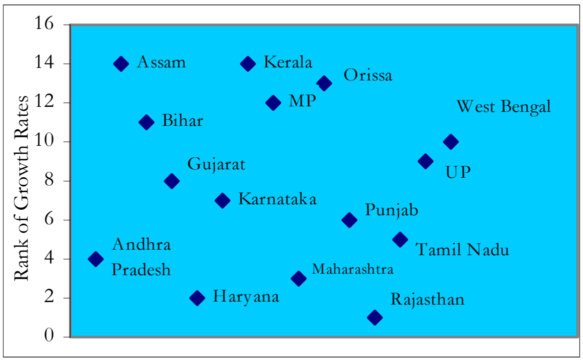
Fiscal Situation and Policies

Introduction

Maharashtra contributes 19 per cent of the country's industrial output, 15 per cent of the services output, and 13 per cent of the country's GDP. It is the state with third highest per capita income in the country. But, its performance is showing deterioration since the mid-1990s. The state's economy has slowed down in recent years after experiencing rapid and sustained growth till the mid 1990's. Trend GSDP growth rate of Maharashtra from a high of 7.3 per cent during the last 15 years has fallen to an average growth rate of 4.2 per cent during 1995-02. Though during fiscal years 2002-03 and 2003-04 the state had an average growth rate of 6.1 per cent, but the same is lower than the target growth rate of 8 per cent for Tenth Five-year Plan (2002-07).

The current growth slowdown does not appear to be a cyclical downturn, but a result of many structural constraints afflicting the state's economy. Ranks of different states for growth rates in GSDP during the two periods, 1980-81 to 1990-91 and 1993-94 to 2000-01, are given in Figures 2.1 and 2.2.

Figure 2.1: Rank of Growth Rate in GSDP of different states during 1980-81 to 1990-91

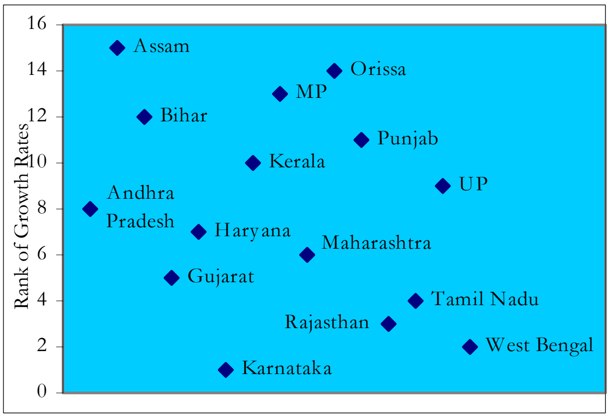


Source: Various GoI Documents

It can be seen from Figure 2.1 that Maharashtra ranked third in terms of growth rate in GSDP, behind Rajasthan and Haryana and followed by Andhra Pradesh, Tamil Nadu and Punjab. But the ranking for the period 1993-94 to 2000-01 shows that Maharashtra slipped to sixth place in terms of growth rate in GSDP and states – Karnataka, West Bengal, Rajasthan, Tamil Nadu, and Gujarat were ahead of it (Figure 2.2).

While the reasons for such a systematic decline in Maharashtra's growth rate are not well understood, it can be said with some degree of assurance that other states which forged ahead witnessed an acceleration in new growth sectors such as Information Technology and Pharmaceuticals (World Bank: 2002, p.3). Table 2.1 gives the average long-term growth rate of various sectors during 1985-86 to 2000-01 and growth during 2002-03 in Maharashtra.

Figure 2.2: Rank of Growth Rate in GSDP of different states during 1993-94 to 2000-01



Source: Various GoI Documents

Table 2.1: Average long-term growth rate of various sectors during 1985-86 to 2000-01 and in 2002-03 in Maharashtra (at 1993-94 Prices)

Sub-Sector of the State Economy	Growth Rate (%)	
	1985-2001	2002-03
Banking and Insurance	12.8	6.4
Unregistered Manufacturing	9.0	5.8
Transport, Storage & Communication	8.7	8.3
Utilities	7.6	6.9
Trade and Hospitality	7.6	10.7
Registered Manufacturing	6.9	5.0
Public Administration	6.1	7.4
Agriculture	5.3	-2.4
Mining & Quarrying	5.2	4.1
Construction	4.1	11.5
Real Estate Services	3.7	4.5
GSDP	**7.1**	**6.1**

Source: World Bank, 2002 and Economic Survey, 2003-04

Slow down in the economy and stagnant own-revenue effort has constrained the Government to undertake necessary productive expenditure in social and economic services, especially in infrastructure. This had adverse consequences on the long-term growth prospects of Maharashtra's economy. Deteriorating revenue mobilisation and rising unproductive expenditure resulted in growing fiscal and revenue deficits with corresponding increase in debt and interest payment obligations. The gross fiscal deficit of major states as percentage of GSDP during the two five-year periods, 1990-95 and 1995-2000, and during three-year period of 2000-03 and their relative rankings are given in Table 2.2. Maharashtra ranks at third, sixth and fourth, respectively during these periods. Though during 2000-03 Maharashtra improved its relative ranking, its gross fiscal deficit was still nowhere near 1990-95 level.

Table 2.2: Gross Fiscal Deficit of States as a percentage of GSDP and their relative ranking

State	**Gross Fiscal Deficit as Per centage of GSDP**		
	1990-95	**1995-2000**	**2000-03**
Andhra Pradesh	3.2 (5)	5.5 (5)	4.6 (7)
Bihar	7 (12)	4.1 (1)	4.5 (6)
Gujarat	7.4 (13)	6.3 (8)	5.7 (10)
Haryana	2.6 (1)	5.9 (7)	3.7 (1)
Karnataka	2.7 (2)	4.1 (1)	4.4 (5)
Kerala	6.6 (11)	5.3 (4)	5.2 (9)
MP	3.8 (6)	5.2 (3)	3.9 (2)
Maharashtra	**2.8 (3)**	**5.8 (6)**	**4.1 (4)**
Orissa	6.4 (10)	9.8 (13)	7.8 (14)
Punjab	7.4 (13)	7.9 (11)	6.2 (12)
Rajasthan	3 (4)	8.9 (12)	6.1 (11)
Tamil Nadu	4.1 (7)	4.5 (2)	3.8 (3)
UP	6.2 (9)	7.8 (10)	5.1 (8)
West Bengal	5.2 (8)	6.7 (9)	7.3 (13)
Average	**4.9**	**6.3**	**4.97**

Note: Figures in the brackets are ranks.
Source: Various GoI Documents.

Theory as well as evidence shows that persistently high fiscal deficits could pose threats to the stability and growth of the economy. Experience also suggests that easy fiscal policies may in the short-run have stimulating effects on the economy, but in the long run, they lead to lower growth. Negative correlation is even stronger between deficit and growth, if the deficit is used for expenditure on current consumption purpose. The case of Maharashtra is one such example. Maharashtra borrowed primarily to finance its current consumption – to pay for salaries and pensions, losses in its PSUs and electricity boards. The low and declining buoyancies in both tax and non-tax receipts and decelerating resource transfers from the centre worsened the situation. The government has taken some steps to correct the imbalance, but whether it is enough remains to be seen.

Section – I

Revenue Receipts

Powers of the states to raise resources are enumerated in the Seventh Schedule of the Constitution of India. Revenues of the states can broadly be divided into two heads - tax revenue and non-tax revenue. Major sources of tax revenue at state level are sales tax, state excise on alcohol, stamp duties and registration fees, motor vehicles tax and taxes on goods and passengers. Non-tax revenue includes mineral and forest royalties, fines and fees or user charges for publicly provided goods and services. The states also get transfer and grants from the Center. Besides the above, the states also have access to capital receipts. These include internal loans of the state government and loans and advances from the Central government, recovery of loans and advances by the state government, receipts from public accounts such as small savings, provident funds, etc. Composition of revenue for Maharashtra from 1996-97 to 2003-04 is given in Table 2.3.

Table 2.3: Maharashtra's Revenue Composition

(In per cent)

Item	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Own Tax	60.8	67.5	65.3	68.3	66.7	70.7	69.7	70.2
Own Non-Tax	19.5	17.9	16.4	15.6	18.9	15.5	13.9	10.1
Central Tax Shares	11.8	8.5	13.4	10.3	9.4	8.2	7.6	8.2
Grants	7.8	6.0	4.8	5.8	4.9	5.6	8.8	11.5
Total Revenues	100	100	100	100	100	100	100	100

Source: Finance Accounts, and State Finances, RBI, April 2004

Profile of revenue receipts as percentage of GSDP for fiscal years 1996-97 to 2002-03 is given in Table 2.4.

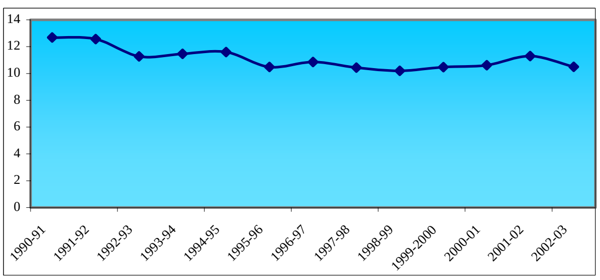
Table 2.4: Revenue Profile of Maharashtra as percentage of GSDP

Item	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Own Tax Revenue	6.61	7.05	6.66	7.15	7.09	8.02	7.73
Own Non Tax Revenue	2.12	1.87	1.68	1.63	2.01	1.75	1.53
Central Rev. Transfers	2.13	1.52	1.86	1.68	1.52	2.39	0.33
Tax Share	1.28	0.89	1.37	1.08	1.00	0.92	0.77
Total Grants	0.85	0.63	0.49	0.60	0.53	0.63	0.51
Total Revenues	10.86	10.44	10.20	10.47	10.62	11.33	10.54

Source (Basic Data): Finance Accounts, Economic Survey of Maharashtra, 2003-04

The own tax revenues as a percentage of GSDP though varied between 6.6 per cent and 7.7 per cent during 1996-97 and 2002-03 (going up in 2001-02 to 8 per cent) has been on rise. But non-tax revenues to GSDP ratio showed a secular decline from 2.12 to 1.53 per cent from 1996-97 to 2002-03. Central tax shares and grants have also been on decline, going down from 1.3 per cent to 0.8 per cent and 0.85 per cent to 0.5 per cent, respectively, during this period. But the overall revenue as percentage of GSDP has been static around 10.5 per cent along a fluctuating trend. If we compare this to earlier years, we find that the ratio had increased from 12.2 per cent in 1980-81 to 15.6 per cent in 1986-87, and then started declining (Figure2.3).It is often stated that reasons for such decline in the revenue receipts-to-GSDP ratio is due to a steady decline in the central transfers. But it can be seen that shared taxes and grants as a proportion of GSDP had been declining even prior to 1986-87. But since own revenue – both tax and non-tax – was buoyant, it had more than made up for the decline and in fact, it resulted in an increase in the revenue-to-GSDP ratio.

Figure 2.3: Total Revenue of Maharashtra as percentage of GSDP during 1990-91 to 2002-03



Source (Basic Data): Finance Accounts

Major heads of revenue receipts for the past three years, 2001-02 to 2003-04, are given in Table 2.5. As can be seen from the table, sales tax is the major source of revenue receipts of the Maharashtra Government. Other tax sources, having relative significance during 2003-04 were stamp and registration fees (3.22 per cent), state excise duty (6.2 per cent), taxes on income and expenditure (2.74 per cent), taxes on vehicles and goods and passengers (4.54 per cent), and electricity duties (3.45 per cent).

Table 2.5: Revenue Receipts during 2001-02 to 2003-04 (In Rs. Billion)

Item	2001-02	2002-03	2003-04RE
Sales tax	121.31	134.88	154.85
Stamp and Registration Fees	24.43	28.23	31.0
State Excise Duty	17.87	19.39	23.0
Electricity Duties	10.34	11.49	12.8
Taxes on Income and Expenditure	9.86	10.32	10.2
Taxes on Vehicles	9.48	9.41	10.25
Taxes on commodities & services	6.87	8.11	8.61
Taxes on goods & passengers	10.27	2.45	6.65
Land Revenue	2.60	3.87	3.38
Taxes on Agriculture Income Tax	0.0016	0.00	0.00
Non-Tax Revenue	46.55	60.23	80.48
Share in Central Taxes	24.68	30.37	30.37
Grants-in-Aid from the Central Government	16.81	15.06	42.74
Total Revenue Receipts	**300.93**	**311.03**	**371.59**
Per Capita Revenue Receipts (In Rs.)	**3077.46**	**3426.44**	**3762.56**

Source: GoM Budget Document

Own Tax Revenues

Relative importance of various taxes can be analysed from the structure of own tax revenue of the Maharashtra Government. It can be seen from Table 2.6 that the major sources of own tax revenue are from the sales tax, followed by state excise and other taxes, viz., stamp and registration duty, taxes on goods and passengers and electricity duty. It can also be seen that the share of sales taxes in total own

Table 2.6: Structure of Own Tax Revenue (In per cent)

Item	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Taxes on Agricultural Income	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other Taxes on Income & Exp.	3.29	3.16	3.02	3.26	2.89	4.63	4.52	3.91
Land Revenue	1.00	1.20	1.10	0.94	0.67	1.23	1.7	1.3
Stamps & Registration	7.96	11.81	11.30	10.88	12.32	11.47	12.37	11.89
Imm. Property not ag. land	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
State Excise	11.74	9.99	9.79	9.12	12.03	8.39	8.5	8.82
Sales Tax	61.60	60.91	62.59	62.23	57.04	56.94	59.1	59.39
(a)Central Sales Tax	10.80	10.29	10.55	10.63	9.32	9.56	9.11	8.16
(b)General Sales Tax	41.42	41.32	42.40	40.63	36.05	31.55	34.73	35.45
(c)Tax on Motor Spirits etc.	7.25	8.84	9.14	10.14	10.92	15.41	14.9	15.72
(d)Sugarcane cess/purchase tax	2.11	0.43	0.49	0.73	0.63	0.38	0.34	0.00
(e)Turnover Tax	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
(f)others	0.02	0.02	0.01	0.10	0.12	0.04	0.04	0.06
Taxes on Vehicles	3.51	3.64	3.87	5.24	5.48	4.45	4.13	3.93
Taxes on Goods & Passengers	3.27	2.95	2.27	1.71	2.49	4.82	1.07	2.55
Taxes & Duties on Electricity	4.37	3.56	3.27	3.44	3.90	4.85	5.04	4.91
Other Taxes	3.26	2.77	2.78	3.17	3.18	3.23	3.56	3.30
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Own Tax Revenue (Rs. Billion)	**117.15**	**137.19**	**142.02**	**172.65**	**197.27**	**213.04**	**228.15**	**260.74**

Source (Basic Data): Finance Accounts

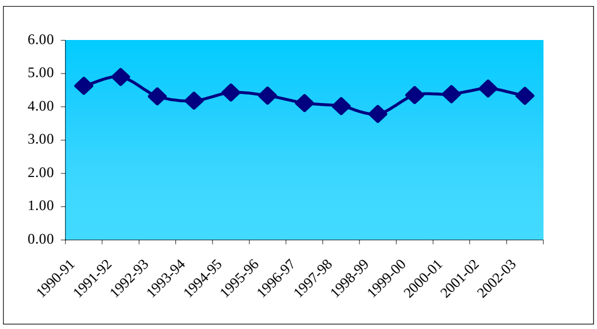
tax revenues declined from 61.60 per cent in 1996-97 to 56.94 per cent in 2001-02. This decline in the share of sales tax was due to the decline in the share of central sales tax and general sales tax from 10.80 to 9.56 per cent and 41.42 to 31.55 per cent, respectively. During 2002-03 and 2003-04, the sales tax share in the own-tax revenue has shown some rise, 59.1 and 59.4 per cent shares. Share of tax on motor sprit, etc. had also shown consistent rise during the period. But share of State excise duty had not been very encouraging, remaining below 10 per cent, except for two years 1996-97 and 2000-01 when it went up to 12 per cent. But thereafter during past three years 2001-02 to 2003-04, it has been around 8.5 per cent.

