Role of the State Governments in Fiscal Reforms

RAO, M. Govinda

(出版者 / Publisher)
Institute of Comparative Economic Studies, Hosei University / 法政大学比較経済研究所

(雑誌名 / Journal or Publication Title)
Journal of International Economic Studies

(巻 / Volume)
10

(開始ページ / Start Page)
95

(終了ページ / End Page)
118

(発行年 / Year)
1996-03

(URL)
https://doi.org/10.15002/00002130

Journal of International Economic Studies (1996), No. 10, 95-118

Role of the State Governments in Fiscal Reforms

M. Govinda Rao

I. Importance of State Level Reforms

Persistent fiscal imbalances in India throughout the eighties led to macroeconomic and balance of payment imbalances. The economic crisis became untractable when the oil prices increased following the Gulf crisis, thus forcing the Government to seek structural adjustment loan from the International Monetary Fund. The economic reforms were initiated since 1991 with a view to stabilise the economy in the short term and impart competitiveness and export orientation in the medium and long term. This involves transition from public sector dominated, heavy industry based, import substituting industrialisation strategy evolved over four decades of planning to a system where resource allocation is made largely according to market determined incentives. Thus, during the last four years, a series of policy measures aimed at stabilisation and structural adjustment have been initiated.

The policies intended to restructure the economy were initiated mainly by the Central government. The attempts to contain fiscal deficits, reform exchange rate regime, liberalise industrial, trade and foreign investment policies, and to regulate capital markets have met with varying degrees of success. Much more remains to be done to reduce fiscal imbalances and to impart greater efficiency in resource allocation by improving the standards of social and economic infrastructure, initiating tax reforms, restructuring public enterprises and by removing fiscal and physical impediments to free movement of factors and products throughout the economy.

Even more important is the need to involve the State governments in the economic reform process. The Constitution assigns the responsibility of providing key social and economic services to the States exclusively or concurrently with the Central government. Adequate and cost-effective provision of these public services is critical to the optimum utilisation of economic resources in the country. This calls for not only efficient implementation of States tax, expenditure and regulatory policies, but also proper coordination and harmonisation of the policies with the Centre. Further, the pursuit of selfinterest and free-riding by individual States can be at the cost of others and this may reduce aggregate social welfare in the country. Therfore, it is important that the policies of different States are coordinated and harmonised to reduce welfare reducing competition among them. Third, in the changing economic scenario it is necessary for the States to identify and eliminate micro-level inefficiencies generated by their tax, expenditure and introduce effective regulatory system to ensure fair competition, reform their implementation machinery and reduce bureaucratic and political interference to ensure a competitive enviroment in which the existing resources are utilised efficiently, and a congenial institutional framework with incentives is evolved to make significant improvements in productivity.

Reform at the sub-central levels is important also because the decentralised; governmental units have a greater role to play in a market economy than in a planned economy. By itself, planning calls for centralised decision making. Further, when the government adopts heavy industry based import-substituting industrialisation strategy, concentration of economic power in the hands of the Central government is inevitable. The vast resources needed to make large investments in the public sector, and the execution of various physical controls, the most important of them being exchange control, industrial licensing and import restriction and extension of ownership of means of production and exchange that of the banking and financial sectors, cannot but result in very high degree of concentration of power with the Centre. In short, as stated by Chelliah (1991, p.7), '...comprehensive Central planning, involving as it does, centralised decision making in relation to production activities and disposal of resources in the 'national interest' ...is the negation of the principle of true federalism". However, when greater role is assigned to the market, the State and local governments too will have to respond to the varying needs arising from functioning of the market economy. In addition to ensuring the orderly functioning of the market, they have to provide the social and economic infrastructure.

In spite of the importance of the subject, the discussions on Indian economic reforms have largely been confined to the reforms at the Central level and the issue of State level problems and reforms, if touched at all, has been only cursory. There have been some individual papers highlighting critical areas of reform at the State level (Rao, 1992; Guhan, 1993 and Sen, 1994). At the governmental level too, a committee was appointed by the National Development Council (NDC) chaired by the Chief Minister of one of the States (Orissa) to recommend austerity measures. However, the report of the committee was not even discussed in the NDC, leave alone implementing its recommendations, Of course, there have been some in-depth analysis of specific State policies. The reports of the committees on irrigation charges (Vaidyanathan Committee) and on electricity boards (Sharad Pawar Committee) and the NIPFP study group report on the reform of domestic trade taxes are the notable ones. Also, some individual States have taken initiatives to commission detailed studies on their financial management with particular emphasis on rational ways of raising revenues, economising expenditures and phasing out the loss making public enterprises.[1] These however, are only isolated attempts to identify the problems and

1) The State governments of Karnataka and Kerala appointed committees to undertake a comprehensive review of their State finances. Similarly, the Government of Punjab commissioned a detailed study on the management of pyblic finances in the State. There have also been several committees and commissioned studies in various States examining their sales tax structures and analysing implicit subsidies arising from their dudgetary operations.

policies and a blue print for a comprehensive State level reform is yet to emerge. In this paper, an attempt is made to highlight the problem areas and suggest the policy changes required to restore functional stability of State finances.

II. State Level Reforms: Fiscal Decentralisation and Allocative Efficiency.

a. Importance of State Level Reforms

The importance of State level reforms is underscored by the pre-eminent role they have been assigned to play in regulating. and directing economic activities in the Indian federation. The States' share in total government expenditure is close to 55 per cent. They incur almost 86 per cent of the total expenditure on social and community services and about 60 per cent of spending on economic services. They also raise about 43 per cent of total revenues and their collection in total domestic trade taxes is almost 55 per cent. Their jurisdiction over major activities specified in the Constitution under the State and the Concurrent lists requires them to regulate economic activities in a wide variety of areas.

Thus, the States play a significant role in tax, expenditure and regulatory activities and the allocative consequences of their policies need to be analysed and monitored carefully in order to ensure efficient allocation of resources. What is important, as mentioned earlier, even in a liberalised economy, the State governments will continue to play as big, if not bigger, role as they have played so far. In particular, their responsibility over agriculture and irrigation sectors wil require continued intervention in agricultural extension and investments in irrigation to achieve accelerated growth and reduction in rural poverty. Similarly, human resource development is considered to be the cornerstone of economic transformation and given the present low level if investment particulary in primary education and preventive health care, significant increases in the outlay on this critical sector will have to be secured. In this endeavour, the State governments will have to play major role. Equally important is the role of the States in providing social security to the persons displaced in employment because of the structural adjustment programme. Satisfactory execution of these functions by the Stale Governments requires them to incur larger government expenditures in these functions than in the past and therefore, cost-efficient use of resources and finding resources to finance these activities in a non-distortionary manner are critical. Distortionary taxes will only cause non-competitiveness and in a liberalised environment, such inefficiencies could drive the marginal firms out of business.

