretical justification, curtailing of expenditure for attaining the targets etc (Bhaduri, 2006; Patnaik, 2006). The most important criticism is fixing of uniform deficit reduction targets for all states. It has been argued that this 'one-size fits all' approach has constrained fiscally strong States to raise more resources. Based on this argument the Commission on Centre-State Relations (2010) recommended state specific targets for the deficit reduction. But this can be of consequences as already there exist wide disparities between states in their borrowings. The low income states are able to raise only fewer resources compared to the high income states, while the interest burden is more on them. The question arises in this context is that; whether the state specific targets for deficits will accentuate the existing disparities among states?

The borrowing regime of states seems to be highly regressive and it adversely affects the progressive nature of the fiscal transfers. It contributes to the widening of existing inequalities between states. So the poor states will get trapped in situation of inadequate resources and lack of opportunities to develop.

4.7: Summary

The states borrow from different sources in order to finance their activities. For them it is an important source to raise resources. From the analysis, we realize that there has been a significant change in the composition of outstanding liabilities of states. The importance of centre in the borrowing regime of states is reduced, as the share of the 'loans and advances from centre' component in the total outstanding liabilities of the states is only marginal in the recent years. On the other hand internal liabilities emerged as a major source of borrowing which is mainly driven by increasing share of market borrowings and special securities issued to NSSF. Market borrowings emerged as a major source of borrowing, as special securities issued to NSSF is declining in the recent years.

When the 'loans and advances from the centre' was the major source of borrowing in the 90s, the share of this item in the outstanding liabilities of both the high income and middle income states was high when compared to the lower income states. In 2000s, when the market borrowings emerged as the major source of borrowing, it is the same high income states that are borrowing

highly from this source. We can observe disparities between states in their borrowings from different sources. The high income and middle income states are collecting much resource from various sources like market borrowings, banks and financial institutions, special securities issued to NSSF etc, when compared to the poor states. In the 1990s, even the loans and advances from the centre, which was a part of the transfers by the Planning Commission, favored the high income states. Even though the poor states collected much less resources on a per capita basis through borrowing, their interest burden was too high than any other states. The interest payments on market borrowings by the low income states were much higher when compared to the other states, even when they borrowed less on a per capita basis. It means that the market is considering the states' income levels and fiscal strength to assess the risk involved and charge interest based on that. Apart from this the enactment of FRBM Act by the states has placed restriction on the borrowings by them. But there are arguments that state specific targets should be introduced for deficit reduction rather than common targets which constrain the fiscally strong states from raising resources. The question is that, what will happen to the equity concerns if state specific borrowing targets are introduced in a regressive borrowing regime. So the inequitable borrowing regime nullifies the progressiveness in the fiscal transfer mechanism. It also adversely affects the resource position of the low income states, which can ultimately lead to deterioration in their finances and widening of disparities between states.

Chapter 5

Conclusion

The study was focused on the expenditure made by Indian states and resources they raised through fiscal transfers and borrowing, during the two decades of economic reforms, i.e., from 1991 to 2010. It is an era characterized by the greater role of the states in the economic development. There is a paradigm shift from a planned economy to a market economy. In these new circumstances public investments are envisaged to play lesser role than earlier. This contributed to a shift in the role of states from directly undertaking investments to facilitating necessary environment including infrastructure requirements- human and physical- that may attract private investments and boost economic activities. In this context we analyzed, how the states in India make their expenditure, whether there are any disparities between states in the process of spending etc. It was important because there are already wide disparities between Indian states in many realms which badly affected the poorer states. Apart from this the fiscal imbalances in the federation also adversely affects the resource position of the states. Two possible ways for the states to raise enough resources to meet their expenditures are the fiscal transfers (given for correcting the fiscal imbalances) and the borrowing (which helps to finance large capital expenditures which is inevitable in the development process). In this context we analyzed the federal fiscal transfers in India to see if it is successful in offsetting the fiscal disabilities of the poor states and in providing a level playing field to them to compete with fiscally stronger states. We further looked in to the borrowing regime of states to know if it is equitable and helps the poor states to raise adequate resources.

In the introduction chapter, we gave an idea about the broader context in which the study is contextualized. The chapter also introduces the fiscal federalism, focusing on the rationale behind federal fiscal transfers, besides presenting the research problem and the objectives of the study. A brief account of the data sources and methodology is also given.

An analysis of the pattern of expenditure made by the state governments in India is undertaken in the second chapter. In various sectors and items of expenditure like total expenditure, development expenditure, capital expenditure, social sector expenditure, expenditure on education, medical and public health etc, we can observe the existence of wide disparities among

the states. In almost all the sectors of expenditure, the low income states like Bihar, Madhya Pradesh, Orissa, Rajasthan, and Utter Pradesh were spending an amount much lower than the average of all states whereas that of the high income states like Gujarat, Haryana, Maharashtra, and Punjab was much higher than the all state's average. The middle income states were also spending reasonably well in most of the expenditure items. The coefficient of variation in the per capita expenditure in almost all sectors showed an increase in the 1990s and by the end of 2000s it reached a disparity position which is worse than that in 1991.

The disparities among the states in expenditures in critical areas can have serious aftermaths, especially in the era of economic reforms. It can create differences in the socio-economic development of the states and the standard of living of the people. The present globalizing environment demands creation of better infrastructure facilities- both human and physical- and enabling atmosphere that will attract the private investments and augment the economic activities in the states. If the poor states are unable to make substantial investments in critical areas, then the private investments will flow to the richer states which provide better infrastructure facilities. So if the states are not on an equal footing, it will accentuate the existing disparities between states in an era of globalization.