Stamp duty and registration fees and taxes on vehicles have also not been significantly rising. Share of stamp duty and registration fee in the own-tax has been fluctuating around 11.5 per cent. Similarly the shares of other minor taxes have also remained more or less stagnant during the period. Land revenue also did not show any perceptive rise. Agricultural income tax remained a non-starter.

Sales Tax

As already seen, close to 60 per cent of the own revenue of Maharashtra comes from the sales and purchases tax, including the central sales tax. During the last two financial years, 2002-03 and 2003-04 (revised estimates), annual sales tax revenue of Rs. 134.88 billion and Rs. 154.85 billion were collected. If we take the ratio of the sales tax revenue to the GSDP, we find that the ratio has been somewhat stagnant, hovering between 0.04 and 0.05 over the last 12 years (Figure 2.4).

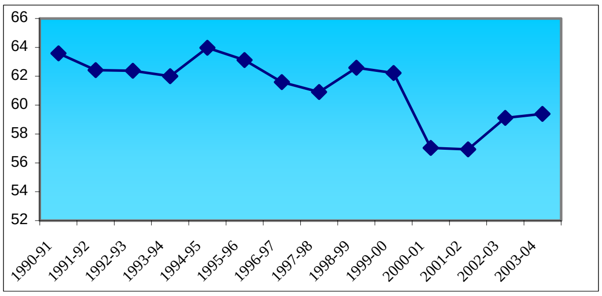
Figure 2.4: Ratio of Sales Tax Revenue to GSDP during 1990-91 to 2002-03



Source (Basic Data): Finance Accounts

In fact, the percentage of sales tax revenue in own-tax revenue has been showing a declining trend, from 63.59 per cent in 1990-91 to 56.9 per cent in 2001-02 (Figure 2.5). During the years 2002-03 and 2003-04 (RE), the share of sales tax in the own-tax revenue has however shown some rise, being 59.1 per cent and 59.4 per cent, respectively.

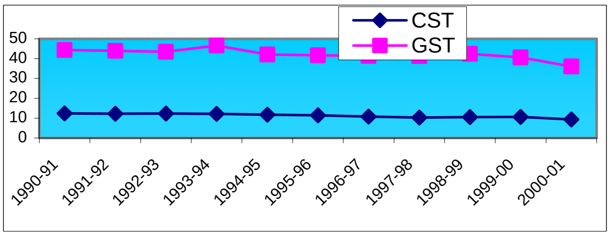
Figure 2.5: Percentage of Sales Tax Revenue to Own tax Revenue of Maharashtra during 1990-91 and 2000-01



Source (Basic Data): Finance Accounts

This decline in the share of sales tax can be mainly due to decline in the share of general sales tax from 44.35 to 36.05 per cent and that of central sales tax from 12.40 to 9.32 per cent (Figure 2.6).

Figure 2.6: Percentage of Central Sales Tax (CST) and General Sales Tax (GST) in Own Tax Revenue



Source (Basic Data): Finance Accounts

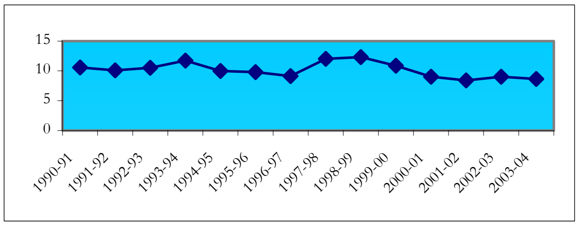
Sales tax includes taxes on sales or purchases, Central Sales Tax on inter-state sales, etc. Most of the commodities are taxed at 13 per cent and 10 per cent, and there are eight ad valorem sales tax rates from 0 per cent to 20 per cent. The average tax rate on non-exempt commodities was 8.17 per cent in 1998-99.

Major factors contributing to decline in sales tax collection appear to be widespread use of tax exemptions and deferrals and vertical integration of units to optimise tax liability under a first point regime. An estimate of revenue sacrifice from the exemptions and the package schemes puts it at Rs. 83.57 billion and Rs. 21.66 billion, respectively, which constitute about 25 per cent of the sales tax collections. Though the package schemes of incentives were discontinued some time back following an all-state agreement, their effect would continue to deprive the state of revenues for some time. With introduction of state-level Value Added Tax (VAT) from 1st April 2005, some of these tax collection woes may be mitigated because a first-point tax regime, unlike VAT, attaches a premium on vertical integration of activities by tax payers. With vertical integration, under a first point tax regime, hitherto taxable turnovers become endogenous to the firm and so cannot be taxed and the tax base narrows. With sales tax applicable on output and not on value added, a change in the composition of output towards higher value added products reduces sales tax revenue as a proportion of GSDP.

State Excise Duties

State excise duties are levied on the production of alcohol and other narcotic substances, besides license fees for liquor wholesale and retail permits. During the last three years, the state excise duties have constituted around 8.5 per cent of the state's own tax revenue. Figure 2.7 shows the trend over last 13 years.

Figure 2.7: State Excise Duty as a percentage of Own Tax Revenue



Source (Basic Data): Finance Accounts

Maharashtra is the largest producer of alcohol in the country. The chemical industry also has use of alcohol. Around 32 per cent of excise is collected from the country liquor and the balance from Indian Made Foreign Liquor (IMFL), wine and beer. Over the last ten years the percentage of excise duty in the tax collection of the state has remained at a long-term average of 11 per cent. But over the last three years there has been a declining trend in the excise duty despite ad valorem taxation. Fines and fees contribute about 10 per cent of the duties. Studies by the Excise Department show that Unit realisation from Beer has fallen by 18 per cent and that for country liquor by 33 per cent since 1997-98.

Professions Tax

Professions tax contributes about 4 per cent of Maharashtra's own revenue collections. This is one of the direct taxes levied by Maharashtra. This stream of tax has a wide scope to expand.

Stamp Duties and Registration Fees

The share of revenue from Stamp duties and registration fees as percentage of the state's own tax revenue is 11.46 (2001-02), 12.37 (2002-03) and 11.89 (2003-04 RE). Share in the total receipts during these three financial years was about 8 per cent. This share can be increased given that Maharashtra has high real estate values. But this is also a constraint as there is a persistent attempt to understate the value of the property. Stamp duty on the property sales is 10 per cent of the property value and there are another 8 rates prevalent. As 10 per cent rate is high, large numbers of transactions (almost 70 per cent) are undervalued. (World Bank, 2002, p. 9.30)

Due to high stamp duty, transfers are often shown as gifts, through General Power of Attorney, sale within the same co-operative society etc. In fact concessional Stamp duties and registration fees for housing co-operatives result in major loss of revenue to the state. Given the above situation, growth in revenues can only be secured through better implementation of market value scheme and procedural improvements. Besides, there are some inherent deficiencies in the legal provisions, which also require a closer look. For example, the current registration act only covers registration of documents and not property titles *per se.* Rate structures of the registration have not been updated for long. In the present scenario, they do not seem to cover even the cost of its administration.

Motor Vehicles tax

The motor vehicle taxes are collected in the state under the Indian Motor Vehicles Act, State Motor Vehicle Taxation Act, and as services and service fees and other receipts. In the year 2000-01, Rs. 0.86 billion was collected under Indian Motor Vehicles Act, Rs. 6.96 billion under State Motor Vehicle Taxation Act and a meager Rs. 7.9 million as services and service fees.

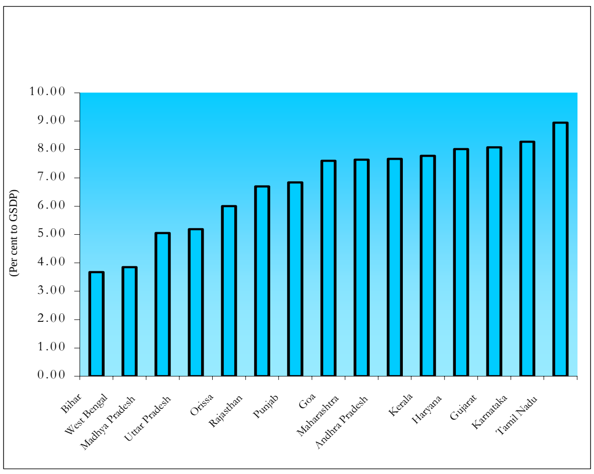
Motor vehicles taxes contribute less than 4.5 per cent of the state's own tax revenue. In terms of GSDP, this is about 0.3 per cent. This is far less in Maharashtra as a proportion of GSDP than in other states. Besides the rate problem, lack of adequate collection from the state transport undertakings is a cause for poor collection of the motor vehicles tax. Another cause for the poor collection of taxes is illegal and clandestine operations and lack of enforcement mechanism. Some of the reasons for poor collection are difficulty in enforcement of permits for specified routes, non-rationalisation of rate structure and tax basis for inter-state vehicles. Life tax system can be considered for small commercial vehicles apart from the non-transport private vehicles. The turnover basis can be converted to seating capacity basis and can be uniformly applied to private carriages.

Tax Effort of Maharashtra

Tax efforts of various states can be compared so as to make an assessment of Maharashtra vis-à-vis other states. Tax effort can be understood as a ratio of the tax collection and some measure of taxable capacity (Chelliah and Sinha, 1982). Figure 2.8 gives a comparison of different states in tax efforts. It may be seen from Figure 2.8 that Maharashtra's tax effort is lower than that of some major states like Kerala, Tamil Nadu, Karnataka, Haryana and Gujarat. One of the reasons for the lower tax-GSDP ratio of Maharashtra is that the octroi revenue in Maharashtra is not accounted in the state revenues, but it is considered as municipal revenue.

Even if we make allowance for that (Octroi would account for not more than one percentage point of GSDP), Maharashtra would still not compare favourably with better performing states in terms of tax revenues (GoM Documents, 1999). Inter-state comparison of tax-GSDP ratio also brings out the fact that there is considerable scope for improving the tax effort of Maharashtra. The state being the second highest per capita income state, the tax base and the fiscal capacity is much higher than other states including those states which are better performing in terms of tax-GSDP ratio.

Figure 2.8: Tax-GSDP Ratio of Major States (2000-01) Additional Revenue Measures in Own tax Revenues



During 2002-03, Maharashtra Government raised Rs. 11.3 billion of tax revenue through additional revenue measures (ARM). Distribution of the above additional revenue in terms of value (Rs. billion) and percentage is given in Table 2.7.

Table 2.7: Additional Revenue Mobilisation (ARM) Measures of Maharashtra during 2002-03

Item	Amount of Revenue Rs. billion	Per centage to Total Revenue Mobilisation
Stamp Duty	0.05	0.4
Sales Tax	9.75	86.3
Electricity Duties	0.8	7.1
Entertainment tax	0.65	5.8
Other Taxes	0.05	0.4
Total ARM	11.3	100

Source: RBI's Study of State Finances, 2003

In comparison, Tamil Nadu raised Rs. 6.90 billion, Punjab Rs. 4.77 billion and Uttar Pradesh Rs. 2.46 billion through additional revenue mobilisation measures. It may be noted that as in the case of Maharashtra, so also in the case of other states, the percentage of revenue through ARM in sales tax is the largest.

Long Range Buoyancies of Revenues

Estimated buoyancies of major taxes of Maharashtra with respect to both non-agricultural GSDP and total GSDP are shown in Table 2.8.

Buoyancy gives an indicator for response of state taxes to the rise in output. Among the major taxes the highest buoyancy at more than 1.7 was shown by stamp duty and registration with respect to both non-agricultural GSDP and total GSDP (Table 2.8). Apart from stamp duty and registration, other major taxes having buoyancies above one are state excise duties and tax on motor sprit etc. The sales tax, which has the highest share in total taxes, showed buoyancy below one with respect to both the bases. Some of the taxes, which have shown buoyancy above unity, their combined share in total taxes is much lower than that of sales tax. Thus, the overall buoyancy of own tax revenues suffers and remains below one with respect to non-agricultural GSDP and marginally above one with respect to GSDP.

Table 2.8: Buoyancy of major taxes in Maharashtra: 1990-91 to 2000-01

Item	With respect to Non-agricultural GSDP	With respect to Aggregate GSDP
Own Tax Revenues	0.998 (24.01)	1.027 (23.70)
Land Revenues	0.609 (3.94)	0.624 (3.896)
Stamp Duty and Registration Fee	1.736 (16.84)	1.784 (16.03)
State Excise duty	1.040 (16.83)	1.075 (19.44)
Sales Tax	0.962 (24.80)	0.989 (23.20)
Central Sales Tax	0.821 (23.03)	0.844 (21.76)
General Sales Tax	0.896 (19.53)	0.920 (18.42)
Tax on Motor Spirit/ etc.	1.602 (6.1)	1.644 (6.21)
Sugarcane Cess / Purchase Tax	0.864 (3.12)	0.902 (3.22)
Taxes on Vehicles	0.969 (6.55)	0.996 (6.53)

Note: Figures in brackets are t-values.

Source (Basic Data): Finance Accounts, World Bank, 2002

Increase in the buoyancy (aggregate) is an important pre-requisite for additional non-debt resource mobilisation. This needs to be done through an increase in the sales tax buoyancy above one and also through other relatively less buoyant taxes. The buoyancy estimates show that some of

Table 2.9: Long Run Buoyancies of Own Revenue and Components, 1980-81 to 1999-00

States	Per Capita GSDP in Rs. (1999-00)	Own Revenue	Own tax Revenue	Sales tax	State Excise duty	Motor Vehicles	Stamp Duty
West Bengal	16054	0.92	0.98	1.02	0.91	0.41	1.13
Andhra Pradesh	16205	0.9	0.91	10.5	0.65	0.96	1.04
Karnataka	20269	0.94	1	1.06	0.89	0.98	1.24
Tamil Nadu	22179	0.94	0.97	0.98	0.98	0.91	1.04
Kerala	23089	0.93	0.99	1.04	0.85	1.04	1.05
Gujarat	24961	0.99	1	1.03	0.78	0.84	1.11
Haryana	25436	1.07	0.97	1.06	0.76	0.84	1.09
Maharashtra	**26486**	**0.91**	**0.95**	**0.96**	**1.07**	**0.89**	**1.48**
Punjab	26840	1.07	0.94	0.97	1.06	0.78	0.88
Average	**18027**	**0.97**	**0.99**	**1.02**	**0.99**	**0.9**	**1.14**

Source: World Bank, 2002

the worst performing taxes are land revenues, taxes on goods and passengers and taxes on electricity duty.