It is therefore, necessary that the State Governments are involved actively in the economic reform process. The State governments, on their part should not only foresee the consequences of the policy charges initiared by the Centre and undertake measures to prepare for and insulate themselves from the adverse consequences, if any, but also identify and eliminate the sources of inefficiencies and inequities in their fiscal and regulatory systems. It is also important that their policy actions should be suitably negotiated and coordinated so that Central and State policies do not work at cross purposes. Thus, a coordinated policy intervention is needed not only for providing the required levels of public services costeffectively in different regions in oder to maximise the national output, but also to ensure nation-wide market free from impediments to the movement of factors and products.

b. Fiscal Decentralisation and Allocative Efficiency

In a large and heterogenous economy like India, federalism provides an appropriate institutional framework and creates a congenial environment for the efficient functioning of the market economy. The large nation-wide market enables the production units to reap economies of scale fully. The decentralised provision of public of public services hepls to provide public services corresponding to the diversified preferences of the people residing in different States and encourages competition among them. This could lead to innovation and efficient provision of public services (Oates, 1972, King, 1984). The competitive sprit among the States can be harnessed to reap gains in productivity particularly in a liberalised economic environment where the resource allocation in the economy is divided not by the planning agency but by market forces.

However, "competitive federalism" will lead to efficient allocation of resources only under certain preconditions. First, competition among the States, to be beneficial, calls for equality in the 'power' of different States. A necessary condition for equalising the competitive strength of different States within a country is to enable them to provide a given normative level of social and economic infrastructure at a given tax-price. This calls for offsetting the fiscal disabilities of the States with lower than average revenue raising capacity and higher than average unit cost of providing public services due to factors beyond their control. Competitive equity can be achieved by appropriately designing either the regional policies or Central transfers to the States. The 'competitive equality' thus brought about would ensure that larger \ stronger units are not in a position to continuously dominate, coerce or prevent the smaller \ weaker units from making independent decisions, nor can they inflict disproportionate damage on them (Breton, 1987). Second, it is also necessary that costs and benefits of a State's decisions should be borne by its own residents (appropriability of costs and benefits) in order to avoid unequal and unhealthy tax or benefit spillovers among the States.

Competitive equality and appropriability of costs and benefits by themselves may not result in efficient allocation of resources. There should be equally conducive institutions and policies. Institutions and policies determine the structure of incentives (Olson, 1982, 1992). Allocation of resources in an institutional structure and policy framework which does not provide incentives to the producer cannot be expected to promote optimal factor use, the employment of the most appropriate technology or promote innovations.[2] Equally important precondition for

2) For instance, an efficient administrative and legal environment to protect the property rights is an important necessary condition for economic growth.

competitiveness is the non-existence of impediments for the free movement of factors and products. The existing institutions themselves may place impediments to labour mobilities; rigidities in labour mobility may also be caused by illiteracy, language differences, lack of information and arragements such as boned or contracted labour. Further, such inflexibilities may not be uniform across the States. The policy framework, therefore, should attempt to do away with all the hindrances to free trade and investments across regions.

We may now summarise the important preconditions for the efficiency in resource allocation in a large federal polity like India. First, equalising the powers of different States ensures a level playing field for all of them. This is achieved by enabling every State to provide a given normative level of public services at a given rax-price (Breton, 1987), through inter-governmental transfers or regional policies.[3] Such a measure will eliminate distortions created by fiscally induced resource flows. When translated into specific policy measures, this calls for offsetting fiscal disadvantages of poorer States and setting up a mechanism to compensate inter-State tax and benefit spillovers. Second, a pre-condition for efficient allocation of resources is the appropriation of costs and benefits of governmental decisions of a State within its own residents. This would eliminate the States' tendency to pass on the burden of financing their public services to non-residents through tax exportation (or expenditure spillins). Third, establishing mechanisms to ensure accountability and incentives provides the right environment for economic growth. This calls for administrative and legal reforms to protect property rights to individuals, creating proper regulatory framework and monitoring institutions to enable efficient functioning of the market, removing bureaucratic and political hurdles in decision making by the economic agents, securing fast clearances for setting up industrial units and establishing a system of reward and penalty to promote work culture, incentives and accountability and, finally, eliminating all impediments-fiscal, physical and financial, to the free movement of factors and products.

As mentioned above, the Constitution vests the State governments with the responsibility of providing basic social and economic services and their expenditure responsibility even in a liberalised environment is likely to show an increase rather than a decline. The transition from an economy where production decisions are taken by the planning agency to the one where resources are allocated according to market signals calls for greater degree of decentralisation. First, the detailed regulatory framework needed for the efficient functioning of the market economy will have to be put in place and effectively enforced. Second, efficient functioning of the markets is possible only when adequate levels of social and economic infrastructure is provided and provision of services like education, health and family welfare, urban infrastructure, agricultural extension, rural development and irrigation calls for large outlays at State and local levels. In addition, the State will have larger responsibility in creating retraining and redeployment and in providing social security to the labour displaced in structural adjustment.

3) The horizontal equity argument advanced for making inter-governmental transfers arrives at the same Conclusion. See, Buchanan (1952) and Boadway and Flatters (1983).

c. Constraints on States' Revenues

While the States' expenditure commitments will continue to expand, their budget constraints will increasingly become severe. In the Constitutional assignment, the Central government enjoys both overwhelming and overriding powers. Assignment of almost all broad-based taxes to the Centre (except the sales tax),vesting the Centre with residuary powers of taxation and the prevalence of Central authority over that of the States in the event of conflict of jurisdiction over any item in the concurrent list are some of the centralising factors. Further, although the States can levy a broad-based sales tax, the Centre has the power to levy Union excise duty vitrually on the same base and thus, can preempt the States' levy to some extent.

There are limitations on the States' borrowing powers as well. Article 293 of the Constitution does allow the States to borrow from the market. However, when a State is indebted to the Centre, it has to seek Centre's permission to exercise its borrowing powers. As all the State governments are indebted to the Centre, they have little leeway in determining their market borrowing. In actual practice, the Planning Commission in consultation with the Union Finance Ministry and the Reserve Bank of India (RBI), simply determines the total quantum of States' borrowing and allocates each State's share. Of course, the States could and did get round this problem to some extent by taking recourse to unauthorised overdrafts,[4] which were converted into medium terms loans from time to time by the Centre. This liberal recourse to overdrafts did contribute to laxity in fiscal management. However, the overdraft regulation scheme introduced in January, 1985 stipulated that the RBI can dishonour the cheques of those States having unauthorised overdrafts for more than seven continuos working days which was later enhanced to ten days. This effectively hardenedtheir budget constraint. Consequently, once the quantum of shared taxes, grants, Central loans and market borrowing is decided, the States' flexibility to increase expenditures is restricted to their capacity and willingness to raise tax and non-tax revenues. Given the political difficulties in raising revenues, if some special interest groups succeed in getting larger outlays on items of public expenditure beneficial to them, expenditures on socially more productive public good would have to be necessarily reduced.[5] Of course, there hvae been some attempts to soften the budget constraint by borrowing from financial institutions. To some extent, this has also been achieved by the State enterprises directly borrowing from the market. But,

4) The States can take ways and means advances from the Reserve Bank of India (RBI) to overcome their short term liquidity problems. These limits are fixed as some multiple of the minimum balances of the respective State governments with the RBI. In addition, they can take special 'ways and means' advances (provided against the collateral of Government securities) subject to stipulated limit. The State governments, however, have to clear the overdrafts within ten consecutive working days. To cease the short term liquidity problems faced by the States, both normal and special ways and means limits were revised in November. 1993 to 84 times and 32 times the minimum balances respectively (from the previous 56 and 20 times) and the time period for clearance was increased from seven days to ten days. The overdrafts over and above the normal ways and means advances are termed as 'unauthorised' overdrafts.

