

## The Indian Economy: Dealing with Public Finance Deficits

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*“Fiscal Deficit estimate, could be even higher, in case, the government is unable to stick to the budgeted expenditure target”, Pranab Mukherjee, busniss world, 5<sup>th</sup> july, 2011.*

### Introduction

Of late now, Indian economy has been in the spotlight. It has been among the fastest growing economies during the last two decades. Wide ranging economic reforms have taken place. It has undergone a significant structural transformation. The economy is more resilient, less vulnerable to external shocks and has opened up for more potentials.. Despite several international shocks such as East Asian crisis, rise in international oil prices and economic sanctions, the growth momentum of economy has not been seriously affected. Price stability has been by and large maintained and the balance of payments has also been remained comfortable.

Even though India has made considerable progress in implementing economic and structural reforms since the early 1990s, the reform process has slowed in the past few 6 years, partly due to political uncertainty and partly due to the contagion of the Asian financial crisis. The government not only needs to resume and accelerate the pace of economic reform but also to widen its scope to achieve sustained higher economic growth.

Over the years, the Centre has seen a burgeoning of non-plan expenditure in the face of inadequate buoyancy of revenues. They have responded by resorting to larger and larger volumes of borrowing to finance plan expenditure, which is shrinking as a percentage of GDP. This process has led to steady build up of debt, which in turn has generated a rising interest burden. One of the crises that India faced in 1990-91 was the unsustainable imbalance between

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government revenues and expenditure. Revenue deficit have been financed by running up surpluses on the capital account of the budget. Such surpluses on capital account of the budget will prove harmful for the long run growth prospects of the economy. The steady deterioration in the revenue account caused enlargement of gross fiscal deficit. Prior to 1991, budget deficits generally meant revenue deficits and the overall deficits. The term "Fiscal Deficit" entered the terminology of fiscal management of the country as a prominent line since 1991-92 budgets. The fiscal reform process in India initiated since 1991 has a strong under pinning in the goals of macroeconomic stabilization and growth. The attempt to regain control on macro-economic situation through fiscal adjustment has been a global phenomenon since the beginning of 1980's as this period unfolded for many developing countries the events of internal and external debt, high rate of inflation and major declaration in growth performance. The global context in which India was placed and the expediency of the situation in 1991 was the two most immediate factors, which led to the introduction of comprehensive set of reform measures in the Indian economy. The process of fiscal adjustment launched in 1991 as part of structural adjustment programme placed strong emphasis on reducing fiscal deficit of the Centre. Budget deficit of the Central government became a matter of serious concern for Indian policy makers. The precarious fiscal position of the Centre called for bold and decisive policy measures to reduce fiscal deficit of the Centre.

Since 1991, Centre has carried out number of measures of tax reforms as part of the ongoing economic reforms. The overall impact of these reforms on the Central government finances has not been quite encouraging. The tax GDP ratio of the Centre, which as reached a level of higher than 11percent in the late eighties, has come down below 10 percent in the recent years. But Center's effort to contain its deficit led to fiscal deficit to remain below 6 percent. Subsidies have been cut and monetized deficit has been virtually declined. With the deterioration of state finances, Centre became concerned over states and leads a helping hand to states in overcoming their fiscal deficit. In the recent years, the deterioration in state finances has become a problem of great concern as it has caused severe erosion in the budget support for development and led to large borrowings even to meet current expenditure, mainly salaries to

employees and interest payments. The scenario is not indeed bleak for the reform agenda at the state level without which the state finances could not improve nor would state governments be able to deliver basic services to the people. States are not even able to maintain existing public assets, yet alone creating new facilities and expanding infrastructure on the required scale. Unlike the Centre which had surpluses on revenue account in the budget till 1978-79, the states seemed to be managing their finances relative better but in the late eighties they also began to run revenue deficits which led to the steady deterioration in the revenue account which caused increase in states gross fiscal deficit. Revenue deficit have been financed by running surpluses on capital account of the budget.. The rising fiscal deficit of the states became a matter of concern for Central government. To overcome the fiscal crisis of the states, Centre gave some bold and drastic measures or steps which will have to be taken on all fronts, if states want to come out of its fiscal crises. Such measures came to be known as “Fiscal Reforms Programme for states”.

With the era of frequent elections and competitive populism practiced by different political parties aspiring for power, the regime of responsible public finance has become extremely difficult.

As we look ahead there are many unfinished agenda awaits us. At the top of this agenda is reforms and in that of fiscal reforms.