An estimation of the long-run buoyancies of own revenue for 9 major states has been reported in Table 2.9. From this (Table 2.9), it can be seen that stamp duty and the state excise duty are the two most buoyant sources of taxes. The sales tax follows the two. But as we discussed earlier, sales tax constitutes the major portion of the revenue receipts. Given the above scenario, it would be appropriate to shore up sales tax revenue collection in case the state has to improve the revenue collection. It should be noted that sales tax system suffers from various deficiencies and no comparable reforms have taken place in the area of sales taxes. Major problems of sales tax system, as already stated, are multiplicity of rates with large spread, plethora of exemptions and rate war between states. All these have contributed to a very complex structure of sales tax, which in turn contributes to large-scale evasion of tax, problems of enforcement and administration and compliance. Also, the sales tax being levied on gross value at the successive stages of production lead to considerable cascading, leading further to increase in the cost of production and the consumer price.

Direction of sales tax reform as suggested by various studies and expert groups include the following: eliminating cascading through full rebate on tax on inputs, zero rating of inter-state sales tax, reduction in the number of rates and adoption of at least uniform floor rates for specified groups and commodities, reducing the number of exemptions, phasing out of sales tax incentives, extending the tax to resellers on a value added basis.

VAT across the states, as a replacement of sales tax, is to be introduced from 1st April 2005. The essence of VAT is in providing set-off for the tax paid earlier. This is given effect through the concept of input tax credit or rebate. Under this system, there will be only two basic rates – of 4% and 12.5%, plus a specific category of tax-exempted goods and a special VAT rate of 1% only for gold and silver ornaments. The VAT system would cover about 550 goods, and so multiplicity of rates, which exist in the present system of sales tax, will be done away with.

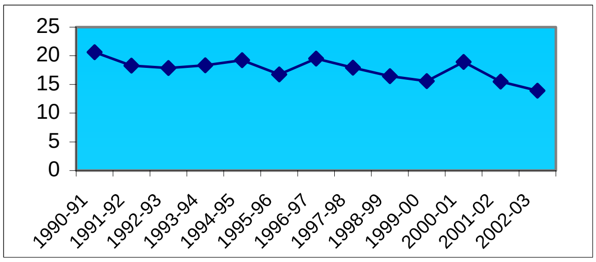
Effects of the VAT system will be to rationalise the tax burden. This will stop unhealthy tax-rate war and trade–diversion among the states, which had hitherto adversely affected interests of all the states. This will also improve tax compliance and ensure revenue growth.

Despite tax gains in the long run, it is feared that there may be revenue loss to states in the initial years of transition. The Government of India has agreed to compensate for 100 per cent loss in the first year of introduction of VAT, 75 per cent in the second year and 50 per cent in the third year of introduction, on the basis of an agreed formula for computing the loss.

Own Non-tax Revenue

Share of own non-tax revenue in total revenue over a period of twelve years, 1990-91 to 2002-03, has been declining from 23 per cent as shown in Figure 2.9. Non-tax revenue comprises mainly interest earning, dividends and profits from the state public sector enterprises (PSEs), earnings from general services, social services and economic services.

Figure 2.9: Share of Own Non-tax revenue in the total revenue of Maharashtra



Source (Basic Data): Finance Accounts

Amongst all the sources of own non-tax revenue, interest earnings constitute the largest share in total non-tax revenues. In fact, its share in total own non-tax revenue had increased from 36.70 per cent in 1990-91 to 56.50 per cent in 2000-01 (Table 2.10). But during the last three fiscal years it has sharply declined to 39.65 per cent in 2001-02, 24 per cent in 2002-03 and only 8.54 per cent in 2003-04. Such sharp decline in the interest receipts may be due to reasons of declining interest rate, default in interest payment, and waiver of loans given to SEs. If we see the above along with sharply declining dividends and profits which in 1990-91 had a share of 0.49 per cent and was only 0.07 per cent in 2000-01, along with dismal recovery rates on the investments made in various corporations and public sector enterprises, we find that while government investment in Maharashtra increased in absolute terms from Rs. 8.48 billion in 1990-91 to Rs. 96.81 billion in 2000-01 (an increase of 11.4 times), dividend receipts and the corresponding rates of return on the equity invested are extremely low. The highest recovery rate was 1.03 per cent in the year 1990-91 which declined to 0.04 per cent in 2000-01 (Table 2.11). The situation demands that the state government should take up suitable steps to make these enterprises either profitable or else wind up the defunct and the perennially loss-making units, as it otherwise becomes a sink for the costly resources.

Table 2.10: Structure of Non-Tax Revenues during 1996-97 to 2000-01 (In per cent)

Item	1996-97	1997-98	1998-99	1999-00	2000-01
Interest Receipts	54.18	46.53	46.29	43.80	56.50
Dividends and Profits	0.25	0.26	0.17	0.10	0.07
General Services	7.67	8.74	7.90	11.02	9.77
Social Services	4.64	6.34	7.39	7.99	5.43
Economic Services	33.25	38.13	38.25	37.09	28.23
Total	100	100	100	100	100
Non-Tax Rev. (Rs. Billion)	37.55	36.41	35.73	39.37	55.96

Source (Basic Data): Finance Accounts

Also, the share of earnings from economic services declined from 41.79 per cent in 1990-91 to 28.23 per cent in 2000-01, and that from the general services declined from 16.12 to 9.77 per cent during the period. The share of earnings from social services, however, increased marginally from 4.90 per cent in 1990-91 to 5.43 per cent in 2000-01; though during the year 1999-00 the same share had gone up to 8.00 per cent. Studies have shown that the rates of recovery under social and economic services are very low across the states. Major reason for the low rates of recovery is the abysmally low user charges as most of the state PSEs are in utility services. Non-revision of user charges for years put the current prices of these services out of alignment with cost, resulting in huge subsidies. The recovery rates in social services and economic services, as estimated by Srivastava and Sen (1997) for Maharashtra, were as low as 4.53 and 18.24 per cent, respectively. Since goods and services provided by the public sector are classified as 'merit' and 'non-merit' categories. Merit goods and services are those goods and services that have strong externalities associated with their provision. Non-merit ones are the others. While low recoveries may have some justification in case of merit goods and services, it is hard to defend very low recovery rates for non-merit categories.

Table 2.11: Outstanding Investment and Recovery Rate

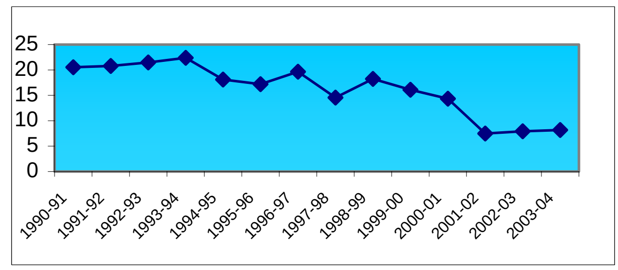
Item	Investment at the end of the year (Rs. Billion)	Dividend /Interest received (Rs. Million)	Rate of Recovery (%)
1990-91	8.48	87.5	1.03
1991-92	9.69	91.1	0.94
1992-93	10.47	56.0	0.53
1993-94	11.79	27.3	0.23
1994-95	14.17	37.9	0.27
1995-96	17.40	41.6	0.24
1996-97	18.74	92.7	0.49
1997-98	20.03	93.3	0.47
1998-99	54.40	60.1	0.11
1999-00	67.84	39.6	0.06
2000-01	96.81	39.5	0.04

Source (Basic Data): Finance Accounts

Central Transfers

Central transfers supplement the states' resources through tax devolution and grants, to eliminate both vertical and horizontal fiscal imbalances. It can be seen from Figure 2.10 that the revenue transfers (tax share and grants) from the Centre showed a declining trend during 1990-91 to 2000-01. In 1990-91, it formed 20.52 per cent of total revenue of the state but was only 14.35 per cent during 2000-01. It further declined after that, and is now around 8 per cent.

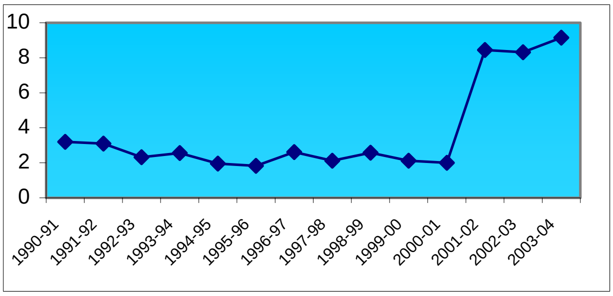
Figure 2.10: Share of Revenue transfers from Centre in the Total Revenue of Maharashtra



Source (Basic Data): Finance Accounts

Total central transfers to the state during this period, 1990-91 to 2000-01, also showed a declining trend in terms of its share in GSDP. The share of total transfers in the GSDP of the state declined from 3.20 per cent to 2.0 per cent during this period (Figure 2.11).

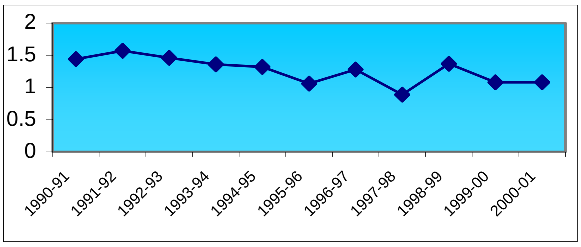
Figure 2.11: Total Central Transfer as a percentage of GSDP



Source: (Basic Data): Finance Accounts

The decline in transfers has been witnessed both in the case of shares in Central taxes and the grants. Sharing of Central taxes with the states is mandated by the Constitution and the principles involved in the sharing are determined by the Finance Commission for the vertical division of tax revenue between the Centre and the States and the horizontal division among the states. The tax shares as percentage of GSDP has gone down from 1.44 per cent during 1990-91 to 1.08 per cent in 2000-01. The inclusion of all Central Taxes in the devolution of resources to the States as per the Eleventh Finance Commission recommendations resulted in sharing of taxes like corporation tax, customs duty, services taxes etc with the states. Though the rise in Central tax shares during 2000-01 over the previous year was Rs.1.72 Billion, its share in GSDP remained the same as that of the previous year (Figure 2.12).

Figure 2.12: Tax Share of Maharashtra as a percentage of GSDP

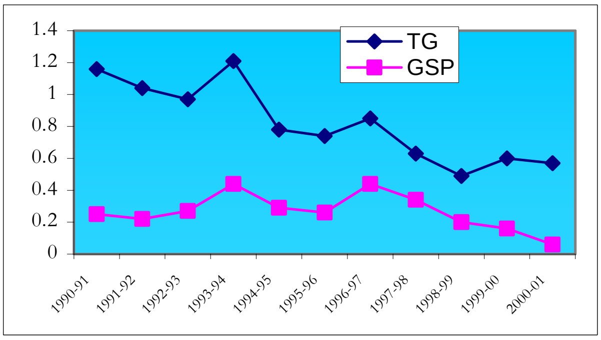


Source (Basic Data): Finance Accounts

The decline in quantum of devolution of share in central taxes, to a great extent, has been influenced by the deceleration in the growth of Central taxes. The recessionary condition of the economy and low rate of industrial growth during later part of the nineties accentuated this problem. Continuance of the trend of decelerating growth in Central taxes may actually defeat the goal set by the new devolution scheme involving all Central taxes for sharing with the states.

A substantial part of central devolution is received by the states from the Planning Commission in the form of plan grants for the state plans. This is distributed on the basis of Gadgil formula. The assistance given to the non-special category states (which is the case with Maharashtra) under the Gadgil formula is distributed on a 70 per cent loan and 30 per cent grant basis. Total grants to the state as a percentage of GSDP showed steep decline during this period. It went down from 1.16 per cent to 0.57 per cent of GSDP. Grants for state plan schemes, which were showing a higher trend as compared to the initial years, also declined after 1997-98 (Figure 2.13).

Figure 2.13: Total Grants (TG) and Grants for Sate Plan Schemes (GSP) as percentage of GSDP



Source (Basic Data): Finance Accounts

Need for revenue mobilisation

Own-tax revenue constitutes substantial part of the total revenue and so efforts towards revenue mobilization have also to concentrate on the own-tax revenues. Increase in tax buoyancy can come mainly from the sales taxes. Reform, therefore, should concentrate on sales tax under two broad categories of tax policy and tax administration.

As already stated, exemptions and concessions complicate tax administration and involve loss of revenue. Tax incentives should be looked upon as tax expenditure, as tax incentives are not only ineffective and it affects industrial investment in an adverse way. Since Maharashtra has traditionally been considered to have better infrastructure than most other states, the role of incentives in encouraging investment can at best be limited. So effort, while designing a tax system, should be on to have a tax system that is transparent, simple and promoting better tax compliance. Adoption of state-level VAT with a wide base, multi-point taxation and a moderate rate would ensure that value added at all stages of production and trade are taxed, preventing artificial manipulation with the tax base.

Objective of good tax administration is to ensure that there is minimum leakage of taxes and compliance cost for the taxpayers is low. A good tax administration would promote tax compliance. It would frame a suitable audit strategy whereby high-risk categories of taxpayers are identified and taken up for detailed audit (possibly at the place of business). For this a good database would be required to be collated with supplementary information from the related sources. The tax department should maintain information about collection of taxes by commodity. Production figures can be obtained from other sources. These two sets of data should be used to infer about the level of compliance by a particular segment of dealers. A step in the direction would be to embark on a large-scale computerization with an efficient and quick way of retrieving the data.

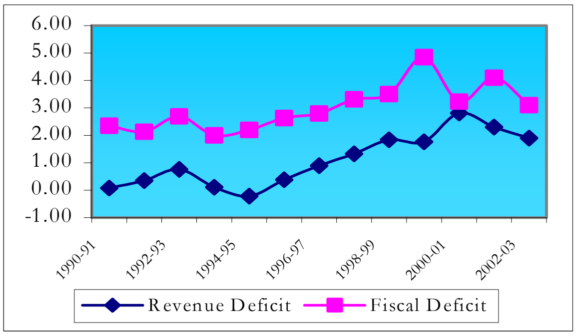
For all non-merit services, it would be imperative to increase the recovery rates. In fact in this respect it was seen that Maharashtra does not compare well even with some other states. Some of the best practices in India can be adopted by Maharashtra; e.g. Haryana has significantly higher recovery rate for transport and urban development, Goa for housing etc.