5) Public good, by definition is available in equal quantitites and benefits large groups of people. Encompassing coalitions necessarily involve large numbers which is more difficult to form (Olson, 1982) and, therefore, special interest group action cannot protect outlays on these services.

Table 1 Growth of States' Revenues and Expenditures

(per cent per year)

Item of Revenue/Expenditure	1974-75 to 1980-81	1980-81 to 1991-92	1974-75 to 1991-92
A. States' Revenue Receipts			
a. Own Tax Revenue	14.8	16.1	15.7
b. Non-Tax Revenue	11.8	12.7	12.4
c. Total	14.2	15.5	15.1
d. Central Transfers to States	20.0	15.4	16.9
e. Total Revenue Receipts	16.8	15.6	15.9
B. State's Expenditures			
a. Current (revenue) Expenditure	16.6	17.6	17.3
b. Capital Expenditure	19.9	9.6	12.6
c. Total Expenditure	17.4	15.8	16.3

Note: * Growth rates have been calculated by rmploying the Kinked Exponential Model. Figures for 1991-92 are Revised Estimates.
Source: Indian Economic Statistics/Public Finance Statistics, Ministry of Finance, Government of India.

the extent of such budgetary accommodation is, as yet. not very significant.

The prospects of the States securing more resources through larger Central transfers do not seem to be bright in the medium term either. In fact, with the Centre's attempts at compressing fiscal deficit not succeeding to the desired extent, the temptation could be to exercise the softer option of cutting transfers to the States. As it is, gross transfers to States as a ratio of GDP are budgeted to decline from 7.6 per cent in 1993-94 (revised estimate) to 6.6 per cent in 1994-95 (budget estimates). Thus, on the one hand, the States have to fulfil their large commitments and on the other, are faced with hard budget constraints. Unless they undertake prudent fiscal management and adopt innovative approaches to contain unproductive expenditures and raise revenues in a non-distortionary manner, structural adjustment programme can not be brought to a successful fruition.

III. Trends in State Finances

a. Revenues, Expenditures and Deficits

One of the most distressing features of the State finances is the emergence of sizeable and growing levels of budgetary dissavings in recent years. The continuous outpacing of growth of current (revenue) expenditures by that of current revenues, (Table 1), in both the seventies and the eighties, has led to serious deterioration in the States' current budgetary position from a surplus of 1.2 per cent of GDP in the mid-seventies to a deficit of about 1 per cent of GDP in 1991-92 (Table 2). In absolute terms, the net budgetary dissavings on the States' account was over Rs. 50billion in 1992-93 and by 1994-95, it is budgeted to be Rs. 83.6 billion.

The budgetary dissavings of a significant magnitude which first appeared in 1987-88 has shown rapid increases year after mainly due to very high growth of current expenditures, The increases in expenditures have been particularly alarming in the 1980's when it grew at an average rate of 17.6 per cent per annum. The high and increasing volume of current budgetary deficits necessitated larger volume of borrowing. Consequently, interest liability grew at 22.7 per cent per year and thus, expenditure growth became self-propelling.

It is important to note that the problem of growing fiscal imbalance has emerged in spite of revenues increasing at fairly high rates. The States' own total revenues registered and average annual growth rate of 15.5 per cent in the eighties, and the tax revenues actually registered higher growth rate at 16 per cent per year. However, the non tax revenues increased only at the rate of 12 per cent per annum and if cess and royalty on mines and minerals is excluded, the gorwth rate was just about 8 per cent. The reluctance to levy proper user charges on social and economic services provided by the Governments, and the poor and declining returns from departmental and non-departmental commercial enterprises are the principal reasons for the dismal growth and declining importance on non-tax revenues. It is also notable that, during the last decade, the Central current transfers to the States grew at almost the same rate as the States' own revenues (15.5 per cent) and was higher than that of Central revenues (14.5 per cent). The transfers within the revenue account, at present, form about 38 per cent of Central revenues and, given the Centre's own difficult fiscal position, as mentioned earlier, it would be too optimistic to expect any increase in the transfers as a ratio of Central revenues.

Table 2 States' Budgetary Deficits

Year	States' Revenue Deficits (Rs. Million)	States' Fiscal Deficit (Rs Million)		States' Revenue Deficit as Percentage of GDP	States' Fiscal Deficit as Percentage of GDP		Aggregate Fiscal Deficit (Rs Million)		Aggregate Fiscal Deficit as Percentage of GDP	
		Gross	Net		Gross	Net	Gross	Net	Gross	Net
1980-81	+14850	37130	17150	+1.1	2.7	1.3	104480	72590	7.7	5.3
1985-86	+6540	75120	47990	+0.2	2.9	1.8	236210	153070	9.0	5.8
1990-91	53090	187870	145320	1.0	3.5	2.7	534410	395010	10.0	7.4
1991-92	56510	189000	157460	0.9	3.1	2.6	458520	341500	7.4	5.5
1992-93	51140	208920	157700	0.7	3.0	2.2	521440	422030	7.4	6.0
1993-94 (RE)	60550	233120	182420	0.8	2.9	2.3	714560	576920	9.0	7.2
1994-95(BE)	83650	297380	231460	0.9	3.2	2.5	709650	589010	7.8	6.4

Note: R.E. Revised Estimates
B.E. Budget Estimates
+ Indicates surplus
* Estimated on the basis of implicit GDP estimates derived by
Fiscal deficit/GDP ratio of Centre at 6 per cent
Source: Annual Report - 1993-94, Reserve Bank of India.

The outpacing of the growth of current expenditures by that of the revenue receipts has created and explosive cycle of expenditure growth. The use of borrowed funds for meeting government consumption expenditure and transfers significantly enhances interest liability, but does not generate corresponding sources of revenue. In addition, as even the capital expenditure on various projects are not efficiently utilised, the revenues to finance debt servicing are not generated and consequently, interest liabilities feed back into the growth of expenditures requiring even larger diversion of borrowed funds. Thus, the States' gross interest payments during the decade of the 1980's grew at the rate of 22.7 per cent, while the growth of net interest payment (after adjusting for interest receipts) was as high as 31.2 per cent. Clearly, such a high growth of expenditure on interest is unsustainable.

Another important cause of increasing indebtedness at the State level has been the emphasis on having large developmental plans even when commensurate resources were not available. As the borrowed resources were not effectively used to generate either direct revenue yielding assets or infrastructural facilities, the debt repayment obligation had to be necessarily met by resorting to more borrowing. Thus, outstanding liabilites of the State governments which was only Rs. 216 billion at the end of March, 1980, increased by almost seven times in 14 years to reach Rs. 2548 billion in March, 1994. As a proportion of GDP, the States' indebtedness increased from 17.6 per cent in 1980-81 to 19.3 per cent in 1994-95. This has created a very serious problem of debt servicing in every State. The Finance Commissions prior to the ninth, reduced the problem to some extent by rescheduling and writing off of the Central loans, which merely meant transferring the burden or repayment from the States' taxpayer to the national taxpayer. Given the underlying trends, this practice by the Finance Commissions only provided temporary relief as, at the end of every five years, the new Finance Commission had to deal with the same problem, but with greater intensity. in 1993-94 alone the States' estimated loan repayments worked out to Rs. 50.9 billion while the loan recoveries amounted to a mere Rs. 22.8 billion.