Fiscal policy is the policy under which the government of a country uses fiscal measures (or instruments) to correct excess demand and deficient demand and to achieve other desirable objectives. Fiscal policy deals with the taxation and expenditure decisions of the government. Monetary policy, deals with the supply of money in the economy and the rate of interest. These are the main policy approaches used by economic managers to steer the broad aspects of the economy. In most modern economies, the government deals with fiscal policy while the central bank is responsible for monetary policy. Fiscal policy is composed of several parts. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Fiscal policy is an important constituent of the overall economic

framework of a country and is therefore intimately linked with its general economic policy strategy.

Public expenditure is an important component of aggregate demand. Therefore, excess demand can be corrected by reducing government expenditure. Reduction in government expenditure also leads to a decline in the volume of national income due to the backward operation of investment multiplier. Reduction in national income leads to a decline in aggregate demand and fall in the price level. On the other hand, government should increase expenditure on public works programmes such as the construction of roads, expansion of railways, setting up of power projects, construction of irrigation projects, schools and colleges, hospitals and parks and so on. Besides, government should also enhance expenditure on social security measures, like old age pensions, unemployment allowances, sickness benefits etc. As a result, national income would rise due to the operation of multiplier and aggregate demand for goods would expand.

Like tax and public expenditure, public borrowing is also an important anti – inflationary instrument. Government of a country should resort to borrowing from the non-bank public to keep less money in their hands for correcting the state of excess demand and inflationary situation. On the other hand, to correct deficient demand, government should reduce borrowing from the general public so that purchasing power in the hands of the people is not reduced. Rather, government should repay the past loans to the people to increase their disposable income.

Besides the above fiscal measures, government should resort to deficit financing to correct deficient demand. Deficit financing is a technique of financing a deficit budget by (i) printing notes, & (ii) borrowing from the central bank or drawing down the cash balances on part of the government from the central bank. In any case, deficit financing makes an addition to the total money supply of the country and can correct deficient demand. However, deficit financing beyond a limit may produced inflationary situation in a country. Therefore, deficit financing must be kept within a limit and should be used with caution and care.

Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables. On a broad generalisation, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. If it draws down on its foreign exchange reserves, a balance of payments crisis may arise. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the „crowding out“ of private investment.

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than 11percent in the late eighties, has come down below 10 percent in the recent years. But Centre's effort to contain its deficit led to fiscal deficit to remain below 6 percent. Subsidies have been cut and monetized deficit has been virtually declined. With the deterioration of state finances, Centre became concerned over states and leads a helping hand to states in overcoming their fiscal deficit. In the recent years, the deterioration in state finances has become a problem of great concern as it has caused severe erosion in the budget support for development and led to large borrowings even to meet current expenditure, mainly salaries to employees and interest payments. The scenario is not indeed bleak for the reform agenda at the state level without which the state finances could not improve nor would state governments be able to deliver basic services to the people. States are not even able to maintain existing public assets, yet alone creating new facilities and expanding infrastructure on the required scale. Unlike the Centre which had surpluses on revenue account in the budget till 1978-79, the states seemed to be managing their finances relative better but in the late eighties they also began to run revenue deficits which led to the steady deterioration in the revenue account which caused increase in states gross fiscal deficit. Revenue deficit have been financed by running surpluses on capital account of the budget.. The rising fiscal deficit of the states became a matter of concern for Central government. To overcome the fiscal crisis of the states, Centre gave some bold and drastic measures or steps which will have to be taken on all fronts, if states want to come out of its fiscal crises. Such measures came to be known as "Fiscal Reforms Programme for states".

With the era of frequent elections and competitive populism practiced by different political parties aspiring for power, the regime of responsible public finance has become extremely difficult. Therefore the important question is how to manage the public finance of India both at Centre and state level and how to reduce the deficits.

### **What Causes Deficits?**

The principal cause for such imbalance is the fact that in spite of limited resources base that states has to cope with the significant growth in their committed expenditure like wages

,salaries pension, interest payments which constitute a major portion of non plan expenditure. Causes of this imbalance are also well known the chief amongst them are the propensity of political leadership to counterproductive populism and avoidance of tough measures to stem the root. Political instability contributed to the above trend. It is not likely that there would be any drive towards financial prudence and corrective measures would be taken to stop the drain through pensions state electricity board, irrigation, state road transport corporation etc Therefore the question which assumes significance is that how long the state would sustain it. Some of the important factors are:

#### **a) Increase in Subsidies**

Subsidies are used to modify market outcomes, especially to take account of positive externalities, and, sometimes, to subserve certain well-defined redistributive objectives. The government has been providing subsidies on a number of items such as fertilizers, exports, food items, etc. This has resulted in a fiscal imbalance. The major subsidies provided by the Central Government of India have increased over the years resulting in fiscal imbalance.