Section – II

Fiscal Deficit

The finances of Maharashtra have been under severe strain. Figure 2.14 captures the deteriorating trend of gross fiscal deficit (GFD) and revenue deficit of Maharashtra as a ratio of GSDP over the ten-year period, from 1990-91 to 2000-01. It can be seen that the GFD was 2.35 per cent in 1990-91, and increased only slightly to 2.79 per cent in 1996-97. But major deterioration in this came in 1997-98, and worsened sharply from 1998-99 onwards, with a slight improvement in 2000-01. In 2001-02, 2002-03 and 2003-04 RE, it was 4.1, 4.8 and 5.9 per cent, respectively.

Figure 2.14: Gross Fiscal and Revenue Deficit of Maharashtra (per cent to GSDP)



Key financial indicators of Maharashtra over two five-year periods from 1990-91 to 2000-01 are given in Table 2.12. It can be seen that the ratio of primary deficit to GSDP increased nearly two and a half times during the five-year period 1995-2000 over the earlier period of 1990-95. The interest burden of the state, calculated as a ratio of interest payment to revenue receipts, also increased from 11.5 per cent to 15.1 per cent i.e. a change by 31.3 per cent. The own-revenue resources declined to 60.6 per cent during 1995-2000 to finance the aggregate expenditures from an earlier position of 62.6 per cent during 1990-95 i.e. deterioration by 3 per cent.

Primary deficit (fiscal deficit, net of interest payment) has further increased from 1.5 per cent of GSDP in 1995-96 to 3 per cent of GSDP in 2003-04.

Table 2.12: Key Fiscal Indicators of Maharashtra

Item	1990-95	1995-2000
Primary Deficit/ GSDP	0.90	1.83
Debt/ GSDP	13.54	13.57
Interest burden = Interest Payment/ Revenue Receipts	11.5	15.1
Own Revenue Resources Aggregate Expenditure	62.6	60.6

Source: RBI, 2002

In 1993-94, Maharashtra recorded revenue deficit and fiscal deficit of 0.1 per cent and 2.0 per cent of GSDP, respectively. In the year 2001-02, the same were recorded at 3.1 per cent and 4.1 per cent of GSDP, respectively. Table 2.13 gives the deficit figures from 2000-01 to 2003-04.

Table 2.13: Deficits of Maharashtra Government

(Rs. Billion)

Item	2000-01	2001-02	2002-03	2003-04 RE
Revenue Deficit	78.34	81.88	93.71	90.37
Fiscal Deficit	85.76	105.92	148.81	184.60
Primary Deficit	33.51	41.62	75.95	97.58

Source: Economic Survey, 2003-04

Table 2.14: Gross Fiscal Deficit

(Rs. Billion)

Item	2000-01	2001-02	2002-03	2003-04 RE
Revenue Deficit	78.34	81.88	93.71	90.37
Capital Expenditure outside the Revenue Account	44.63	29.48	36.84	96.87
Net Loans and Advances given by the State Government	-33.21	-2.39	12.35	7.53
Total gross Fiscal Deficit	89.76	108.98	142.9	194.77
Total Gross Fiscal Deficit as per centage of GSDP	3.8	4.1	4.8	5.9

Source: Economic Survey of Maharashtra, 2003-04

The disaggregation of gross fiscal deficit consisting of revenue deficit, capital outlay and net lending given by the State Government for 2001-02 to 2003-04 is given in Table 2.14. The gross fiscal deficit of the state has shown continuous increase over the years mainly due to high levels of revenue deficit. In fact, the share of revenue deficit in the gross fiscal deficit for the year 2002-03 was 65.6 per cent, and that for the year 2003-04 (RE) was 46.4 per cent.

Revenue expenditure of Maharashtra grew at an average rate of 15 per cent between 1994-95 and 2001-02 and the capital outlay grew at the average rate of 4 per cent during the same period. When seen with the increase in the government's deficit financing, this change in the composition of spending indicates that the State had borrowed primarily to finance current consumption, i.e., to pay for the growing salaries, pensions and the increasing interest payments. These items together accounted for close to 80 per cent of total revenues. This is also reflected in the ratio of revenue deficit to fiscal deficit, which reached 55 per cent in 2001-02. In the budget for 2003-04, the development expenditure accounts for 41.6 per cent of the total expenditure at Rs. 624.62 billion, while the non-development expenditure constituted 58.4 per cent. If we look at the revenue and capital expenditures of Maharashtra during two periods, viz. 1993-96 and 2000-03, we find that while revenue expenditure increased from 10.68 per cent of GSDP to 14.10 per cent (an increase of 3.42 basis points), capital expenditure declined from 2.56 per cent of GSDP to 1.47 per cent (a decrease of 1.09 basis points). This puts across the budgetary deterioration of Maharashtra sharply if we compare the above to all-states figures of revenue and capital expenditure during the same period. All states figure for revenue expenditure are 13.94 per cent in 1993-96 to 16.67 per cent (an increase of 2.72 basis points) – a trend similar to Maharashtra but not as much; the difference is in capital expenditure, which was 2.66 per cent in 1993-96 and 2.26 per cent in 2000-03 - a decrease of 0.40 basis points but not as sharp decline as in Maharashtra. The above comparison suggests that no doubt other states experienced similar expenditure shifts, but with a difference. Maharashtra was one of the top rankers in increasing revenue expenditure, only to be outranked by Orissa, Gujarat and Madhya Pradesh; the difference being that in all these three states there was an increase in capital expenditure rather than a decline – as in the case of Maharashtra.

Budgetary deterioration

Composition of government spending in Maharashtra changed significantly between 1994-95 and 2001-02 - with decline in capital and development outlays, non-wage O&M expenditure, reduction in certain social sector spending, but increase in salary, pension, interest payments and subsidy (Table 2.15).

Table 2.15: Changes in composition of expenditure

(as percentage of total expenditure)

Item	1994-95	2001-02
Salary and Pension and Interest payments	51	60
Non-wage O& M	15	13
Capital Expenditure	19	10
Subsidies	2	5
Others	13	12

Source: World Bank Report, 2002

Increase in the committed liabilities - wages and salaries, interest payment and pension, from 54.99 per cent of revenue receipts in 1990-91 to 82.70 per cent in 1999-00 led to the budgetary deterioration. This also reduced the share of revenues available for discretionary expenditure from 46.01 per cent in 1990-91 to 17.30 per cent in 1999-00, which was alarming (Table 2.16).

Table 2.16: Incidence of Committed Liability on Revenue Receipts and Revenue Expenditure

Item	1990-91	1994-95	1999-2000
As a percentage of revenue receipts			
Wages and Salaries	41.63	40.95	57.08
Interest payment	10.12	11.66	19.33
Pension	3.24	3.24	6.29
Total Share of Committed Expenditure	54.99	55.85	82.70
Share of discretionary expenditure	46.01	44.15	17.30
As a percentage of revenue expenditure			
Wages and Salaries	41.37	41.73	48.83
Interest payment	10.06	11.88	16.53
Pension	3.73	3.55	5.50
Total Share of Committed Expenditure	55.16	56.96	70.86
Share of discretionary expenditure	44.84	43.04	29.14

Source: GoM Budget Documents

Such limited resource availability both for plan expenditure and non-wage operation and maintenance implied a thin distribution of resources across various projects and programmes which then were incapable of meeting the actual resource requirement for the upkeep of public services or completion of plan projects.

Salary and Pension

Salary payments account for a major share of the committed expenditure. Maharashtra, like all other states, experienced a sharp increase in its salary and pension bill due to implementation of the Fifth Pay Commission's recommendations. While salary bill of GoM increased by 66 per cent in one year from Rs. 100.31 billion in 1998-99 to Rs. 166.35 billion in 1999-00, pension bill increased by 63 per cent from Rs. 12.49 billion to Rs. 20.34 billion in the same period. The pension bill continued to rise even in 2000-01, increasing by 51 per cent between 1999-00 and 2000-01, before falling marginally in 2001-02 RE (World Bank: 2002, p10-11). The salary and pension bill fell modestly in 2000-01 to 24.4 per cent of the revenue receipts from 29.2 per cent in 1999-00, it was high in absolute terms for 2001-02 and 2002-03 at Rs. 72.35 billion and Rs. 74.63 billion, respectively.

If we calculate the above increases in terms of salary expenditure per employee to see the effect of Pay Commission recommendations, we find that during 1997-98 and 1998-99 average salary of an employee per annum was Rs. 58,000 and Rs. 65,000, respectively. This jumped to Rs.100,000 per annum in 1999-00. Though the same declined to Rs. 88,000 in 2000-01 and Rs.90,000 in 2001-02; important to note here is the higher level of salary payment after implementation of Pay Commission recommendations.

Another reason for increase in salary and pension bill was increased recruitment in grants-in-aid (GIA) institutions. The revenue grants given to local bodies, educational institutions and other aided institutions, which was Rs. 34.73 billion in 1993-94 increased to Rs.122.62 billion in 2002-03. Major parts of these grants were incurred on salaries and wages. Apart from the regular wage increases on the basis of Central Government regulations, the growth in wage bill was also due to growth in employment. The number of employees in the state and local governments more or less remained the same over the last 6-7 years at between 0.6 and 0.7 million. While the average rate of growth in salaries of state and local government employees was 13 per cent during 1995-96 to 2000-01, the GIA salaries grew by 20 per cent during the period. During this period the employment in GIA institutions increased from 0.58 million to 0.68 million, an increase of 17 per cent. Besides the above, there were also separate SPVs (Special Purpose Vehicles) to manage large irrigation and road works with employment load and pay burden on the exchequer (World Bank: 2002).

Profile of annual growth rate of pension for Maharashtra is given in Figure 2.15, which shows decline from 1996-97 onwards. Pension also registered very rapid growth in the government budgets in Nineties. Though the rate of growth of pension in Maharashtra was relatively lower than other major states in the country. During the period, 1991-92 to 1994-95, the rate of growth of pension was 14.74 per cent. This increased to 18.60 per cent during 1995-96 to 1998-99 (Table 2.17). Pension expenditure as percentage of GSDP during 1993-96 was 0.36, this went up to 0.88 in 2000-03. The increase, though significant, was not as high as that for all-States average, where the average went up from 0.73 per cent during 1993-96 to 1.56 per cent during 2000-03.

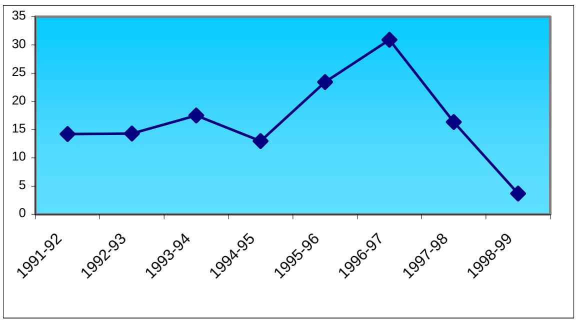
If we see the pension payments as percentage of revenue receipts, we find that in 1999-00 there was sharp rise in pension payment, which continued rising up to 2001-02. Thereafter, it declined. Even if it is on decline, the expenditure in absolute terms was still very high. It was Rs. 27.81 billion in 2003-04. Given that the state has enormous financial burden, reforms of the existing pension scheme assumes importance. For the new employees, the state has introduced a new contributory pension scheme on the same line as the Central government.

Table 2.17: Growth rate of pension for Major States during the two periods, 1991-95 and 1995-99

States	1991-95	1995-99
Andhra Pradesh	23.43	16.54
Bihar	24.58	21.94
Goa	16.16	47.29
Gujarat	15.92	35.15
Haryana	18.47	44.72
Karnataka	15.95	20.01
Kerala	18.00	19.87
Madhya Pradesh	23.10	32.10
Maharashtra	**14.74**	**18.60**
Orissa	22.32	30.86
Punjab	14.73	35.73
Rajasthan	17.68	31.23
Tamil Nadu	18.60	27.86
Uttar Pradesh	23.84	38.84
West Bengal	21.64	26.18
Total	**19.16**	**26.63**

Source: Report of the 11th Finance Commission, GoI

Figure 2.15: Annual Growth rate of pension for Maharashtra during 1991-92 to 1998-99



Source: Report of the 11th Finance Commission, GoI

Procurement Schemes

Another source of increase in the committed liabilities was the functioning of cotton monopoly procurement schemes (CMPS) and the government support to the sugar cooperatives. Since 1994-95, CMPS incurred huge financial losses. In the year 1999-00, the amount of loss was Rs. 7.73 billion (World Bank: 2002, p. 58), which was to be financed through budgetary support. This increase in the loss was primarily due to an increase in the procurement price of cotton over the years. In the case of sugar cooperatives, mainly, the liabilities of the state government arose by way of default of guarantees given by the state on loans taken by these cooperatives from various financial institutions. The outstanding government guarantees to the sugar cooperatives was Rs. 33 billion. Unless these market interventions of the government in cotton and sugar are curbed, it would further add to the committed expenditures of the government.

Borrowings

The large stock of debt, much of which was borrowed during the period of high interest rates, had led to steady increase in GoM's interest payments. In 2001-02, interest payments amounted to Rs. 64.14 billion, nearly 21 per cent of revenue receipts. For subsequent years also the interest payments continue to be at 21 per cent. According to a recent report on Maharashtra's finances, the average effective rate of interest on state government borrowings is estimated at nearly 12 per cent per annum.

Given the state government's limited ability to undertake any significant debt restructuring exercise (like retiring high cost debt owed to the central government by raising new debt from the market at a lower interest rate), and with many expensive off-budget borrowings in its portfolio (more than Rs.10 billion was raised by one of the irrigation corporation through seven different bond offerings at an average interest rate of 17.5 per cent), the share of interest payments in total revenue expenditure is not likely to go down in coming years.

Many public sector undertakings (PSUs) in Maharashtra have also raised money in the domestic capital market with 'unconditional and irrevocable' guarantee from the GoM. These borrowings have been kept outside the purview of the budget, as they do not need the approval of the state legislature. The deficit of the GoM does not include the losses incurred by these state undertakings, including the losses of the Cotton Federations and the Sugar Cooperatives, which have grown over time.

The GoM did not engage in any Off-budget Borrowings (OBBs) prior to 1995-96, though it had been issuing guarantees on extra-budgetary borrowing since the 1980s. But now, OBBs have been growing at an average annual rate of 34 per cent between 1997-98 and 2001-02 RE, and they now account for nearly one-fifth of GoM's total liabilities.

Government Guarantees

The guarantees have grown at a breakneck pace of 44 per cent a year. These guaranteed borrowings have generally been used to finance commercial enterprises in co-operative and infrastructure sectors, cover up operating losses of PSUs, and finance their capital investment. Maharashtra had guarantees worth Rs. 549.04 billion outstanding on 31st March 2002. This is 12.77 per cent of GSDP. The structure of guarantee is shown in Table 2.18. The guarantees of various State corporations including statutory boards constitute more than 60 per cent of the total guarantee given by the state government. Though the share of guarantees given to them declined to 55.14 per cent in 1998-99, it started to increase from 1999-00 onwards.