The difficult resource position in the States has had adverse effect on States' capital outlays as well. The resource constraint which became binding after the introduction of the overdraft regulation scheme in the mid-eighties resulted in a significant show down in the growth rate of capital expenditures from 20 per cent per year in the seventies to just about 9.6 per cent in the eighties. Consequently. capital expenditure as a proportion of GDP declined from 3.9 per cent in 1980-81 to 1.2 per cent in 1992-93.

Thus, the states face an explosive cycle of current expenditure growth and are virtually in the throes of a debt trap. At the same time. the revenues of the States, particularly the tax revenues, have grown fairly rapidly and attempts to increase the buoyancy of the tax system by raising the tax rates may not yield the desired results without seriously affecting the incentives. The remedial action, therefore, should concentrate on decelerating the growth of expenditures and phasing out the hidden subsidies by levying proper user charges.

Assuming that the observed trend in revenues will continue into the future,

Table 3 Growth of Government Expenditures (in 1981-82 Prices): All Selected States (By Functional Categories)

(per cent per year)

	Current Expenditure			Capital Expenditure			Total Expenditure		
	1974-75 to 1981-82	1981-82 to 1990-91	1974-75 to 1990-91	1974-75 to 1981-82	1981-82 to 1990-91	1974-75 to 1990-91	1974-75 to 1981-82	1981-82 to 1990-91	1974-75 to 1990-91
Administrative services	3.5	8.0	6.1	11.3	2.8	6.2	3.7	7.9	6.2
Interest Payments	3.6	11.7	8.3	–	–	–	3.6	11.7	8.3
Social Services	6.0	6.4	6.3	9.0	– 2.7	5.6	6.2	6.3	6.2
Economic Services	8.0	5.3	6.4	6.2	– 0.3	2.3	7.3	3.6	5.1
Net Loans and Advances	–	–	–	8.9	– 3.1	1.7	8.9	– 3.1	1.7
Total Expenditures	6.0	6.8	6.5	7.6	– 1.2	2.3	6.3	5.2	5.6

Source: Rao and Send (1993)

phasing out of revenue deficits by the year 2000, can be achieved only if expenditure growth is decelerated to 14 per cent per annum or by almost 2.6 percentage points. Considering that interest payments have been growing at the average annual rate of 22.7 per cent, the growth of remaining items of expenditure would have to be brought down substantially to 12.5 per cent. Alternatively, the revenue receipts of the States will have to go up to 17.5 per cent per years. Fiscal correction at the State level, therefore, will have to examine the usefulness of every item of expenditure and revenue afresh and take corrective measures to eliminate unproductive expenditure items and enhance revenue productivity. This calls for the analysis of the growth revenues and expenditures.

b. State Government Expenditures: Growth and Composition[6]

The economic implications of expenditure growth are brought out clearly when the expenditure trends are analysed in terms of economic and functional categories. Such an analysis helps not only to identify the items of expenditure registering very high growth rates in recent years but also infer their economic consequences. The growth of per capita expenditures on various economic and functional categories presented in Table 3 and 4 bring out some salient features. First, the increase in expenditures has been very high and has shown an accelerating trend. The growth rate of per capita current expenditure (at constant prices) accelerated to 7.3 per cent per year in the eighties as compared to 6.4 per cent in the seventies even as the growth of per capita total expenditure decelerated from 6.7 per cent to 5.3 per cent during the period. Per capita capital expenditures grew at the rate of just 1.5 per cent per year in the eighties. Second, among the various items of current expenditure in the eighties, interest payments, transfers and subsidies grew at the fastest rate (8.3 per cent) followed by compensation to employees (7.4 per cent). In contrast, current maintenance (2.7 per cent) and capital expenditures (1.5 per cent) grew at very low

6) The analysis of expenditures is drawn largely from Rao and Sen (1993)

rates. It is further seen that the low growth rate recorded in capital expenditures was mainly due to the decline in the growth of capital expenditures on economic services (-0.3 per cent), social services (-2.7 per cent) and more importantly, net loans and advances to public enterprises (-3.1 per cent) including electricity boards and road transport corporations. Thus, there has been a sabstantial decline in expenditures incurred to create social and economic infrastructures in per capita terms.

The deceleration in the maintenance expenditure is clearly evident when we regress wages and salaries expenditures with those on goods and services in a linear form equation. As may be seen in table 5, on an average, the maintenance expenditure per unit of wages and salaries declined steadily from 0.44 in 1971-72 to 0.22 in 1989-90, and in respect of economic services, the decline was from 0.66 to 0.31.[7] Thus, the expenditures allocated to the creation as well as maintenance of economic infrastructure in the States has shown a steady decline over the years.

As already mentioned, expenditure on interest payment registered the fastest growth during the last decade. This was caused by phenomemal increase in States' indebtedness as well as increase in the effective rate of interest on States' borrowing. The States' indebtedness increased at 16 per cent per year on an average since the eighties and the average rate of interest on their borrowing increased from 6.1 per cent in 1981-82 to 11.7 per cent in 1992-93. Fast growth of transfers is another cause of high expenditure growth. This was caused mainly by the growth of subsidies on irrigation and spending on rural development (poverty alleviation) schemes. The expenditure on wages and salaries has shown the fast growth mainly because net employment increased at about 3.6 per cent per year (Rao, 1992) and increase in the emoluments per employee in constant prices, on an average, was about 3.8 percent per year.

The expenditures on social services continued to increase at a high rate even as the budget constraints of the States hardened, particularly after the mid-eighties when the overdraft regulation scheme was introduced. But a large part of the growth in expenditures must be attributed to fast increases in the unit cost of providing the services rather than the quantity or quality of the services provided. Given that social services are employment intensive, much of the increase has been due to increase in the wage rates. The analysis of per capita education expenditures, for example, shows that the growth of per capita expenditure (constant prices) increased at 6.6 per cent per year during the latter half of the eighties and of this, 3.5 percentage points were attributable to the real increase in the per employee salary alone.

However, in spite of recording very high growth rates during the last decade, the level of expenditures on social services continued to be low. Expenditures on education in 1990-91 for example, was less than 3.5 per cent of GDP and this compares poorly with the average levels prevailing in the developing countries (4.1 per cent)[8]. What is more, since 1991-92, the effect of deceleration in Central transfers to States and attempted expenditure compression by States themselves has

7) For details, see, Rao and Sen (1993).
8) The estimate relates to 1987, see, Statistical Year Book, 1989, UNESCO.