The Indian government, since Independence has been subsidizing many industries and products, from gasoline to food. Loss-making state-owned enterprises are supported by the government. Farmers are given electricity for free. Overall, a 2005 article by International Herald Tribune stated that subsidies amounted to 14% of GDP As much as 39 % of subsidized kerosene is stolen On the other hand, India spends relatively little on education, health, or infrastructure.

Total non-merit subsidy for the Central and State governments taken together amount to Rs. 102145.24 crore in 1994-95, which is 10.71% of GDP at market prices. The share of Central government in this is 35.37%, i.e. roughly half of corresponding State government subsidies. The recovery-rate for the Centre, in the case of non-merit subsidies, is 12.13%, which is somewhat higher than the corresponding figure of 9.28% for the States. The difference in recovery rates is striking for non-merit social services, being 18.14% for the centre and 3.97%

for the States. It is only marginally different for non-merit economic services (11.65% for Centre and 12.87% for States) where, in fact, States do better.

The total non-merit subsidies for the year 1994-95 amounted to 10.71% of GDP at market prices, resulting in a combined fiscal deficit of 7.3% for the Centre, States and Union Territories. Therefore, if these subsidies were phased out, the same would have a discernible impact on the fiscal deficit. It can be done by increasing the relevant user charges, which would also lead to a reduction in their demand. Apart from these first round effects, there would also be positive secondary effects on fiscal deficit, as the overall efficiency in the economy rises with an improved utilisation of scarce resources like water, power and petroleum. With an increase in efficiency, the consequent expansion of tax-bases and rise in tax-revenues would further reduce the fiscal deficit.

#### **b) Payment of Interest**

One of the major components of government expenditure is the interest payment both on domestic loans and foreign loans. The government debt has increased considerably over the years. This has resulted in increased interest burden on the government. Reflecting the less than prudent fiscal management of the past, interest payments have been growing at a steady rate and appropriating about 35 per cent of the revenue receipts in the last five years. Interest payment of the Central Government increased from Rs. 21,500 crores in 1990-91 to Rs. 24 8664crores in 2009-10. As percentage to GDP the interest payment was 3.2% in 2009-10.

#### **c). Defence Expenditure**

The defence expenditure is increasing over the years. The government has limited scope to reduce defence budget due to security problems across the Indian borders. The defence expenditure on the part of central government has increased from Rs. 10,874 crores in 1990-91 to Rs. 87344 crores in 2009-10. Defence expenditure was 1.1 % of GDP in 2009-10.

#### **d) Poor Performance of Public Sector**

The poor performance of public sector has also resulted in fiscal imbalance. The poor performance of public sector is due to various reasons such as political interference, inefficiency and corruption of management, low labour efficiency, lack of professionalism, surplus staff, etc. Due to poor performance of public sector, the Government gets low revenue by way of dividend from public sector units.

A major source of revenue imbalances reflected in dissaving of the public sector is rooted in the poor profitability of the PSUs. The returns on capital invested by the Government in case of SEBs, and SRTC have been low. The rationale regime that governs the supply of power to agriculture is an enormous source of fiscal pressures and in discipline. The agricultural supply to farmers is unlettered and often free. Even if payments are required for electricity, they are lump sum and so the marginal cost to the consumer of an additional unit of consumption is zero. The biggest problem facing the power sector is the lack of commercial discipline in three areas that is, in the utility customer relationship, non-paying customers are frequently not disconnected and bills are often not paid. Second, is government utility relationship. Governments typically fail to compensate utilities for the losses incurred by them due to supply of power at non-remunerative rates, Third, on the utility supplier relationship utility lacking cash in part as a result of the payments defaults..

**e) Pensions:** Salaries are such large part of government spending that they must be at the core of any expenditure restructuring effort. Salaries make up 30 percent of state governments spending. India's public private wage differentials are in fact among the highest in the world. In India about 40% of the state government employees are teachers. "Pensions are increasing at a faster rate due to the longevity of life". However, no major reform has been taken so far by state governments towards increase expenditure of salaries and pensions. As suggested by World Bank, for maintaining a policy of wage restraint will be avoidance of another pay commission leading to significant increase in real wages. New hiring is needed in the civil service in priority areas; overall hiring restraint is justified because there are large areas of overstaffing as well as understaffing. Targeted retrenchment programmes would be the best

way to free up space for new hiring but have not been success in India. A second set option through which much can be achieved is attrition based restructuring. Pensions also forms a mounting liability and as a source of fiscal vulnerability. Pension's payments at the state government's level have also risen sharply during the last 10 years. Pensions expenditure of states are proposition of revenue receipts rose .