Compared to 34 and 44 per cent growth rate of off-budget borrowings and guarantees, respectively, the corresponding average annual growth rate of budgetary borrowings and nominal GSDP are 19 and 10 per cent, respectively, indicating that the state's borrowing program is clearly on an unsustainable path. Recognising the above problem, White Paper on the State's Finances noted that, "*with the proportion of productive expenditure showing a declining trend, the capacity of the government to service the mounting debt without resorting to even larger borrowing is undermined. The situation has been further compounded in recent years with growing resort to off budget borrowings through bonds floated by state sponsored corporations but with debt servicing (including interest and repayment of principal) being assumed by the state government*" (GoM, 1999).

Special Purpose Vehicles

Several states including Maharashtra have resorted to significant borrowing through the creation of new public corporations, generically called Special Purpose Vehicles (SPVs). Reasons like falling revenues and an increasing wage bill of the GoM prompted creation of these SPVs. Primary objectives of SPVs was to carry out essential capital and infrastructure expenditure.

Table 2.18: Structure of Government Guarantees during 1996-97 to 2000-01 (in per cent)

Item	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**
Corporation including Statutory Boards	62.66	60.86	55.14	59.24	61.35
Government Companies	7.79	9.38	7.22	3.71	3.04
Banks	0.00	0.00	0.00	0.00	0.00
MCs/ Zilla Parishad/ Other Local Bodies	4.04	3.75	3.35	4.23	3.56
Co-operative Banks	13.22	12.92	22.35	17.75	19.57
Co-operative Societies - Sugar Factories	7.05	6.71	5.98	6.41	5.27
Other Co-operative Societies	5.20	6.34	5.92	4.90	3.99
Other Institutions	0.05	0.04	0.04	3.77	3.22
Total	**100**	**100**	**100**	**100**	**100**

Note: Others include government companies, MC and other local bodies and cooperative banks and societies.
Source (Basic Data): Finance Accounts

Some of these were newly created and some were the existing public bodies, like the Maharashtra State Road Development Corporation (MSRDC), the Maharashtra Jeevan Pradhikaran (MJP), the Maharashtra Water Conservation Corporation and the Maharashtra Cooperative Development Corporation. Debt charges - interest and principal - of these SPV borrowing are paid directly from the state budget; therefore, these were part of the government's own borrowings. The State also extended guarantees liberally to these Special Purpose Vehicles (SPVs).

In most cases, the financial returns on the investments fell far short of the interest and amortisation payments due on their borrowings. The current economic slowdown exacerbated the problem. So, there is a possibility that many of the

Box 2.1: Off-budget Borrowings as a means to finance investment

In Maharashtra, the Government has authorised various PSUs in irrigation (Maharashtra Krishna Valley Development Corporation, Tapi Irrigation Development Corporation, Vidarbha Irrigation Development Corporation, Godavari Marathwada Irrigation Development Corporation, Konkan Irrigation Development Corporation), water supply (Maharashtra Jeevan Pradhikaran), roads (Maharashtra State Road Development Corporation) and power (Maharashtra State Electricity Board) to mobilise resources through bonds, which are guaranteed, and in many cases, also serviced by the Government from the budget. The resources thus mobilised are partly used to finance capital outlays in the sectors.

Gross off-budget borrowings (bonds guaranteed and serviced by the state government) in Maharashtra have averaged Rs. 21 billion or 0.9 per cent of GSDP per annum over 1996-97 to 2001-02. Gross guarantees given for bonds (excluding bonds which are serviced by the government) have averaged Rs. 8 billion or 0.4 per cent of GSDP per annum over the same period.

guarantees given to these corporations are invoked in the coming years.

From the public expenditure management point of view, the borrowings by SPVs are not economical. Also the capacity of these SPVs to service debt is virtually nil. In fact, credit-rating agencies have recently downgraded the bonds issued by SPVs in the irrigation sector to categorise them for default of slipping up on interest payments. It is also reported that NABARD had alerted the Maharashtra Government about dues of Rs.7.50 billion lent to Land Development Banks (LDBs); 15 of these LDBs have been under liquidation on account of huge losses.

Subsidies

Reliable estimates of budget based and off-budget subsidies are not available for Maharashtra. However, information from several sources including various sectoral departments indicates that subsidies for public services are growing. According to GoM's own calculation, the subsidies that are administered through the state's budget have increased from Rs. 28.63 billion in 1994-95 to Rs. 48.53 billion in 1998-99. A study by NIPFP finds that the total value of explicit and implicit subsidies taken together is around Rs. 188.27 billion or 7.5 per cent of the GSDP in 1998-99. The study also estimates the share of merit to non-merit subsidy as 50 per cent in social sectors and 33 per cent in economic sectors. The sectors that are major recipients of the subsidy include power, agriculture (cotton, sugar and onion), irrigation, grant-in-aid institutions (particularly education), transport, industry, and food (milk). An estimate of power subsidies show that average retail tariff represents only 87 per cent of the average cost of generation, transmission and distribution. The agricultural customers pay only 26 per cent of the average cost of power supply. An estimate of power subsidy to farmers with pump sets puts the figure at Rs. 9,250 per beneficiary as the subsidy. Given that the average cost of power supply in 2000-01 was Rs. 3.4 per kWh and the recovery from the agricultural sector was Rs. 0.9 per kWh, the subsidy in 2000-01 was Rs. 7.20 billion.

Section – III

Outstanding Liabilities

Composition of outstanding liabilities of Maharashtra over the past three years is given in the Table 2.19. It may be seen that the share of internal debt of the Maharashtra Government has gone up from 12.88 per cent of the total debt at the end of March 2001 to 22.99 per cent at the end of next year. The same had further gone up to 29.17 per cent at the end of March 2003. On the other hand the corresponding share of loans and advances from the Central Government declined from 62.97 to 47.53 per cent during this period. The other two components of total debt though had gone up in absolute terms, but did not change substantially as a ratio of the total debt.

There are some variations in the figures reported in the Economic Survey of the Maharashtra Government 2002-03 and the Budget for 2003-04. Figures reported in the budget document have been underlined in Table 2.19.

Perusal of the above figures suggest that the internal debt of the Maharashtra Government for the year 2001-02 actually declined from the revised estimates by Rs. 54.67 billion and the loans and advances from the Central Government increased by Rs. 46.71 billion, indicating more reliance on the Central loans and advances. The trend continued in the revised estimates for 2002-03 also. For the year

2003-04, the Maharashtra Government had total debt of Rs. 801.49 billion in the budget (Table 2.20).

Table 2.19: Composition of Outstanding Liabilities at the end of March for Maharashtra (Rs. Billion)

Item	2001	2002	2003
Internal Debt	64.82 (12.88)	140.54 (22.99) 85.87	203.65 (29.17) 181.45
Loans and Advances from the Central Government	316.89 (62.97)	323.93 (52.99) 370.64	331.75 (47.53) 375.59
Special Securities issued to NSSF	56.39 (11.2)	75.45 (12.34) 70.74	84.77 (12.14) 75.65
Provident Funds etc.	65.09 (12.93)	71.31 (11.67) 71.43	77.83 (11.15) 78.36
Total Debt	503.19	611.23 598.69	698.00 711.07
Percentage of GSDP	21.1	22.5 22.04	24.1 24.55

Note: Figures in bracket represent ratio of the debt component to the total debt.
Source: Economic Survey of Maharashtra 2002-03 and the Budget for 2003-04

Table 2.20: Debt Position in 2003-04 (Budget estimates) (Rs. Billion)

Items	Receipts	Repayment	Net	Closing Balance
Internal Debt	207.21	136.12	71.09	252.55
Loans and Advances from the Central Govt.	16.87	13.12	3.75	379.35
Special Securities issued to NSSF	22.04	13.79	8.25	83.90
Provident Funds etc.	20.99	13.66	7.33	85.69
Total Debt	**267.11**	**176.70**	**90.41**	**801.49**

Source: Maharashtra Budget, 2003-04

Interest Burden

The expenditure on interest payments, which was Rs. 1.1 billion in 1980-81 increased to Rs. 8.81 billion in 1990-91 and reached to Rs. 52.25 billion in 2000-01. It further increased to Rs. 71.30 billion in 2002-03. The expenditure on interest payments as percentage of revenue receipts was 5.4 in 1980-81. This increased to 10.1 in 1990-91 and reached 17.7 in 2000-01 and 20.2 in 2001-02. In 2002-03 it was 22.9 per cent (Table 2.21 and 2.22).

Table 2.21: Interest payments as percentage of total revenue receipts in Maharashtra

Year	Percentage of revenue receipts
2000-01	17.7
2001-02	20.2
2002-03	22.9

Source: RBI's Study of State Finances.

Table 2.22: Gross and Net Interest Payments of Maharashtra (Rs. Billion)

Year	1999-00	2000-01	2001-02
Gross	48.83 (33.0)	55.84 (14.4)	64.14 (14.9)
Net	31.59 (56.5)	34.51 (9.20)	54.32 (57.4)

Note: Figures in bracket represent percentage variation over the previous year.
Source: Economic Survey of Maharashtra, 2002-03

Market Borrowings

Article 293 of the Constitution enjoins the states to obtain the Centre's approval for borrowing if they are indebted to the centre. The reason for such stipulation is to ensure that the states do not borrow indiscriminately and a hard budget constraint is imposed. But as in the case of other states, and also in the case of Maharashtra, the gross market borrowings have gone up by 40 per cent over the last three years; the net market borrowing went up by 45.7 per cent during the same period (Table 2.23).

Table 2.23: Year-wise Market Borrowings of Maharashtra (Rs. Billion)

Year	Gross	Net
1999-00	7.72	7.01
2000-01	8.09	7.70
2001-02	10.81	10.20

Source: Annual Report of RBI, 2001-02

The maturity profile of these loans for March 2001 and March 2002 is given in Table 2.24.

Table 2.24: Maturity Profile of Maharashtra Government Loans at the end of March (Rs. Billion)

Year	0-5 years	6-10 years	Over 10 years	Total
2001	11.73	38.41	1.89	52.03
2002	15.80	48.51	-	64.32

Source: Annual Report of RBI, 2001-02.

In fact, the repayment of debt by the Maharashtra Government – internal loans, loans and advances from the Central Government, provident fund and other interest-bearing obligations is going to be in the manner given in Table 2.25.

Table 2.25: Repayment of Total debt by the Maharashtra Government at the end of March

(Rs Billion)

Items	2002 Actual	2003 Revised Estimates	2004 Budget Estimates
Internal Debt	126.61	132.95	136.12
Loans and Advances from the Central Government	9.61	11.10	13.12
Reserve Funds	0.33	0.43	0.41
Deposit Bearing Interest	8.13	14.78	13.38
Provident Funds etc.	11.78	12.89	13.67
Total Repayment	156.47	172.15	176.71

Source: Budget of Maharashtra Government, 2003-04

As out of a debt of Rs. 698 billion at the end of March 2003, Rs. 331.76 billion was owed to the Central Government carrying an average interest rate of 11.5 per cent; retiring some of the loans was resorted to as the rate of interest then was not so high. During 2002-03, the Maharashtra Government retired Rs. 11.1 billion of the debt owed to Centre, Rs. 2.68 billion to the FIs and banks and Rs. 5.52 billion of the debt owed to investors in the off budget instruments. Thus, a substantial part of the receipts went towards retiring old and expensive debts. This was done in spite of the fact that Maharashtra remained in the large open market for borrowing, which the Centre arranged through the RBI to retire old and high cost debts.

Debt Relief Recommended by Tenth and Eleventh Finance Commissions

As an incentive for better fiscal management, the Tenth Finance Commission (TFC) designed a scheme linking debt relief to the fiscal performance of a state. The TFC measured improvement of fiscal performance by comparing the ratio of revenue receipts (including devolution and grants from the centre) to total revenue expenditure in a given year with the average of corresponding ratios in the three immediately preceding years. Thus, each State was to be considered against its performance in the past. The TFC recommended that generalised debt relief could take the form of certain percentage of repayment falling due in each of the period of its recommendations being written off. The magnitude of relief with respect to two illustrative figures of percentage relief, namely, 5 per cent and 10 per cent indicated by the TFC can be seen from Table 2.26.

Table 2.26: Debt Relief (Incentive Scheme) to States on repayment of Central loans during 1995-2000

(Rs. Million)

State	Repayment during 1995-00	Stipulated Relief under General Incentive Scheme at	
		5 %	10 %
Maharashtra	**11247**	**562.35**	**1124.7**
A.P	8588.8	429.44	858.88
Tamil Nadu	6234.2	311.71	623.42
Kerala	4631.3	231.57	463.13
Karnataka	5676.8	283.84	567.68
Gujarat	10401.4	520.07	1040.14

Source: Study on management of public expenditure by the State Governments in India, Planning Commission, 2001

Under its terms of reference, the Eleventh Finance Commission (EFC) was required to make as assessment of the debt position of the States as on March, 31, 1999 and suggest corrective measures as were deemed necessary, keeping in view, the long term sustainability for both the Center and the States.

It was for the first time that the phrase "long term sustainability of debt" was included in the terms of reference to a Finance Commission. The EFC looked at the relative position of the states in terms of interest payments to revenue receipts, which included the states' share of Central taxes and grants. Most of the states had ratio of interest payments to revenue receipts ranging from 25 per cent to below 10 per cent. The EFC felt that the scheme of general debt relief linked to the fiscal performance needed to be strengthened. Reasons for that were: a) states should get higher quantum of relief by improving their fiscal performance and b) higher relief would act as incentive for encouraging better performance for determining the quantum of relief. Based on the above, the EFC enhanced the factor of two to five and recommended that the extent of relief should be 25 per cent as against 10 per cent given by TFC.

Sustainability of Public Debt

The build-up of fiscal deficits results in the formation of public debt. Servicing or amortizing public debt requires increased taxation and revenue generation or giving up productive expenditure. High and growing debt/ GDP ratio is anticipated to make the public debt eventually unsustainable in the sense that they tend to increase interest rates, thereby increasing the debt service component of the budget. This, in turn reduces the flexibility of fiscal policy.

Though there is no unique level of public debt, which can be considered unsustainable/sustainable, the judgment on sustainability of debt is to be based on an assessment of the rate of borrowing by the government, the rate of growth of GDP and the rates of interest on government borrowing. The familiar debt-dynamics equation shown below reveals that debt is sustainable as long as real rates of growth of the economy is more than the real rates of interest with a declining primary revenue deficit. When the economy's rate of GDP growth exceeds its interest rate, government could continue borrowing to repay interest, since the relatively high economic growth would reduce the relative size of the debt stock. Thus, the fiscal policy can be considered sustainable so long as the rate of growth of GDP remains above the interest rate. The growth-interest relationship depicted in the debt-dynamic equation may not hold good in the long run. Consider the situation where an economy has a rate of GDP growth equal to or less than its interest rate. If the primary deficit persists over a long run, rising interest payments will increase the need for new debt more rapidly than the relative size of the decline in the outstanding stock of debt in relation to GDP. If this situation continues, the debt-GDP ratio would eventually explode and the fiscal situation would become unsustainable. If the debt level is too high, there is an urgent need to generate primary revenue surplus to arrest the growth of debt-GDP ratio (Shome, 2002).