Table 4 Growth Per Capita State Government Expenditures by Economic Categories (Constant Prices)

(per cent per year)

Expenditures Items: Economic Categories	1974-75 to 1981-82	1981-82 to 1989-90	1974-75 to 1989-90
1. Consumption Expenditure			
a. Compensation to Employees	5.86	7.37	6.32
b. Net Government Maintenance	8.39	2.72	5.25
Total	5.88	6.22	6.86
2. Transfers			
a. Subsidies	34.70	6.02	18.16
b. Transfer to Local Bodies	1.71	7.43	4.80
c. Other Transfers	6.70	8.48	7.67
Total	7.69	8.35	8.85
3. Total Current (1+2)	6.38	7.15	6.89
4. Gross Fixed Capital Formation	9.25	4.55	6.65
5. Financial Outlay	3.01	4.84	4.01
6. Total Capital Transfers and Advances			
a. Local Bodies	9.68	1.95	5.38
b. Others	8.78	-2.06	2.71
c. Total	8.76	-1.20	3.19
7. Total Capital Expenditure (4+5+6)	8.35	1.49	4.54

Source: Rao and Sen (1993)

Table 5 Maintenance Expenditure Per Rupee of Wages and Salaries in Major States

Types of Services/year	Administrative Service	Social Service	Economic Service	All Services
1971-72	0.242	0.217	0.664	0.439
1976-77	0.307	0.051*	0.375	0.315
1980-81	0.250	0.045*	0.393	0.260
1985-86	0.228	0.041*	0.359	0.238
1989-90	0.238	0.102	0.313	0.218

Note: 1. The estimates have been made by regressing net governement maintenance expenditure on wages and salaries across the States in a linear equation.

2. Coefficients marked* are not significant at 5 per cent

Source: Rao and Sen (1993).

been to reduce the share of expenditure on social services (Gupta and Sarkar, 1994). Even within this low level of outlay, the share of primary education was just about 40 per cent. Similarly, as a ratio of GDP, expenditure on medical and public health was less than 1.5 per cent, housing and urban development was just about 0.3 per cent and the amount spent on social security and welfare was 0.8 per cent. The Constitution assigns a predominat role to the States in the provision of these services and satisfactory provision of these services calls for substantial increase in the outlay on them.

The problem is not merely one of low levels of expenditure on social and economic infrastructures but also their uneven spread. Our analysis shows that generally, per capita expenditures are higher in the States with higher per capita incomes and this cannot be attributed to their better tax efforts. The higher expenditure levels in richer States is mainly due to their greater ability to raise revenues. Thus, the Central transfers have failed to offset the fiscal disabilities of poorer States. The inter-State variations in per capita expenditure levels were particularly significant in social and economic servies. Further, our detailed disaggregated analysis shows that expenditure levels on different services were generally higher in States where the respective physical levels of services were higher.

The uneven distribution of expenditures clearly indicates the unequal access to social and economic infrastructure. This, in turn, results in uneven flow of private investments and accentuates inequalities in the standards of living in different regions. To the extent provision of infrastructure facilities enhances marginal productivity of poorer regions more than that of richer regions and helps in better utilisation of their resources, maximisation of the national product is achieved through a more balanced spread of infrastructural facilities. In such cases both equity and efficiency objectives are compatible. But even in cases where there is a trade off between the twin objectives, more balanced spread of infrastructure may be necessary due to imperfect polulation mobility between regions. Besides, ignoring the poorer people in less developed regions may not be politically acceptable.

c. Additional Revenues: Problems and Prospects

i. Tax Revenue

As mentioned earlier, tax revenues in the States have registered a fairly rapid growth in the last decade. Further increases in revenue productivity can come about through improvement in administration and enforcement of State taxes and not by increasing the tax rates. At the same time, the structure of States' taxes has been a source of inefficiency. It has altered relative prices in unintended ways and has posed impediments to the free movement of factors and products. Therefore, simplification and rationalisation of the States' tax systems must receive immediate attention to make them both growth oriented and growth responsive.

Over the years, the States' tax system has become highly complicated and distorting. First, increasing resort to taxation of inputs and capital goods has introduced a very high degree of cascading element into the tax systems. In addition, the tax is increasingly being levied at the first point of sale for administrative convenience and this has led to more cascading. The problem is accentuated by the taxation of inter-State sale on the one hand and the tax on the entry of goods into a local area for consumption, use or sale (Octroi) on the other. Thus, we have cascading taxes which alter relative prices of commodities in unitened ways, taxes on exports from one State to another and on imports into urban local body jurisdictions. Together, besides distorting relative prices, these features divide the country into several tariff zones, impede the free movement of goods throughout the federation and cause inequitable inter-regional resource flows.

In addition, the States' attempts to attract trade and industry on the one hand, and to export the tax burden to non-residents on the other, have led to significant inter-State differences in effective tax rates and alterations in relative prices.[9] It is difficult to estimate the extent of trade diversion and resource misallocation caused by inter-State tax competition in the form of indulgence in rate war and by according generours sales tax incentives for industrialisation; but surely, this must be considerable. Besides, such a competition works only to the disadvantage of the poorer States. Although it is neither desirable nor feasible to have idential tax structures in a fiscal federalism, taking measures to minimise inequity and distortions arising from the States' free-riding behaviour is certainly called for.

Extreme complications in the States' tax structures is another serious issue. If equity considerations dictated some rate differentiation, the 'rate war' among the States have multiplied them further. The constant struggle between the taxpayer to evade and avoid the tax and the tax-collector to enforce the tax by plugging loophooles through various amendments to the Acts has only added to the complications. In addition, administrative considerations have led most of the States to progressively switch over to taxing at the first point of sale in respect of many commodities. Some States, however, continue to have the last point tax, double point tax and even multi-point tax on some commodities. Consequently, the sales taxes levided in the States present a wide array of systems with varied mixtures of single point at the first (manufacturing) or the last stages, double-point and multi-point levies. The rate differentiation varies from six in Orissa to as many as 21 in Bihar and Gujarat. In addition, there are additional sales taxes or turnover taxes or surchagres on sales taxes. The complications resulting from this medley and mixture defeat the very purpose for which they are introduced in the first place and increase both administrative and compliance costs. It is possible to achieve the objectives of equity, efficiency and revenue, by substantially reducing the complications in the sales tax structures. There is a strong case for evolving a model sales tax law which can be followed by all the States with adequate flexibility to modify them to suit their own particular situations. Simplification of sales tax structure, standardisation of its administration and enforcement will be a step forward in tax harmonisation among different States. There can be a broad agreement relating to the taxation of inputs, incentives for industrialisation, maximum rates of tax to be levied on items of mass

9) The variations in effective tax rates can arise from differences in nominal tax rates, schemes of sales tax incentives for industrialization and standars of administration and enforcement of the tax.

consumption and minimum rates in respect of others. The mode tax law thus evolved should keep in view the fact that redistribution is mainly the function of Central government and therefore, should make minimum rate differentiation.[10]

Another serious problem arising from the prevailing sales tax systems is the inter-State tax exportation. The taxation of inter-State sale at the rate of 4 per cent has virtually segregated the States' economies into different tariff zones and substantially reduced the gains accruing from an integrated common market. The taxation of inputs and capital goods under the States' Sales tax Acts has accentuated this phenomenon. Even where the tax system allows a set-off on the tax paid on inputs, in some States the relief is limited to the goods sold within the State and inter-State sales carry the burdent of input taxes also. Besides being a source of inefficiency, the taxation of residents in the consuming States by the producing States has resulted in perverse resource flows. Trade and industry has tried to avoid the inter-State sales tax through consignment transfers, and there has been considerable pressure on the Centre by the States to levy the tax on consignment transfers as well. So far, the Centre has avoided such a short-sighted policy. The solution lies in getting rid of the taxation of inter-State sale and not in strengthening the regional segregation and accentuation of inter-regional inequity. Surely, tax evasion cannot be condoned, but it is necessary that the tax itself should not be undesirable or unreasonable. A time has come to evaluate the merit of having an inter-State sales tax itself, keeping in view the long term interests of the economy. Better economic integration of the country and rationl resource allocation is possible only when all barriers to inter-State trade are removed. Such a step will help in reaping greater gains from the customs union in the long-term.