#### **f) Other Factors**

Tax Evasion is another factor responsible for crisis. Indian tax system is made up of complex procedures with numerous exemptions. Corruptions are rampant at all levels, which leads to the fiscal imbalance. Weak Revenue mobilisation is another cause of high deficit. While increase in government expenditure has been the major cause of fiscal imbalance, inadequate rise in revenue receipts also contributed to fiscal imbalance. The revenue receipts of the centre, consisting of tax revenue, net of state's share and non-tax revenue has increased at slower rate than that of growth in expenditure. The gap between expenditure and revenue is financed through loans, both internal and external. The borrowings have been spent on unproductive purposes as well. The huge borrowings resulted in large interest payments.

#### **Consequences of Fiscal Crisis**

The fiscal imbalance has resulted in harmful consequences like mounting inflation, deficit in balance of payment, etc. It has also adversely affected the growth of economy. The government must introduce major fiscal correction policies to overcome the fiscal crisis. The consequences of fiscal crisis i.e. sustained high fiscal deficits over 20 years are as follows :

- A. **Debt Trap:** Maintaining sustainable levels of government debt is critical to sustained high macroeconomic outcome. In fact, typically the fiscal rules under the fiscal responsibility and budget management framework entail assessment of what is usually a sustainable level of public debt for the country.. Even in the years of fiscal expansion there has been marginal decline in outstanding liabilities as a proportion of GDP. These

declined from 56.9 per cent in 2007-08 to 51.2 per cent in 2010-11 (RE) and are budgeted at 48.8 per cent in 2011-12. (Economic survey 11-12). With increasing levels of borrowing for financing activities, which have zero or low yields, interest payments increase at a faster rate. Thus, non-productive expenditures rise, give rise to higher and higher revenue deficits.

**B. Cut in Capital Expenditure:** Because of debt service payments forming a higher proportion of expenditures, all other activities of the government suffer. The main sufferer in this process is government capital expenditure in both economic and social infrastructure.

**C. No Increase in Expenditure on Education and Health:** High debt service payments also prevent an increase in or even maintenance of real expenditure on social services, i.e. on education and public health.

**D. High Interest Rates:** The continued high level of public borrowings has an effect on the rest of the economy through prevalence of high interest rates.

**E. Slow Economic Growth:** The fiscal imbalance affects economic growth in the country. Fiscal imbalance first affects capital formation which in turn affects the economic growth.

**F. Other Consequences** Some other consequences of fiscal crisis are:-

- i. Fiscal imbalance may also lead to inflation in the economy.
- ii. High fiscal deficit may discourage foreign investment in the country.
- iii. The government has to borrow additional funds to solve fiscal deficit, which puts an extra burden on the government for payment of interest. It further worsens the fiscal imbalance.
- iv. The fiscal imbalance however still continues as the Government has failed to reduce its own expenditure. The extravagant expenditure done by politicians and ministers continues without any restriction. The populist policy followed by the Government, failure to reduce fertilizer subsidy, and massive burden of interest

payment has still not take out the Indian economy from a situation of severe fiscal imbalances.

### **Fiscal Consolidation: Reforms by Government**

Fiscal sector reforms were perhaps the most critical part of the reforms initiatives taken by the government after the 1991 economic crisis. Notwithstanding the initial fiscal adjustment measures for correcting the fiscal imbalances immediately after the crisis and the subsequent fiscal reforms, a high level of deficits in the government budgets particularly during the second half of 1990s, continue to hound the growth impulses for the economy. The level of fiscal deficit combined both for the Central government and State governments was more or less at the same level at the end of nineties as it was at the beginning. Government debt was approaching a critical mark beyond which it could be labeled as unsustainable. Almost all the state governments are facing hard budget constrain in providing even the basic minimum services through budget. Capital expenditure through budget has come down sharply. Public sector saving has hit the bottom, it being almost negligible. The macroeconomic impact of the Government's fiscal operations is thus evaluated by looking at consolidated General Government finances. In the Indian fiscal system, the budgetary resources and expenditures are determined through the annual budget of the Central Government and the State Governments.