The debt dynamics equation discussed above is presented below where the interlinkage between government borrowing, rate of growth and interest rate is examined.

$$X_t = X_{t-1} + X_{t-1} * r - P_{st}$$

$$X_t = (1+r) * X_{t-1} - P_{st}$$

$$\frac{X_t}{Y_t} = \frac{(1+r) * X_{t-1}}{Y_t} - \frac{P_{st}}{Y_t}$$

$$\frac{X_t}{Y_t} = \frac{(1+r) * X_{t-1}}{(1+g) * Y_{t-1}} - \frac{P_{st}}{Y_t}$$

In a steady state condition

$$\frac{(1+r)}{(1+g)} = 1$$

$$r - g = \alpha = 0$$

$$X_t = \alpha_t X_{t-1} - P_{st}$$

Where α is the real interest rate (r) less the growth of output (g) (adjustment factor); P_{st} is the non-interest surplus net of seigniorage (seigniorage is the revenue from money creation by the Central Bank of any country); and X_t is the stock of debt.

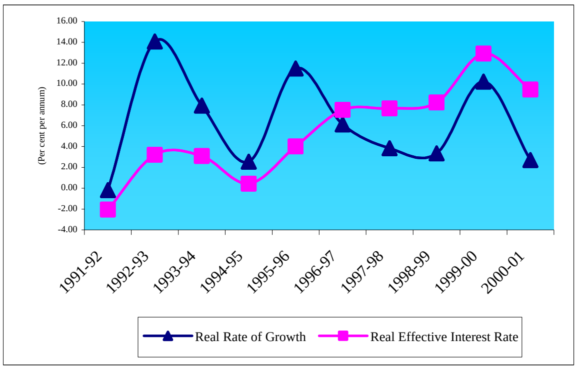
It is to be noted that in India, the state government does not have access to monetisation of deficit and thus there is no provision of seigniorage. Thus P_{st} represents the non-interest surplus. In order to find out the movement of the adjustment factor we plot the real rates of growth and real rates of interest. It is evident from the Figure 2.16 that the real rate of growth of the economy was more than real rates of interest in 1996-97. However, the sustainability condition got violated from 1997-98 onwards and that trend is continued till 2000-01. Violation of debt sustainability condition poses serious threat to the long run fiscal sustainability of the government of Maharashtra, unless corrective fiscal restructuring programme is undertaken.

We can also look at the sustainability criteria in terms of the ability to freeze the debt/GDP ratio. More stringent criteria could be to reduce the debt to zero at a particular future point in time. This would, however, need a highly restrictive fiscal stance, which may not be feasible.

In the literature, the condition that real rate of interest less than or equal to the real rate of economic growth is considered necessary for sustainability, but whether it is also sufficient is a debatable question as it is felt that it does not ensure that the initial stock of debt would be equal to the present discounted value of primary surpluses in the future.

For public debt to be amortised in *n* years it is necessary that the present discounted value of primary surpluses until period *n* be equalised to today's debt. The longer the horizon for the government to stabilise or repay the debt, the smaller is the primary surplus requirement. But the time period *n* cannot be indefinite (Figure 2.16).

Figure 2.16: Debt Sustainability Condition: Movement of Real rate of Growth and Real Rate of Interest



Source: GoM Documents

The Eleventh Finance Commission (EFC) observed that in order to ensure sustainability of debt over a medium-term, the proportion of interest payments to revenue receipts of States including devolution should be about 18 per cent. The EFC, therefore, recommended that the States should keep this as their medium-term objective. Currently, as per the RBI report the proportion of interest payments to revenue receipts is more than 18 per cent in the combined position of all States and individually in many States. Since the public debt to GDP ratio of the States and the Centre combined stands at 63 per cent, the issue of its sustainability becomes relevant. The rationale of debt to GDP ratio can be construed to indicate that, were a country or state to retire its public debt in one step, how much of its GDP would it have to sacrifice. Since that would necessitate extraction of that portion of GDP so required, it should ideally exclude GDP required for subsistence.

The sustainability of public debt is usually discussed in terms of size of the primary deficit, fiscal deficit net of interest payment. Three criteria are tested for the sustainability of Maharashtra's public debt:

a) Debt should be zero at specified future period *n*.
b) Debt to GDP ratio at a future period *n* should be reduced to a specified fraction of today's ratio.
c) Debt to GDP ratio for the future is fixed at today's ratio.

The average interest rate of Maharashtra's public debt during 2002-03 was 10.15 per cent (total interest payment as per the RE of 2002-03 being Rs.72.22 billion on total debt of Rs.711.07 billion). The nominal growth rate of Maharashtra's economy at current prices on the basis of figures available up to 2001-02 was 8.79 per cent, averaged over a period of six years from 1996-97 to 2001-02. The situation worsens for the year 2003-4, if we assume the same growth rate for the economy, and compare that with the estimated interest rate of 10.36 per cent for the year 2003-04. As the nominal growth rate is lower than the nominal interest rate, it may not be possible to accommodate a primary deficit within a sustainable debt. In fact, a primary surplus is essential for a sustainable debt.

A simulation, based on the formula given below, can be attempted reflecting prevailing macroeconomic indicators (Shome, P., 1997). Nominal growth rate of the State economy "g" can be assumed at 9 per cent. Average nominal rate of interest on public debt of the State (defined as interest payment of the State by the public debt) "*i*" can be assumed at 10 per cent.

The tests as stated above could be put in formula for testing as:

a) Debt should be zero at period n at specified interest rates (solvency).

$$PB = \frac{D_t * (1+i)^n}{\sum_{j=1}^{n} (1+i)^{n-j}}$$

PB = primary balance

D_t = public debt

i = interest rate

On the basis of an interest rate of 10 per cent for a time horizon of 15 years, a primary balance of 3.5 per cent of the GSDP (at the latest available estimates for the year 2001-02) would be needed for the present debt size of the state. For the time horizon of 10 years, however, the size of primary surplus would have to increase to 4.3 per cent.

In case the interest rate goes down to 9 per cent, the required size of primary balance for 15 years' time period would be 3.25 per cent of the GSDP at its estimates of 2001-02 and the same for 10 years period would be 4.09 per cent of the GSDP at 2001-02 estimates.

b) Debt/GSDP at period n is a given fraction α of current period (t) debt/ GSDP (stabilising or reducing the debt to income ratio)

$$\frac{PB}{Y_t} = \frac{D_t}{Y_t} * \frac{[(1+i)^n - (1+g)^n * \alpha]}{\sum_{j=1}^{n}(1+i)^{n-j}}$$

Y = GSDP

g = rate of growth of nominal GSDP (Gross State Domestic Product)

In this case, the public debt to GSDP ratio is targeted to be reduced over a specified period of time. Let that the ratio is targeted to be reduced to 40 per cent, i.e. α is 0.40. In this case for a time horizon of 15 years, the State would need 2.24 per cent of the GSDP at interest rate of 10 per cent. At interest rate of 9 per cent and α of 0.60, the primary balance required for time period of 15 years would be 1.3 per cent of the GSDP. Thus, we see that the sustainability criterion is sensitive towards interest rates.

c) Debt/GSDP in future is fixed at today's (t) debt/GSDP (Freeze change in debt to income ratio).

$$\frac{PB}{Y_t} \lesseqgtr \frac{\beta * (i-g)}{(1+g)}$$

Where β is the share of debt in GSDP (D/Y) at time (t-1).

To evaluate if the debt as on March 2004 (on the basis of budget 2003-04) is greater or less than the debt as on March 2003, we may take the effective interest rate at 10.15 per cent and the GSDP growth rate as averaged over the last six years at 8.79 per cent, we find that the debt to GSDP ratio on March 2004 would be less than the debt to GSDP ratio of March 2003. Thus the debts are going down. In this calculation the GSDP has been taken at the 2001-02 value as reported in the budget 2003-04.

Section -IV

Finances of Local Bodies

73rd and 74th Constitutional Amendment related to some fundamental changes in the functioning of local self-governments Panchayat Raj and Urban Local Bodies. It also sought to empower the local self-governments through taxation powers and financial transfers. Constitution of State Finance Commissions to periodically review the financial positions and to make recommendations for resource devolution was mandated. As mandated by the Constitutional Amendment, Eleventh Finance Commission recommended measures to augment the resources of Panchayats and Municipalities. Certain criteria have been made which would form the basis of distribution of grants to the States to meet the requirements of the local bodies.

In Maharashtra, there are 27,832 Villages Panchayats, 33 Zilla Parishads, 224 Municipal Councils, 19 Municipal Corporations and 7 Cantonment Boards. The total income of all the local bodies together during 2001-02 was Rs. 177.82 billion and expenditure was Rs. 157.62 billion. Income during 2002-03 went up by 9.96 per cent to 195.54 billion in 2002-03. Correspondingly, expenditure also went up by 9.21 per cent to 172.14 billion in 2002-03. Table 2.27 gives local body-wise details of such income and expenditure. It can be seen that except for the municipal councils, the other local bodies have shown healthy increase in revenue and commensurate growth in expenditure.

Revenue Mobilisation by the PRIs

Receipts of the PRIs can be classified into four broad categories:

- Tax and fee receipts
- Non-tax receipts
- Borrowings
- Grants in aid and assigned revenues from the Central/ State Governments

Amongst the above sources "Borrowings" is almost non-existent by all three layers of the PRIs. Tax/ fee receipts of the PRIs are major sources of revenue among the own revenue sources of the PRIs. In fact, in future, all the layers of PRIs are expected to rely on these sources. Taxes assigned to each tier of the PRIs can be classified into following four categories:

- Taxes imposed, assessed and collected by the PRIs (e.g. tax on land and buildings by the GPs).
- Fees imposed, assessed and collected by the PRIs (e.g. special water arte imposed by the GPs).
- Taxes imposed by the PRIs but assessed and collected by the State Government (e.g. cess on land revenue apportioned to the ZPs and The PSs).
- Taxes imposed, assessed and recovered by the State Government (e.g. stamp duty charges, which are partially apportioned to the ZPs and GPs).

Table 2.27: Income and Expenditure of Local Bodies in 2001-02 and 2002-03 (Rs. Billion)

Type of Local Body	Number	Income		Expenditure	
		2001-02	2002-03	2001-02	2002-03
Village Panchayat	27832	7.33 (29.9)	7.75 (5.7)	5.29 (32.58)	5.44 (2.83)
Zilla Parishad	33	66.39 (7.6)	66.19 (-0.3)	60.56 (6.94)	60.28 (-0.46)
Municipal Council	224	15.17 (-8.3)	15.60 (2.8)	13.28 (-9.35)	12.79 (-3.83)
Municipal Corporation	19	87.96 (21.9)	104.56 (18.87)	77.64 (17.37)	92.34 (18.93)
Cantonment Board	7	0.98 (13.9)	1.34 (36.73)	0.84 (13.51)	1.22 (45.23)
Total		**177.82 (13.3)**	**195.54 (9.96)**	**157.62 (10.85)**	**172.15 (9.21)**

Note: Figures in the bracket indicate the percentage rise or fall over the last year.

Source: Economic Surveys of Maharashtra, 2001-02, 2002-03, and 2003-04.

Income of the Village Panchayats for the years 2001-02 and 2002-03 are given in Table 2.28. The single major item of own receipts is the receipts by way of taxes/fees. This accounts for about 50 per cent of the total own receipts of the GPs. These tax/fee receipts have been growing at the rate of 17 per cent per annum over the last two years. Major tax/fee items in this group are tax on land and building, water rate, lighting tax and market fees. But there is considerable scope to enhance the receipts of all these taxes/fees by adopting measures such as better valuation of tax bases, improving the recovery performance, enhancement of rates and imposition of at least a minimal set of taxes and fees by every GP. Income of the Zilla Parishads for the years 2001-02 and 2002-03 are given in Table 2.29.

Table 2.28: Income of the Village Panchayats

Item	2001-02		2002-03	
	Actual	% of Total Receipt	Actual	% of Total Receipt
Opening Balance	**1.727**	**-**	**1.931**	**-**
Taxes on houses	1.443	25.8	1.729	29.7
Other taxes	11.104	19.7	1.129	19.4
Total taxes	**2.547**	**45.5**	**2.856**	**49.1**
Government Grants	1.469	26.2	1.503	25.8
Contributions and donations	1.089	19.4	0.911	15.6
Other Receipts	0.497	8.9	0.546	9.4
Total Receipts	**5.603**	**100.0**	**5.819**	**100.0**
Total Income	**7.331**	**-**	**7.75**	**-**

Source: Economic Survey of Maharashtra, 2002-03, 2003-04

Table 2.29: Income of the Zilla Parishads

(Rs. Billion)

Item	2001-02		2002-03	
	Actual	% of Total receipt	Revised Estimates	% of Total receipt
Opening Balance	**3.934**	**-**	**4.571**	**-**
Self-raised Resources	0.924	1.3	1.53	2.5
Purposive Government Grants	24.621	35.3	16.129	26.2
Establishment Grants	17.112	24.5	19.597	31.8
Plan	3.882	5.6	4.408	7.1
Other	8.104	11.6	7.371	12.0
For Agency Schemes	4.024	5.8	3.415	5.5
Total Revenue Receipts	**58.667**	**84.1**	**52.449**	**85.1**
Capital Receipts	**11.090**	**15.9**	**9.173**	**14.9**
Total Receipts	**69.757**	**100.0**	**61.623**	**100.0**
Total Income	**73.691**	**-**	**66.193**	**-**

Source: Economic Surveys of Maharashtra, 2002-03, 2003-04

It can be observed that as regards tax efforts by the PRIs, lowest strata of the PRI is better off than the two upper tiers. It has been further seen that the rates of taxation are low. Therefore, it would be imperative that measures like overall improvement in tax efforts, proper valuation of tax base, increasing the rates of taxation etc. are resorted to. In fact it has been seen that majority of GPs are imposing tax on land and buildings on a flat rate basis. This is not in accordance with the Act. This is primarily due to lack of knowledge on the part of members as well as the Gram Sevaks. Some of the ways and means to enhance receipts could be as follows:

- Impart training and orientation to the GP members and officials.
- Improvement in tax recovery status, particularly in rich GPs.
- Systematising the revaluation of tax base.
- Introduction of slab rates instead of flat rate basis.
- Complete restructuring of the prevailing structure of tax rates as prescribed by the Act.

Studies have suggested that if the measures suggested for the improvement of tax efforts are implemented, the tax receipts can go up by almost two-folds. It can also be seen that the share of own receipts of the ZPs and PSs in their total receipts is almost negligible, generally within 2 per cent to 3 per cent. Even its growth trend is moderate at around 11 per cent. Major contributing factor to these receipts is additional cess on land revenue. A significant growth trend has been observed for this source. Even measures like enhancement of the rates and so on will significantly help to increase the level of receipts from this source. The amount of self-raised resources for Zilla Parishads during 2000-01 was Rs. 1.42 billion, which is less by 30 per cent from Rs. 2.03 billion during 1999-00. This is a matter of concern. In fact, the revenue of ZPs for the year 2000-01 was less by 8 per cent over the previous year 1999-00 and the same has grown only by 1 per cent in 2001-02.