The reform of the taxation of agricultural sector has to go beyond the simple question of direct taxation of land and agricultural incomes. The Constitution places the taxation of land, agricultural incomes and wealth in the State list. The distinction of incomes on the basis of their source and assigning agricultural incomes to the States and non-agricultural incomes to the Centre has narrowed the base of income tax by creating avenues of avoidance (through misclassification) and evasion. More importantly, the whole question of taxation and subsidisation of agricultural sector needs a fresh look as the prevailing system has severely distorted relative prices. On the one hand, there if hardly any open taxation of agricultural sector and in fact, the major agricultural inputs like fertiliser, pesticides, irrigation water and electricity are subsidised. On the other, the high degree of protection given to domestic industry and the policy of price fixation have set the terms of trade against the agricultural sector. Consequently, it has been shown that the agricultural sector is a net taxed rather than a subsidised sector (Gulati and Pursell, 1992). Consequently, there has been a deceleration in the private capital formation in the agricultural sector and along with declining public sector investment, this has adversely affected agricultural growth and reduction in rural poverty (Rao, C.H.H. 1992). The entire policy package relating to the agricultural sector needs to be reviewed to ensure parity in agricultural output prices, minimisation of subsidies on inputs (which cause resource

10) The efficacy of redistributive policy at the State level is limited by inter-State mobility of polulation.

Table 6 Subsidies in Major States

	1987-88 Subsidies (Rs million)	Per cent of total	Recovery rate (Per cent)
I. Social Services			
1. Education of which,	83,090	30.3	1.4
Higher education	19,940	7.3	1.7
2. Medical and public health	25,910	9.4	2.7
3. Water supply, sanitation, etc.	21,110	7.7	5.9
4. Other social services	15,280	5.6	5.6
Total Social Services	145,390	52.9	2.8
II. Economic Services			
1. Agriculture and Allied Activities	40,650	14.8	28.6
2. Irrigation	47,050	17.1	20.6
3. Power and Energy	16,330	6.0	26.5
4. Industry and Minerals	7,050	2.6	28.4
5. Transport and Communication	17,450	6.4	12.7
6. Other Economic Services	710	0.2	–
Total-Economic Services	129,240	47.2	24.6
Total Subsidy	274,630	100.0	14.4

Source: Rao, M.G.. and Sudipto Mundle, "An Analysis of Changes in Government Subsidy at the State Level: 1977-78 to 1987-88", in Bagchi, Bajaj and Byrd (1993).

misallocation within the agricultural sector) and targeted subsidisation of foodgrains consumed by the weaker sections. This, however, involves a coordinated action by both the Central and State governments. The reforms in the State tax system should encompass simplification and rationalisation of other State taxes as well. The high rates on stamps and registration has led to significant undervaluation of sale of immovable properties. Having reasonable tax rates and better tax enforcement could improve horizontal equity and reduce the growth of the underground economy. As regards taxation of alcoholic beverages, the practice of auctioning vends has worked reasonably well - but, in response to popular appeal or for emotional reasons, some of the States have adopted prohibition poicy. Such political decisions, taken in ad hoc manner can destabilise the State's budgets. Besides, laxity in enforcing the declared policy has often led to illicit distillation and consumption of poor quality country liquor causing a number of deaths.

Equally important is the need to restore the place of property taxes in urban finances. Reforms are necessary in valuation of properties to delink it from the standard rents prescribed under the rent control laws. There is a need to improve the tax administration to frequently assess properties. It is also necessary to improve collection efficiency. At present, the local bodies collect only 40 per cent of outstanding demand (Jha, 1992). At the same time "octroi" or its variants (entry tax or terminal tax) which is variously characterised as an obnoxious, vexatious and a distorting tax does not have a place in a modern fiscal system and, therefore, should be abolished. There should also be greater reliance on user charges. Taxation of some services with localised benefits like automobile workshops and nursing homes can also be assinged to them.[11]

ii. Non-tax Revenue

As mentioned earlier, the proportion of non-tax revenue in total revenue receipts of the States has been low and declining over the years. The only item of non-tax revenue which has registered high growth rate in the eighties is the cess and royalty on mines and minerals. The receipts by way of user charges and returns from investments in departmental and non-departmental State enterprises have been actually declining in real terms.

The studies conducted at the National Institute of Public Finance and Policy (NIPFP) have shown that implicit and explicit subsidies involved in the provision of social and economic services in the 14 major States in 1987-88 amounted to Rs. 275 billion or 8.3 per cent of GDP. What is more, over the period, 1977-78 to 1987-88, the volume of subsidy increased at the rate of 18 per cent per year in nominal terms and the cost recovery through user charges as a proportion of the cost of providing the services declined from 22 per cent to 14 per cent (Table 6). Almost 53 per cent of the subsidies accrued in the course of providing social services, and economic services claimed the remaining 47 per cent. Volumes of subsidies were significant in education, agriculture, irrigation and power. On higher education alone, the subsidy amounted to about Rs. 20 billion, and recovery rate was as low as 1.7 per cent. Even in the commercial sectors like irrigation and power, the recovery rates were less than 30 per cent. The NIPFP study also shows that in respect of every sector, the recovery rates declined significantly during the decade 1978-88.[12]

Cost recovery through proper user charges is an important area whereby more revenues can be raised in the short or medium term. Proper pricing of services like higher education, irrigation or electricity, would not only help in raising larger revenues but also would result in the more economic use of resources. The vulnerable sections and the intended groups can be helped through properly targeted subsidies and transfer payments.

An important source of implicit subsidy is the public enterprise losses. The financial performances of the most important State level public enterprises - State Electricity Boards (SEBs) and the Road Transport Corporations (SRTCs) - have continued to be a matter for serious concern. In the case of SEBs, the commercial loss in 1992-93 was estimated at over Rs. 62 billion or 12.6 per cent of the capital base. In as many as ten States, the net losses were more than 15 per cent of the capital base. What is important, the working of SEB's has shown a steady deterioration over time.

11) This would, however, require amendment of the Constitution as at present taxation of services is in the union list.
12) For details, see, Rao, M. Govinda and Sudipto Mundle (1993).

Overmployment, obsolete and ill-maintained equipment and the poor quality of coal and its irregular supply are the causes attributed to the low plant load factor in the generation of electricity in thermal plants. Widespread theft of power and poor maintenance of plants and equipments account for a high degree of transmission and distribution losses. The pressure from the farm lobby has resulted in abysmally low tariffs on the electricity consumed by the influential farmers who have access to electricity and unmetered supply to them has helped to conceal the theft of power even in other sectors by passing it of as agricultural consumption. Added to all these is the inordinate delays in the construction and commissioning of the projects during which the invested capital is simply locked in and does not yield any returns. Road Transport Corporations (SRTC) is the second most important public undertaking run by the States. Although section 22 of the Road Transport Corporation Act stipulates that the SRTCs should carry on their activities on business principles, the net losses in 1992-93 amounted to Rs. 3593 million forming about 9.4 per cent of the capital invested. The net loss was as high as 36 per cent of the capital invested in North Bengal state transport corporation, 57 per cent in Punjab Roadways, 19 per cent in Kerala road transport corporation and about 18 per cent in Tamil Nadu road transport corporation. Only in the states of Haryana (6 per cent), Rajasthan (3.8 per cent), Maharashtra (1.3 per cent), Gujarat (0.9 per cent) and Madhya Pradesh (0.5 per cent) no net losses were reported. In most of the States, the receipts did not even cover the operating expenses, leave alone paying interest on borrowed funds. High staff-bus ratio, poor fleet maintenance and utilisation, low occupancy ratio and revenue earning kilometcrage, widespread pilferage in spare parts and even diesel, cause low operational efficiency. In addition, the SRTCs are required to offer large and multiple concessions for social purposes (in particular student concessions), some of which are clearly underserved.