### **Central government reforms**

As per budget 2010-11 following new reforms has been added for fiscal consolidation. Fiscal consolidation targets at Centre and States have shown positive effect of macroeconomic management of the economy. Amendment to Centre's FRBM Act, 2003 laying down the fiscal road map for the next five years to be introduced in the course of the year. It has Proposal to introduce the Public Debt Management Agency of India Bill in the next financial year.

### **Tax Reforms**

- Direct Taxes Code (DTC) to be finalised for enactment during 2011-12. DTC proposed to be effective from April 1, 2012. Areas of divergence with States on proposed Goods and Services Tax (GST) have been narrowed. As a step towards roll out of GST, Constitution Amendment Bill proposed to be introduced in this session of Parliament.
- Significant progress in establishing GST Network (GSTN), which will serve as IT infrastructure for introduction of GST.

**Expenditure Reforms**

- A Committee already set up by Planning Commission to look into the extant classification of public expenditure between plan, non-plan, revenue and capital.

**Subsidies**

- Nutrient Based Subsidy (NBS) has improved the availability of fertiliser; Government actively considering extension of the NBS regime to cover urea.
- Government to move towards direct transfer of cash subsidy to people living below poverty line in a phased manner for better delivery of kerosene, LPG and fertilisers. Task force set up to work out the modalities for the proposed system.

**People's Ownership of PSUs**

- Overwhelming response to public issues of Central Public Sector Undertakings during current year.
- Higher than anticipated non-tax revenue has led to rescheduling of some disinvestment issues planned for current year.
- 40,000 crore to be raised through disinvestment in 2011-12.

**State Level Reforms**

States have also undertaken sectoral measures to improve their finances. Several states have shown interest in undertaking a comprehensive review of functioning of states public sector undertakings (SPSUs) including the closing down of non-viable units after providing suitable safety nets to employees including voluntary retirement scheme (VRS). States such as Tamil Nadu, Kerala, Haryana, Karnataka, Himachal Pradesh, Goa and Orissa have encouraged private sector participation in the transport and power generation sectors. Karnataka has come out with the policy paper on restructuring of state public sector undertakings (SPSUs) while Maharashtra has introduced a bill for restructuring of the (SPSUs). In order to strengthen the administrative machinery many states have initiated measures to computerize their records as well as their day-to-day functioning.

Efforts to phase out inefficient PSUs were also made at state level. The leaders states include Andhra Pradesh and Orissa. According to the available information from the ministry of disinvestments, 19 states have identified 290 state level public enterprises for disinvestments out of which AP, Karnataka, Kerala and West Bengal account for nearly half of the PEs. Restructuring or closure has been initiated in 221 of these enterprises. So far 69 units have been closed down, 33 units have been privatized

States have also initiated measures to reform the power sector, which is crucial for the fiscal reforms. The main objective of these reforms was to mobilize private sector resources for augmenting power generating capacity. The power sector reforms have assumed critical importance in recent years. The measures taken by the states in this regard relate to the constitution of State Electricity Regulatory Commission (SERCs) for determining tariff structure, unbundling of electricity boards and to separate entities for power generation. State electricity Regulatory commission has been constituted in 21 states out of these SERCs of 15 states have issued tariff orders. The states of A.P., Delhi, Gujarat, Haryana, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan and Uttar Pradesh have enacted their state electricity acts. Twenty-one states have signed Memorandum of Understanding (MOUs) with the Ministry of Power, Government of India to undertake reforms in time bound manner.

The Debt Swap Scheme (DSS) operated during 2002-05 and Debt Consolidation and Relief Facility (DCRF) recommended by the Twelfth Finance Commission have created fiscal space at the State level in India by reducing the expenditure on interest payments. The rule-based framework adopted under FRLs brought in fiscal discipline to the States. The State governments have adopted institutional measures oriented towards fiscal discipline. Thus, States have gradually put in place legislations with respect to various fiscal parameters such as Fiscal Responsibility Legislations (FRLs), Value Added Tax (VAT), New Pension Schemes (NPS), Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF).

Recognizing the need for strengthening their finances, states have initiated measures towards enhancement of various taxes such as land revenue, vehicle tax, entertainment tax, betting tax, luxury tax, sales tax etc. One of the important components of tax reforms initiated since liberalization relate to the introduction of value added tax (VAT). At a meeting of the empowered committee held on June 18, 2004, the state value added tax was implemented from April 1<sup>st</sup> 2005. The empowered committee of state has also come up with a White Paper on the state level value added tax on January 17, 2005. The progress so far has been quite encouraging as far as the implementation of VAT is concerned as all the States have implemented VAT while Twenty Six States have enacted FRLs.