Grants in Aid

Various grants to the Zilla Parishads (ZPs) are Purposive Grant, Establishment Grant, Plan Scheme Grants, Grant for agency schemes and grant for assigned project work. In the total receipts of the ZPs, government grants account for major share. In 1996-97, the share of government grants in total receipts was 90 per cent. The same in subsequent years has gone down (Table 2.30).

Table 2.30: Share of Government Grants in total receipts of Zilla Parishads (as percentage)

Year	Share
1996-97	90
1997-98	83
1998-99	83
1999-00	86
2000-01	84
2001-02	77
2002-03	77

Source: Economic Surveys of Maharashtra

Composition and Trend of the Local Expenditure

As far as the upper two layers of the PRIs are concerned, the total expenditure (revenue as well as capital) incurred by these two bodies are of three different categories - expenditure incurred out of its own resources, expenditure incurred from the various government grants received by them and expenditure incurred on the works assigned to them.

Of the three categories, the expenditures incurred on the assigned works are in a way predetermined and hence are not dependent on resource generation capacity and efforts of the PRIs. Corresponding funds are transferred for the work. Work on grants also have the same nature, except that for expenditure out of incentive grants the PRIs can choose their priorities. For the expenses out of the own resources of the PRIs, the choice and priority is set by the PRI itself.

Table 2.31: Expenditure of the Village Panchayats

(Rs. Billion)

Item	2000-01	2001-02	2002-03
Administration	0.678	1.027	1.027
Health and Sanitation	1.073	1.461	1.482
Public Works	1.343	1.778	1.852
Public Lighting	0.235	0.324	0.298
Education	0.06	0.087	0.142
Welfare of people	0.318	0.395	0.455
Other Expenditure	0.287	0.223	0.188
Total Expenditure	**3.993**	**5.294**	**5.444**

Source: Economic Surveys of Maharashtra.

An analysis of the expenditure pattern suggests that 80 per cent of the expenditure is in the nature of revenue and the balance, capital. But such distinctions are not always very sharp.

In the case of Gram Panchayats, major expenditures are on public works (roads, buildings), health and sanitation (including water supply) and General administration (Table 2.31). Last few years have shown a clear trend towards growth in the expenditure by the PRIs as compared to their receipts. These expenditures are more in the nature of "revenue". In fact "capital" expenditure has shown a consistent decline for ZPs and PSs. This is a cause of concern (Table 2.32).

Table 2.32: Expenditure of the Zilla Parishads

(In Rs. Billion)

Item	2000-01 Actual	2001-02 Actual	2002-03 RE
General Administration	4.657	4.699	3.831
Agriculture	0.673	0.695	0.615
Animal Husbandry	0.618	0.666	0.619
Forests	0.072	0.050	0.045
Irrigation	1.290	1.428	1.331
Public Works	4.116	3.416	3.213
Community Development	1.146	1.159	1.375
Education	26.30	31.407	23.539
Medical and Health Services	3.72	3.87	3.582
Public Health Engineering	2.048	1.72	1.547
Social Welfare	1.023	1.94	2.601
Other Expenditure	7.703	7.355	9.215
Total Revenue Expenditure	53.37	58.41	51.513
Capital Expenditure	7.475	10.347	8.772
Total Expenditure	**60.85**	**68.757**	**60.285**

Source: Economic Surveys of Maharashtra, 2002-03

Urban Local Bodies

There is much heterogeneity among the Urban Local Bodies (ULBs) in Maharashtra. Unlike other states, where all the ULBs are governed by a uniform Act, ULBs in Maharashtra are governed by four Acts. The official categorization of ULBs is as under:

Municipal Corporations have population above 3,00,000 while A class Municipal Councils, B class Municipal Councils and C class Municipal Councils have population ranging between 1,00,000 – 3,00,000, 40,001 – 1,00,000 and 25,001 – 40,000, respectively.

The number of Municipal Corporations in the State was 19 till 2001-02; 224 Municipal Councils and 7 Cantonment Boards. Of the 224 Municipal Councils, 21 were in A class (population of more than one hundred thousand) and 62 in B class (population of less than one hundred thousand but more than 40,000) and the balance 141 in C class (population of less than 40,000).

Income of Municipal Corporations

Revenues of ULBs can be broadly classified as revenue from own sources and those from external sources, such as grants from the state and loans. Own sources of revenue can be further categorised under tax revenues and non-tax revenues.

Following salient points emerge from Table 2.33:

a) Grants from the state government as a ratio of total income have hovered around 5 per cent between 1995-96 and 1999-00.

b) Share of loans in total income was 4.75 per cent in 1995-96. This has steadily risen to 11.73 per cent in 1999-00.

c) Share of octroi in the own income has been the highest among all income items. But it has registered a decline from 50.98 per cent in 1995-96 to 47.72 per cent in 19999-00.

d) Share of property tax has gone up in the own income during the period, from 17.91 per cent in 1995-96 to 21.15 per cent in 1999-00.

The percentage of own income in the total income has shown a declining trend, which is disturbing. Growth rates of the income items is given in the Table 2.34. From this table, we can see that

a) The loans and grants from state government have been inconsistent.

b) Income from own sources is declining steadily.

c) Water rates, property taxes have grown above the inflation, but since significant contribution may have come from expanding supply, it may not be possible to estimate whether recovery proportions improved.

Table 2.33: Share of 'Income Items' to all 'Income' of all 15 MCs

(per cent of total)

Items	1995-96	1996-97	1997-98	1998-99	1999-00
Grants from State Govt./ total income	5.09	5.21	4.76	4.80	4.92
Loans/ total income	4.75	5.91	6.99	9.83	11.73
Octroi/ own income	50.98	49.37	47.79	46.96	47.72
Property tax/ own income	17.91	19.17	20.81	21.29	21.15
Water charges/ own income	10.86	13.20	14.55	13.67	13.43
Conservancy and sanitation/ own income	0.59	0.65	0.66	0.62	0.67
License fees and entertainment/ own income	0.77	0.65	0.63	0.62	0.74
Building Rents/ own income	0.59	0.49	0.51	0.51	0.49
Own Income/ Total Income	90.16	88.87	88.25	85.37	83.35

Source: India Infrastructure Report, 2003

Table 2.34: Growth Rate of 'Income Items' to 'Income' of all 15 MCs (per cent per annum)

Items	1996-97	1997-98	1998-99	1999-00
Grants from the State Government	20.83	3.48	18.45	17.48
Loans	46.61	33.89	65.50	37.01
Octroi	12.51	8.93	11.74	14.00
Property Tax	24.35	22.19	16.34	11.41
Water Charges	41.19	24.04	6.87	10.17
Conservancy and Sanitation	26.88	15.32	5.78	22.22
Street Lights	-	-	-	-
License Fees and Entertainment	-1.62	9.81	10.72	34.59
Building Rents	-3.13	17.48	13.38	8.48
Other Income	4.60	2.78	23.45	8.50
Total Income from Own Sources	16.18	12.54	13.71	12.18
Grand Total Income from all Sources	17.86	13.33	17.56	14.89

Source: India Infrastructure Report, 2003

Further analysis reveals that smaller MCs rely for their revenue generation on octroi. The water charges do not show a healthy trend towards recovery. The smaller MCs need to take steps for widening the source base, and also for improving the recoveries.

Taxation and Levy Powers

Article 243X of the Constitution, inserted after the 74th Constitutional Amendment, envisages that the states would devolve additional taxation powers to the ULBs so as to make them financially competent for discharging the added functional responsibilities, mandated under the Article 243W. But in Maharashtra, no such devolution of taxation powers has taken place. Instead, taxation powers of small ULBs on octroi were withdrawn in March 1999. The taxation powers of the ULBs are limited to its traditional sphere and have not gone beyond various existing provisions.

Municipal Corporations in Maharashtra levy property tax as a percentage of "annual rateable value" of the property, and ceilings for such percentages are laid down in different Acts of the state. These are summarised in Table 2.35.

Table 2.35: Rates of Property tax (as percentage of Value) in Municipal Corporations of Maharashtra

Components of Property Tax	BMC Act	NMC Act	BPMC Act
General Tax	26	12-13	Max. 12
Fire Brigade Tax	4	1	Max. 12
Water Tax	65	10-15	Autonomy to ULB
Water Benefit Tax	12.5	-	Autonomy to ULB
Sewerage Tax	39	12	Autonomy to ULB
Sewerage Benefit Tax	7.5	-	Autonomy to ULB
Education Tax	12	2-12	Up to 5
Street Tax	15	-	Max 10

It can be seen that BMC has no autonomy regarding the components and rate for each component of the tax, while Nagpur has limited autonomy. All other MCs have autonomy regarding the rate of tax in case of components related to water supply and sewerage only. However, there is no freedom to any MC regarding inclusion of any new component or changing the tax base to some other, say, area.

The external sources of revenues for the ULBs are grants from the state. There are about 30 types of grants. All these grants are purposive in nature and not untied. Many of these grants (octroi, profession tax, pilgrim, road etc.) are also compensatory in nature. These grants are given subsequent to withdrawal of respective taxation powers of the ULBs, indicating centralising tendencies of the state. The distributive principles are not uniform. Generally, smaller classes of ULBs get grants higher than the ratio of their collections or expenditure.

Expenditure of Municipal Corporations

The Eleventh Finance Commission (EFC) defined core services as being inclusive of water, streetlights, roads and sanitation. Expenditure of all corporations on these core services as ratio of total expenditure was 35.87 per cent in 1995-96. A very gradual increasing trend is noticed with the exception of 0.1 percentage point reduction in 1998-99. In 1999-00 the ratio stood at 39.18 per cent.

But the EFC defined core services does not have economic connotation. A more appropriate concept will be of local public goods. The local public goods share the characteristic of non-excludability with public goods. In this definition, water, as it can be metered and charged, is excluded but fire brigade is included. In 1995-96, the proportion of expenditure on these services was 24.14 per cent and in 1999–00, the ratio stood at 25.7 per cent. But if the local public goods were to be extended to include education, sanitation, fire brigade, water, roads and street lighting, the ratio of expenditure on these items was 46.02 per cent in 1995-96, and increased to 48.65 per cent in 1999-00. Table 2.36 gives a comparative picture of the growth rates of certain expenditure heads.

Table 2.36: Growth rate of certain expenditure heads (per cent per annum) in the MCs of Maharashtra

Item	1996-97	1997-98	1998-99	1999-00
General Administration, Salaries, Pension etc	14.05	19.04	11.92	14.69
Education, Libraries	15.53	12.64	2.40	24.52
Sanitation, Solid waste Management	46.04	12.01	8.19	18.20
Fire Brigade	3.50	27.89	-3.97	38.50
Water Supply	28.34	20.46	22.60	10.88
Epidemics and Public Health	15.33	18.66	11.15	16.28
Roads	23.86	14.66	22.51	8.51
Street Lighting	27.27	2.66	19.37	8.59
Total Expenditure	23.40	14.28	17.46	11.37

Source: India Infrastructure Report, 2003

Municipal Bonds

Decentralisation initiative, following the 74th Constitutional Amendment, has increased the responsibilities of the municipal bodies, but commensurate measures to improve the finances are yet to be put in place. One such measure for mobilization of resources, though nascent in India so far, is the municipal bonds. Two municipal bodies in Maharashtra, Nashik and Nagpur, have issued municipal bonds. The instruments issued by these municipal bodies were through private placements. Commercial banks, regional rural banks, provident funds, public enterprises, cooperative banks, and domestic financial institutions mainly subscribed to the issues. The revenue sources escrowed were octroi, property tax and water charges.

The Nashik Municipal Corporation issued Rs. 1 billion secured, redeemable, non-convertible bonds with AA - (SO) rating from CRISIL in 1999. The bonds had a coupon of 14.75 per cent per annum payable semi-annually. Nagpur Municipal Corporation received LAA -(SO) rating from the Indian Credit Rating Agency (ICRA). It went in for private placement of secured, redeemable, non-convertible bonds, worth Rs. 500 million, with coupon rate of 13 per cent per annum payable semi-annually.

Normally municipal bonds (so far only nine of them in the country) are traded in the primary market, but municipal bonds of Nashik Municipal Corporation were traded in the secondary market also. As on March 2001, about 8.81 per cent of the total bonds were traded on the secondary market among 60 investors.

Though resource mobilisation by municipal bodies is needed for development of urban infrastructure, it is predicated on improvement in revenue collection. But as the property tax, one of the major tax instruments is calculated on Annual Rental Value (ARV), which is the rent that would be paid by a hypothetical tenant to a hypothetical landlord for property use, efforts are made by the tax payers to keep the rental values artificially low, taking cover of the Rent Control Act (RCA). Thus, though the true market value of the property can be increasing, the yield from the property tax does not rise. Besides, the assessment of the properties which are not covered by the RCA are highly subjective, leading to contests in the courts and so, long delays in collection of taxes.

Revenue-generating capacity of municipal bodies is low. Average of the grants received from the state out of its revenue receipts during 1995-96 to 1998-99 was 1.27 per cent. Besides the growth rates for octroi, in overall, income indicates diminishing trend; this is more prominent for the smaller MCs, as they are more dependent on octroi. In the above background, significant steps need to be taken in case the ULBs see an opportunity in placing the municipal bonds for developing urban infrastructure. But factors such as lack of active secondary market for municipal bonds, lack of investor appetite for long-term paper, stiff competition from other financial securities, difficulties in rating municipal bodies and high cost of issuing bonds are some constraints in developing a municipal bond market.

In addition to the above constraints, the municipal bodies also need to remove an important constraint of replacing an outdated budgeting and accounting system. The municipal bodies in India use cash accounting system. This system of accounting does not capture information about the asset-liability profile of the municipality and the efficiency of a municipal body. These are critical considerations for investors and credit rating agencies so as to take an informed decision about the risk-return profile of the municipal body. The municipal bodies also lack a capital budgeting system.

Section -V

Fiscal situation of Maharashtra: Towards MTFF

Maharashtra's fiscal situation as analysed indicates that if the GoM does not undertake any significant fiscal reforms, and the underlying revenue and expenditure items exhibit the same trends as in the past, the current fiscal situation may become unsustainable. The state is already experiencing liquidity problems of unprecedented magnitude and is not able to cope with high level of debt and deficits. It is not that the GoM has been slow in understanding the nature of the problem or in recognizing the corrective course of action. In fact it can be recalled that the GoM had brought out a White Paper on the State's finances in October 1999, which was presented and discussed in the State Legislature. The paper noted, "…*Maharashtra's finances have been showing widening imbalances, with rising revenue and fiscal deficits. This has led to mounting debt and consequently galloping interest burdens, thus feeding a vicious circle of even larger revenue and fiscal deficits because expenditures have shown no sign of containment.*" Despite the above realization, coalition politics and the coalition government in Maharashtra in recent years relied on populist agenda. This style of polity gave an unfocussed approach to key elements of institutional and policy reform such as restructuring of power sector, reduction in subsidy, reform in the Grant-in-Aid (GIA) institutions, restructuring of the PSUs, controlling guarantees and co-operative institutions, reduction in off-budget borrowings, reform in the civil service, etc.