In 1989-90, there were about 829 State level enterprises of which, 274 were promotional in nature. The remaining 549 financial and commercial enterprises with the investment of Rs. 38 billion, yielded dividend amounting to merely Rs. 480 million, as against the normative retutrn of Rs. 1.75 billion reckoned by the Ninth Finance Commission. The number of State level enterprises by March 31. 1992. has gone up to 875, but their financial performance has continued to remain as dismal as before.[13]

Uneconomic pricing of many of the commercial activities of the State governments has not only resulted in the implicit subsidies accruing to better off sections of society, but also has constrained the resources of the government for making adequate investments in critical sectors like education, health and more importantly, power. The response of the government to meet the excess demand situation in power has been to invite foreign investors by giving them sovereign guarantee and assuring them a guaranteed rate of return on their investments. In the absence of a rational tariff structure, such an arrangement could necessitate sizeable budgetary support. Assuming sovereign guarantee does not promote competition either and would keep the unit cost of producing electricity at very high levels.

13) For details see, Shankar, T.L., R.K. Mishra and R. Nandagopal, (1994).

Overall improvement in the non-tax revenues cannot be brought about unless the state level enterprises are professionally managed vesting them with sufficient autonomy and essuring accountability. It is also important that user charges at proper rates should be levied on social and economic services. The pricing of the services at less than its average cost (and implicit subsidies arising from it) has to be justified in terms of eigher the service in question being in the nature of 'merit good' or as purely a redistributional strategy.[14] While these issues and specific solutions to resolve them have been widely discussed in both official and academic literature, improvement in budgetary positions of the States can come about only when the necessary political decisions are taken and implemented.

IV. Firscal Reforms at Sub-Central Levels: Concluding Remarks.

The foregoing discussion brings out that restructuring allocational role of the government in the developmental process to give greater role to market incentives necessitates a qualitative change in the relative roles of Central and State governments. The concentration of power and centralised decision making implicit in the planned developmental strategy should give way to fiscal decentralisation to provide public services to meet diversified preferences and to optimally harness the resources prevailing in different regions. At the same time, it is necessary to ensure that the pursuit of self-interest by individual sub-central governmental units does not create impediments to the healthy growth of nation-wide market economy.

Catering to the diversified consumption and production needs of regional economies necessitates the provision of a number of quasi-public goods, which is best done at sub-Central levels. It is seen that at present, outlays on many of these services are well below the required amounts and therefore, substantial increases in the outlay need to be secured. This is particularly true of items like elementary and secondary education, medical and public health, family welfare, water supply and sanitation, urban development, agricultural extension, irrigation and rural roads, In all these activities, the Constitution assigns a predominant role to the State Governments.

Besides, the States have the responsibility of providing administration and legal framework and protecting property rights in a market enonomy. Thus, in a liberalised economy, even as the governmental role in allocating resources declines, the role of State governments in providing quasi-public goods may actually show an increase. At the same time, given the constraints on the Central finances, a large part of the resources for increased State spending will have to be found by the States themselves. Therefore, enhanced outly on more productive sectors will critically depend upon States' own ability to compress unproductive expenditures, charge rational user charges on the services of commercial nature rendered by these

14) Even as a redistributional device, making direct transfers to targetted groups is preferable to general subsidisation arising from the pricing policy.

governments, restructure their public enterprises and strengthen administration and enforcement of taxes to enhance revenue productivity of the States'tax systems.

The specific policy measures required to impart strength and stability to sub-Central fiscal positions have been discussed elsewhere in detail and therefore, may be stared only briefly (Rao, 1992). Putting a freeze on new appointments and redeployment of personnel from the surplus to the deficit departments, if necessary, after retraining and pruning the perquisites like leave travel concession, leave encashment facilities and bonus to government employees can help to contain expenditures on wages and salaries. Better targeting of the subsidies and transfers can make them cost effective. Proceeds from the disinvestments in public sector enterprises can be used to retire the debt burden of the States and this can decelerate the growth of interest payments. Given the States' heavy debt service payments to the Centre, the latter can actually work out a scheme to lessen the burden of the former by linking debt rescheduling / writing off to the States' fiscal management parameters at the margin. Privatization of public enterprises even when they are making profits so long as they are not in the core sector can help the States to concentrate on their core functions. The levy of user charges at rational rates, particularly on the services like irrigation, water supply, electricity, road transportation and higher and technical education can go a long way in reducing implicit subsidies and can augment the States' resources considerably. The rationalisation and simplification of the sales tax structure and its coordination with other commodity tax systems, at both vertical and horizontal levels, inclusion of taxation of services in the tax base, abolition of tax on inter-State sale and strengthening the information system and enforcement can make it both growth responsive as well as growth oriented. Similarly, abolition of Octroi and rationalisation of the property tax should be a priority area of reform at sub-State levels. Simplification of other State taxes, building up their information system and better enforcement can also improve the revenue productivity.

The problem with the provision of social and economic infrastructure, at present, is not merely one of general inadequacy. Even the spread of expenditures on these services is extremely uneven and the inequalities have widened over the years. To achieve their even spread, however, it is necessary to make changes in regional policies and inter-governmental transfer systems as well. The regional spread of Central government investments, in spite of the pronouncements on balanced regional development, has been uneven. In March, 1990, the four richest States with a population of 18.8 per cent accounted for over 24 per cent of the gross block of Central public enterprises and the share of the five poorest States with 43 per cent of population was just about 34 per cent (Rao and Sen, 1993). Similarly, the inter-governmental transfer systems have not been designed to offset the revenue and cost disabilities of poorer States. The tax devolution which predominates in Finance Commission transfers is made mainly based on general economic indicators like population, per capita income and index of backwardness. In their formulae, population gets very high implicit and explicit weight and therefore, are not specifically targeted to offset fiscal disabilities. Further, distributing 85 per cent of net proceeds from individual income tax and 45 per cent of union excise duties to the

States can have adverse effect on Centre's incentives to raise revenues from these sources. The practice of filling in the projected budgetary gaps, sometimes with some sprinkling of norms, has reduced the Finance Commissions to the role of fiscal 'dentists' filling in budgetary 'cavities'. Also, population receives very high weight (60 per cent) in the Gadgil formula used to distribure plan transfers and therefore, this source too is not targeted to offset fiscal disabilities of poorer States. As far as specific purpose transfers are concerned, there are over 250 Centrally sponsored schemes, and they show a distinct regressive bias.