The stimulus packages of the Central Government as well as those announced by individual States coupled the increased transfers recommended by the ThFC have implications for the financial position of the States in the medium term. The recommendations of ThFC for the period 2010-15 are presently under implementation. The recommendations take into account the current and likely macroeconomic and fiscal scenarios so as to secure fiscal stability and adequate resource availability for the Centre, the States, and the local bodies. The higher levels of devolution of taxes and the inter-se sharing thereof together with higher levels of non-Plan grants under Article 275 of the Constitution which include specific grants like grants for elementary education, outcomes and environment related grants, maintenance grants, and state-specific grants are likely to bring the combined deficit of the States down to the targeted

levels faster. The borrowing ceiling for each State for the year 2010-11 has been fixed by the Government of India, keeping in view the recommendations of the ThFC based on targets for fiscal deficit. Besides, the ThFC has also provided a basis for the finances of local bodies through a basic grant and a performance grant based on a percentage of the divisible pool of the preceding year. The estimated total grant recommended for local bodies aggregates to ` 87,519 crore over the award period of the ThFC. In this year's Budget, measures were also taken to facilitate movement towards a goods and services tax (GST). These included unification of rates between central excise (goods) and service tax (services) at 10 per cent; removal of certain exemptions in central excise; widening of service tax base through inclusion of eight new services and expansion of scope of some of the existing ones; reduction in excise duty from 16 per cent to 10 per cent on medicines and toilet preparations containing alcohol (excise duty on medicinal and toilet preparations is one of the taxes to be subsumed under the GST); approval of a Mission Mode Project for the computerization of State Commercial Tax Departments.

An empowered group under the Chairmanship of Dr Nandan Nilekani, Chairman UIDAI, is working out the modalities for creation of a special purpose vehicle (SPV) which envisages the setting up of a common portal for the Centre and State Governments through which taxpayers could interact with the two tax administrations. Work is also under way to create and strengthen the IT infrastructure in State VAT (value-added tax) departments so that their transition to the GST becomes easier.

## **CONCLUSION**

Fiscal reforms were the integral and perhaps the most critical part of the overall economic reforms program. The fiscal consolidation measures taken immediately after the crisis situation yielded significantly positive results in terms of reduction in fiscal deficit, control in expenditure and marked changes in the fiscal system particularly in the financing pattern of the deficits through reduction in magnetization. (Himanshu Deshmukh, 2006)

The above analysis and assessment clearly revealed that the significant fiscal consolidation in the immediate aftermath of the fiscal reforms was essentially brought about through cut in investment expenditure, as rise in committed revenue expenditure could not be curtailed. Within a short span, it became increasingly obvious that the Indian approach to fiscal correction was not sustainable. While reduction in investment spending affected future growth prospects with consequent slowdown in revenue receipts, the interest payments at public debt continued to grow, resulting in reversal of fiscal consolidation process in the latter half of the 2000. The key factors underlying the growing resource gap across the States are uneconomical level of user charges particularly in the power sector, sluggishness in the Central transfers due to low buoyancy of Central taxes and the rising interest payments.

The ambitious project announced by private participants in area of health, power housing would neutralize or not. The moot question is will the private investment driven growth will contribute towards the reduction in state financial imbalance. Experience suggests that large public debts normally crowd out private investment. Does the above mention development defy this logic of it is simply a lesson of one of the political party (currently in power) with the private corporate sector.

The argument is that the volume of investment depends more on private sector participation rather than the plan expenditure of the state. Thus there is a good case for attracting private sector investment in Uttar Pradesh. But for private sector participation, a good governance is a prerequisite to sustain it in long run and private sector and government both stands to gain out of it. Montek Singh Ahluwalia in 2000, emphasised the importance of private sector participation. According to him, any effort to increase the total level of investment does not much depend on the plan expenditure but on importance of private sector investment. The poor performing state like Uttar Pradesh suffers from handicaps in attracting private investment. So efforts must be made to attract private investment for robust growth. Causes of this imbalance are also well known the chief amongst them are the propensity of political leadership to counterproductive populism and avoidance of tough measures to stem the root.

Political instability contributed to the above trend. It is not likely that there would be any drive towards financial prudence and corrective measures would be taken to stop the drain through pensions state electricity board, irrigation, state road transport corporation etc Therefore the question which assumes significance is that how long the government would sustain it. Going forward, deepening the reform process would hold the key to sustaining the fiscal consolidation

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