Third chapter looked at the federal fiscal transfers to the states. Basically the necessity of transfers arises from the inadequacy of the own resources of the states, which is a result of the fiscal imbalances in the federation. We observed wide disparities in the own revenue position of the states. The coefficient of variation in per capita tax revenue, per capita non-tax revenue and per capita own revenue showed widening of disparities between states. It shows that the poor states don't have much own resources to finance their expenditure responsibilities when compared to the higher income states. This further widens the existing horizontal imbalances in the federation.

There are compensatory mechanisms to solve the fiscal disabilities of the states through the federal fiscal transfers. In India there are transfers by the constitutionally mandated Finance Commission transfers along with the transfers by the Planning Commission to assist the state's plan expenditure and to implement the Central Sector and Centrally Sponsored Schemes. On the whole the fiscal transfer mechanism favors the poor states when compared to the richer ones. But it has been found that the fiscal transfer mechanism is not adequate to fully offset the fiscal

disabilities of the poor states and fails to achieve equalization. There are many reasons for this, which can be identified within and outside the transfer mechanism. Some of them are the following, (a) there are multiple agencies with overlapping jurisdictions which jeopardize the transfer objectives (b) accommodating different interests complicated the transfer formula of Finance and Planning Commission (c) transfer mechanism is not targeted to achieve equalization and to ensure minimum service levels in the states (d) transfers lead to disincentive effects in the fiscal management of states (e) plan and non-plan categorization of state's budgets leads to complicated expenditure decisions (f) regressive nature of implicit transfers, like disbursal of institutional finance which include the priority lending by commercial banks and assistance from All India Financial Institutions (AIFIs) (g) proliferation of Centrally Sponsored Schemes(CSS) which leads to reduction in the divisible pool and normal plan assistance etc. All these problems prevent the transfer mechanism from achieving equalization and offsetting the fiscal disabilities of the poor states. This further widens the existing disparities between states which is harmful to the development of the federation

Apart from the transfers the states depend on the borrowings to raise resources to meet their expenditure responsibilities. It is a vital source of resources for them. From the analysis done in chapter four, we realize that there has been a significant change in the composition of outstanding liabilities of states. The importance of centre in the borrowing regime of states is reduced, as the share of the 'loans and advances from centre' component in the total outstanding liabilities of the states is only marginal in the recent years. On the other hand internal liabilities emerged as a major source of borrowing which is mainly driven by increasing share of market borrowings and special securities issued to NSSF. The Market borrowings emerged as a major source of borrowing, as special securities issued to NSSF has declined in the recent years. When the 'loans and advances from the centre' was the major source of borrowing in the 90s, the share of this item in the outstanding liabilities of both the high income and middle income states was high when compared to the lower income states. In 2000s, when the market borrowings emerged as the major source of borrowing, it is the same high income states that are borrowing highly from this source. Such disparities between states are also visible in data on each year's borrowing by them from different sources. The high income and middle income states are collecting much resource from various like market borrowings, banks and financial institutions, special securities issued to NSSF etc on a per capita basis. In the 1990s, even the loans and

advances from the centre, which was a part of the transfers by the Planning Commission, favored the high income states.

Even if the low income states were collecting lesser resources through borrowing from different sources, the interest burden on them was much higher when compared to that of the higher income and middle income states. They were spending a higher portion of their GSDP on the interest payments than any other states throughout the two decades of the study. The interest payments on the market borrowings also shows a high burden for the poor states even when they borrowed less from market compared to the richer states. Therefore, the market appears to consider the states' income levels to assess the risk involved and charge interest based on that. It can definitely work against the lower income states. The regressive nature of the borrowings can also nullify the progressiveness in the federal fiscal transfers. It can be seen that the maximum-minimum ratios of the fiscal transfers are less than the maximum-minimum ratios of the borrowings from different sources. Along with this there are fixed ceiling on the borrowing or the fiscal deficit of the states, mandated by the Fiscal Responsibility and Budget Management Act (FRBMA). The states are not allowed to borrow above the specific target. But this has attracted serious criticisms due to its lack of flexibility and most importantly for fixing common targets for all states, which tend to constrain fiscally strong states in raising more resources. There are recommendations for fixing state specific targets in the case of FRBMA (Commission on Centre-State Relations, 2010). But the real concern is that if the state specific borrowing targets are introduced, will this accentuate the already existing disparities between states in the case of borrowing? So borrowing regime of the states is highly inequitable as there exist wide disparities between states in their borrowings from various sources. It does not help the poor states to offset their fiscal disabilities and to raise enough resources for their expenditures. In other words the inequalities in the regime of borrowings actually cancel out the progressiveness in the fiscal transfer mechanism. It adversely affects the poor states and further widens the existing inequalities between the states.

It can be concluded that the low income states are in a disadvantaged position as they are not able to make expenditures which is needed for the creation of infrastructure facilities and enabling environments that would attract private investments. There exist disparities between poor and richer states in the expenditure on various crucial sectors. The fiscal transfers that are

meant to offset the fiscal disabilities of the poor states are not sufficient for that, despite of its progressive nature. The inequitable borrowing regime of the states also works against the poor states and nullify the progressiveness in the fiscal transfers. So the poor states are caught up in a situation of vicious circle that prohibits their development and ability to ensure good living standards for its people. This is a serious issue in the era of globalization as the states with more developed markets and infrastructure can reap higher benefits from access to domestic and international markets and grow faster than those with less developed markets and infrastructure. The existence of disparities between states affects regional equality and thereby the social fabric, political stability and economic development of the federation.

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