Reforming the inter-governmental transfer system to effectively achieve an even spread of social and economic infrastructure is of paramount importance if the resources in the economy should be allocated according to comparative advantage and political tensions between the regions should be minimised. With the delicencing of industries and relaxing of controls on their location, private investments will be made purely according to cost advantages, and if *inter alia*, there are significant inequalities in the levels of infrastructure across regions, industries will not be located according to their comparative advantage. The uneven spread of infrastructure, therefore, can result in accentuating inter-State inequalities in the levels of development in a liberalised environment, unless appropriate corrective measures are taken immediately. This necessarily implies that the transfer system should be more targeted with larger flow of resources to poorer States to augment their infrastructures, but at the same time, it should ensure accountability and incentives.

However, in a situation where the funds available with the Central government to transfer to the States is limited, effectiveness in achieving a balanced spread in the levels of social and economic infrastructure can be improved when the transfers are (i) better targeted to the States with fiscal disabilities, and (ii) conditioned on augmenting outlays on specified servies. Better targeting of transfers call for reduced role of tax devolution and increasing that of grants in aid (Chelliah, Rao and Sen, 1993). At the same time. it may be necessary to enhance the specific purpose transfers designed to ensure that they actually result in augmenting outlay on the desired services. Given the short-term perspective of politicians dictated by electoral politics, the general purpose transfers being completely fungible tend to the used to finance politically appealing, but socially less productive activities. Perhaps, introducing conditionalities may help the political leadership at the State level to overcome short-term political expediency. Of course, this gain in efficiency will be at the cost of fiscal autonomy of the States. Therefore, the conditionalities should not be so detailed as to curb States' own initiatives. At present, the financial resources are thinly spread over 250 Centrally sponsored schemes with detailed conditionalities specified. Perhaps, there is a need to consolidate these small schemes into a handful of large programmes with conditionalities broadly specified to ensure sufficient flexibility to the States in the provision of public services. Of course, providing a centrain level of outlay does not necessarily ensure specified service levels and the individual States should ensure cost-efficient use of the funds.

Even if intergovernmental transfers are redesigned to completely offset the fiscal disadvantages of poorer States, the uneven distribution in the "stock" of infrastructure can cause uneven spread of private investments. Therefore, at least in the short-term, the liberalised industrial policy is likely to widen interregional income inequalities. This trend will be further accentuared by the counter-guarantee as proposed in the power sector. The Central government will give a guarantee for a private sector power projects in a State only when the State Electricity Board (SEB) generates a minimum of 3 per cent return on the fixed assets. The Central government would also have the right to adjust the overdues outstanding from the SEB and payable to National Thermal Power Corporation (NTPC), National Hydro Power Corporation (NHPC) and power grid against the Central plan assistance, the States' share in Central taxes and other Central grants and loans. The conditionalities are likely to result in much of the private investments in the power sector going to the advanced States. Of course, the cost of supplying power to the economy too is likely to increase considerably due to the high guaranteed return and the absence of a well formulated norm on the admissible cost of generating itself.

Finally, decentralisation in fiscal and regulatory functions which the liberalisation will entail may itself interfere with efficiency in resource allocation. In particular, the pursuit of self-interest by individual States could result in 'free-riding' by the States causing significant inter-State tax and expenditure spillovers. The pursuit of self-interest through regulatory and fiscal instruments by individual States may create imperdiments to the free movement of factors and products. The Indian products can be competitive in international market only when such impediments are removed and inter-State coordination in fiscal and regulatory policies assumes immense significance in a liberalised economy in this context. Monitoring inter-governmental competition is also extremely important.

References

1. Bhagwati, J., and T. N. Srinivasan, (1993). *India's Economic Reforms*, Ministry of Finance, Government of India.
2. Boadway, R., and F. Flatters, (1982). *Equalization in a Federal State*, Economic Council of Canada.
3. Bretorn, A., (1987). "Towards a Theory of Competitive Federalism", *European Journal of Political Economy*, Special Issue, VoI. 3, No. 1+2.pp.263-327.
4. Buchanan, J., (1952) "Federalism and Fiscal Equity", *American Economic review*. VoI. 40. pp.583-599.
5. Cheliah, R.J. (1991). Towards a Decentralised Polity, L.K. Jha Memorial Lecture, Fiscal Research Foundation, New Delhi.
6. Chelliah, R.J., M. Govinda Rao and Tapas K. Sen (1992), "Issues Before the Tenth Finance Commission", *Economic and Political Weekly*, Voi. XXVII, November 21.
7. Guhan, S., (1993). "The Federal Dimension of India's New Economic Policies", Paper presented at the seminar on Federalism in Diverse Societies, Centre for Advanced Studies on India, University of Pennsylvania, Philadelphia, (October).
8. Gulati, Ashok and Garry Pursell (1992). "Trade Policy, Incentives and Resource Allocation in Indian Agriculture" (mimeo), The World Bank.
9. Gupta, S.P. and A.K. Sarkar (1994), "Fiscal Correction and Human Resource Development", *Economic and Political Weekly*, VoI. XXIX, NO. 13 (March 26).
10. India, (1993). *Economic Reforms: Two Years After and the Task Ahead, Ministry of Finance*, Government of India.
11. Jalan, Bimal, (Ed)., (1993). *The Indian Economy: Problems and Prospects*. Viking Publishers.
12. Jha, Gangadhar (1991), Property Tax in India: Existing Practices and Issues for Reform (Mimeo). Paper prepared for the World Bank study on Financing Municipal Services in India.
13. King, David, (1984). *Fiscal Tiers*. George Allen and Unwin Ltd. London.
14. Mueller, Dennis, C. (1989), *Public Choice II*. Cambridge, Cambridge University Press.
15. NIPFP., (1994) *Reform of Domestic Trade Taxes in India: Issues and Options*. (Team Leader: A. Bagchi), National Institute of Public Fiance and Policy, New Delhi.
16. Oates, W. E., (1972). *Fiscal Federalism*. Harcourt, Brace and Jovanovich, New York.
17. Olson, M., (1965), The Logic of Collective Action, Massachusetts, Harvard University Press.
18. Olson, M., (1982). *This Rise and Decline of Nations: Economic Growth. Stagflation and Social Rigidities*, Yale University Press, New Haven.
19. Olson, M., (1992). "Why are differences in Per Capita Incomes so Large and persistent?" (processed).
20. Rao, (C.H.H., (1992), "Agriculture: Policy and Performance in Bimal Jalan (Ed), *The Indian Economy: Problems and Prospects*, Viking Publishers, New Delhi.
21. Rao, M.G., (1992). "Proposals for State Level Budgetary Reforms", *Economic and Political Weekely*, Vol.XXVII. No. 5, (February).
22. Rao, M.G., and S. Mundle, (1992) "An Analysis of Changes in State Government Subsidies: 1977-87", in Amaresh Bagchi, J.L. Bajaj and William A. Byrd (Ed), *State*

Finances in India, Vikas Publishing House Pvt. Ltd. New Delhi.

23. Rao, M. G., and Tapas K. Sen, (1993). Government Expenditure in India-Level, Growth and Composition. (Mimeo). National Institute of Public Fiance and Policy, New Delhi.
24. Sen, Tapas K. (1994), Economic Reforms, Industrial Growth and Economic Development at the State Level. (processed).
25. Shankar, T.L., R.K. Mishra and R. Nandagopal, (1994), "State Level Public Enterprises in India", *Economic and Political Weekly*, August 27.