Realising the above constraints, a vision document of fiscal reform program was prepared some time ago. This document known as Medium Term Fiscal Framework (MTFF) intended to provide a coherent quantitative statement of the government's three to five-year fiscal strategy. It defined a path towards fiscal sustainability and set targets for broad fiscal indicators in the medium-term. It was expected to provide stability and predictability to fiscal policy setting, and greater transparency and accountability in the budget making process. It was a vehicle through which a particular fiscal trajectory could be charted to enunciate a medium term development priorities, the role the government could take in shaping the economy and improving the institutional capacity.

The MTFF recommended: (i) improving efficiency in the revenue collection mechanism and processes; (ii) containing expenditure to generate budgetary surpluses; (iii) restructuring the role of the government by reducing involvement in a variety of activities; and (iv) building institutions with stakeholder participation to make the reform process durable.

Given the above scenario, a projection of the future fiscal profile of the Government of Maharashtra has been drawn. In order to arrive at the alternative fiscal projections we construct two fiscal scenarios, viz., base scenario and reform scenario based on various assumptions on the key fiscal parameters.

Base Scenario

The base scenario is arrived by assigning alternative parameter values to the key fiscal aggregates. Objective of the base scenario is to arrive at a medium term fiscal projection based on the assumptions that satisfy the past fiscal profile. In other words, the objective is to understand if the current fiscal situation is allowed to continue, what will be the likely fiscal situation in the medium term. In this scenario, key fiscal variables are allowed to grow on the basis of their trend rates of growth during the 1990s. The key assumptions of the base scenario are given in Box 2.2.

Based on these assumptions, we arrive at a fiscal profile of the state for the period between 2003-04 and 2009-10. It is to be noted that the base year considered for the projection is 2002-03, revised estimates. The study consciously avoided 2003-04, budget estimates for the base year of projection

Box 2.2: Assumptions of Base Scenario

Receipts Side

Own Tax Revenues: Each tax at the state level are allowed to grow at buoyancy-based growth rates respective to each taxes on the basis of their historical buoyancies.

Non-Tax Revenues: Total non-tax revenue is decomposed into two components, viz., interest earnings and the rest. The future stream of interest earning on loans and advances is estimated by estimating the profile of loans and advances and assigning a rate of interest estimated for the year 1999-00, which is 12. 98 per cent.

Share in Central Taxes and Grants: The central tax devolution and grants are assumed to grow at the rate of their historical trend growth rates of 9.2 per cent and 5.82 per cent respectively for the period between 1990-91 and 2001-02.

Expenditure Side

Interest Payment is allowed to grow at its effective rates of interest assigning to the stock of previous year's stock of outstanding debt.

Pension, administrative service and other general services are allowed to grow at their respective trend growth rates.

In social services and also in economic services are allowed to grow at their respective trend growth rates.

Capital outlay and loans and advances are also assumed to grow at their respective trend rates of growth.

because there is always a problem of fiscal marksmanship (fiscal marksmanship is a tool to analyse the deviation of estimated budgetary aggregates from the actuals). It is generally noted that - 'revised budgetary estimates' are closer to the actual. Thus, a reliable and meaningful projection can be undertaken if the 2002-03 revised estimates are considered as base year instead of 2003-04 budget estimates as the base year of projection. In both base and reform scenario, the State GSDP is assumed to grow at the rate of 15.28 per cent. This is the nominal rate of growth of GSDP observed for the period between 1990-91 and 1999-00.

Based on the above assumptions, we arrive at the movement of key fiscal parameters which will enable us to give assess whether the current fiscal policy stance, if allowed to continue, will generate a sustainable debt and deficit regime. The key fiscal parameters projected are given in Table 2.37. It is evident from this Table that without any fiscal correction, the revenue deficit will increase from 2.06 per cent of GSDP in 2002-03 to 4.44 per cent in 2009-10.

The fiscal deficit will also increase from 3.64 per cent to 5.80 per cent during the same period and consequently the outstanding debt from 19.23 per cent 30.11 per cent of GSDP. In other words, the result also indicates that if the fiscal situation is allowed to persist without any fiscal correction, there will be a sharp rise in the fiscal and revenue deficit and outstanding debt which in turn will increase the interest payment of the government from 2.05 per cent of GSDP in 2002-03 to 3.57 per cent of GSDP in 2009-10. Movements of all the key fiscal indicators projected reflect that current fiscal situation is unsustainable.

Reform Scenario

As the current fiscal policy stance is unsustainable reflected in the base scenario, a fiscal correction is a must to achieve a sustainable fiscal policy regime. The reform scenario built in this paper accommodates these corrections and arrives at a sustainable fiscal regime. The fiscal corrections incorporated in the reform scenario are presented in Box 2.3. The fiscal correction as suggested in this Box, once incorporated in the base scenario, the fiscal situation improves significantly. In the reform scenario, revenue deficit as a percentage of GSDP declines from 1.77 per cent in 2003-04 and gets eliminated by the end of 2009-10 (Table 2.38).

Table 2.37: Emerging Fiscal Profile (Base Scenario)

(Per cent to GSD)

Item	2001-02	2002-03 RE	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenue Deficit	2.55	2.06	2.62	2.67	2.99	3.33	3.68	4.05	4.44
Fiscal Deficit	3.38	3.64	4.17	4.19	4.48	4.79	5.11	5.45	5.80
Primary Deficit	1.34	1.64	1.72	1.79	1.87	1.96	2.04	2.14	2.23
Interest Payment	2.05	1.99	2.45	2.39	2.61	2.84	3.07	3.32	3.57
Outstanding Debt	18.66	19.23	18.80	20.49	22.26	24.10	26.02	28.02	30.11

Source: Finance and Accounts and Budget Document, GoM, 2003-04

Box 2.3: Assumptions of Reform Scenario

Receipt Side

Own Tax Revenues: Own tax revenues are assumed to show improved aggregate buoyancy of 1.268 by assigning prescriptive to sales tax and other taxes.

Non-Tax Revenues: The targeted increase in the non-tax revenues is assumed to be from 1.28 per cent of GSDP to 2 per cent of GSDP between 2002-03 and 2009-10.

Share in Central Taxes and Grants: In the case of reform scenario also, the central tax devolution and grants are assumed to grow at the rate of their historical trend growth rates of 9.2 per cent and 5.82 per cent respectively for the period between 1990-91 and 2001-02.

Expenditure Side

A lower interest rate structure is assumed with an effective rate of interest of 9 per cent per annum. This is possible as the interest rates are falling and the states have been given to swap the high cost debts for low cost debts.

The reduction in interest payment and a decline in the expenditure under 'other general services' make a compression of expenditure under general services.

Release of resources, thus reallocated to two basic sectors, viz., health and family welfare, and water supply, sanitation, housing and urban development.

Already declining share of 'economic services' in total revenue expenditure is allowed to continue.

Capital expenditure is assumed to increase from 1.72 per cent of GSDP in 2002-03 to 2.52 per cent.

Revenue deficit is expected to become zero and fiscal deficit is targeted to reduce to 2.25 per cent of GSDP by the end of the projection period.

The fiscal deficit also declines from 3.44 per cent of GSDP to 2.25 per cent during the same period. The burden of interest payment unlike base scenario increases marginally from 1.50 per cent of GSDP in 2003-04 to 1.56 per cent in 2009-10. Movement of outstanding debt behaves in a cyclical fashion with an initial increase up to 2006-07 and then shows a trend of decline. A comparison of the key fiscal profile, viz., fiscal deficit, revenue deficit, primary deficit and outstanding debt in the base and reform scenarios is given in the Figures 2.17, 2.18, 2.19 and 2.20.

Figure 2.17: Revenue Deficit - Base Scenario and Reform Scenario

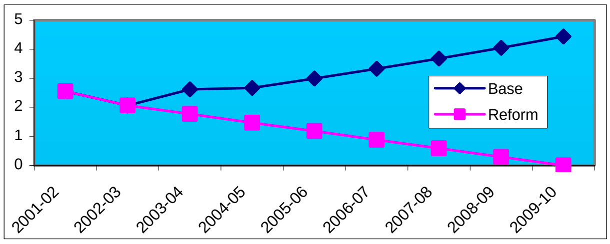


Figure 2.18: Fiscal Deficit - Base Scenario and Reform Scenario

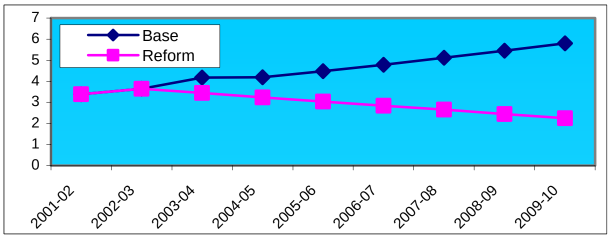


Figure 2.19: Primary Deficit - Base Scenario and Reform Scenario

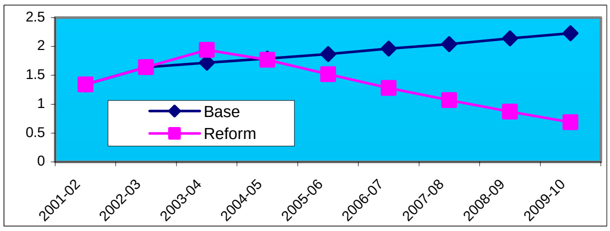
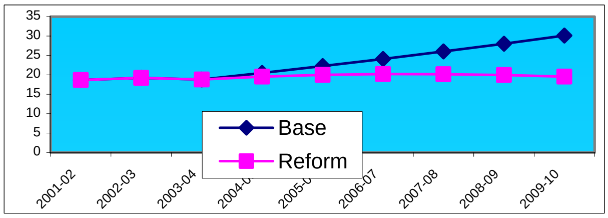


Figure 2.20: Outstanding Debt - Base Scenario and Reform Scenario



The reform scenario, apart form targeting debt and deficit also ensures a restructuring of government expenditure away from general services to social services especially health and family welfare and water supply and sanitation and housing and urban development. It is to be noted from the Table 2.38 that in the case of base scenario, expenditure

Table 2.38: Emerging Fiscal Profile (Reform Scenario)

(Per cent to GSDP)

Item	2001-02	2002-03 RE	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenue Deficit	2.55	2.06	1.77	1.47	1.18	0.88	0.59	0.29	0.00
Fiscal Deficit	3.38	3.64	3.44	3.24	3.04	2.84	2.65	2.45	2.25
Primary Deficit	1.34	1.64	1.94	1.77	1.52	1.28	1.07	0.87	0.69
Interest Payment	2.05	1.99	1.50	1.47	1.53	1.56	1.58	1.57	1.56
Outstanding Debt	18.66	19.23	18.80	19.55	20.00	20.19	20.16	19.94	19.55

Source: Finance and Accounts and Budget Documents, GoM, 2003-04 on health and family welfare declines from 0.56 per cent of GSDP in 2001-02 to 0.42 per cent in 2009-10. However, in the case of reform scenario, its share increases from 0.56 per cent in 2001-02 to 1 per cent and similarly the share of water supply also increased under the reform scenario (Table 2.39).

The above findings indicate that finances of Maharashtra broadly follow the nature of a fiscal crisis. Reasons for the problems are steady decline in the revenue mobilisation and rapid increase in the expenditure in the late 1990s. Reason for the increase in expenditure was upsurge in various committed liabilities. Decline in receipts, apart from poor own tax and non-tax revenue, was also due to steady decline in the central transfers Implementation of recent pay revisions accentuated the problems of fiscal imbalance.

On the basis of the above analysis, this study recommends three major areas of reforms –

- Enhanced resource mobilisation effort,
- Expenditure restructuring and
- Interest cost minimising debt management policy.

Enhanced Resource Mobilisation Effort

Resource mobilisation effort has to concentrate on both own tax and non-tax revenues. The own tax revenue, which had aggregate buoyancy (with respect to both agricultural and non-agricultural GSDP) of less than one during the 1990s, requires sufficient enhancement. The reform scenario constructed in this study puts an aggregate buoyancy of 1.268 for own tax revenues. The increase in buoyancy is expected to come mainly from the sales taxes (with a prescriptive buoyancy of 1.33), electricity duty and motor vehicle taxes. As already stated in Section – I of this Chapter, tax reforms should be in the areas of tax policy and tax administration. Introduction of sate-level VAT from 1st April 2005 would reduce the problems of double taxation of commodities and multiplicity of taxes, resulting in cascading tax burden. The present system of exemptions and concessions complicates tax administration and involves loss of revenue. VAT would have wider base with multi-point taxation and a moderate rate. Since tax in the VAT system would be collected at all stages of production and trade, artificial manipulation with the tax base would be prevented, ensuring better compliance. But this new system should also accompany a better tax administration. The present system should be revamped to have an improved computerisation, with facility to prepare a large database and its retrieval system, so that audit can be done on the basis of third party information system. Since the state contributes 15 per cent of services output of the country, it should try and bring the service sector within the tax net in coordination with the Centre. Chelliah et al (2001) had suggested that state can also tax on its own a few services, namely, entertainments, carriage of goods and passengers by roads and inland waterways, and some identified luxury services.

With regard to the non-tax revenues, the recoveries for all non-merit services assume critical

Table 2.39: Increase in the Share of Selected Services: A Comparison

(As a per cent of GSDP)

Item	2001-02	2002-03 RE	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Base Scenario									
Health and Family Welfare	0.56	0.50	0.49	0.48	0.46	0.45	0.44	0.43	0.42
Water Supply, Sanitation, housing	0.31	0.58	0.58	0.58	0.58	0.58	0.57	0.57	0.57
Reform Scenario									
Health and Family Welfare	0.56	0.50	0.57	0.64	0.71	0.79	0.86	0.93	1.00
Water Supply, Sanitation, housing	0.31	0.58	0.64	0.70	0.76	0.82	0.88	0.94	1.00

Source: Finance and Accounts and Budget Documents, GoM, 2003-04 importance. Corresponding user charges for these non-merit services provided by the government should be linked to the cost. For merit goods, such as primary education and basic health care facilities, this norm may not be applied. There is also sufficient scope for increasing the earnings in the form of interest, dividends and profits. The government must bring out a proper disinvestments policy for withdrawing from the sectors, which can be considered to be non-core areas. Proceeds of such disinvestments can be used to finance the high cost debts by introducing large-scale debt swap.

Expenditure Restructuring and Debt Management Policy

On the expenditure side, any reform is more difficult due to the steady increase in the share of committed liabilities like interest payment, pension and salaries and wages. But any reform would have to involve expenditure reduction also. One way of reducing the salary payments is to go for reduction of the number of state government employees. It can be suggested that the reduction in numbers can be 2 per cent per annum. This is so because average natural attrition rate is 2.8 per cent per annum. But such reduction should not be such as to affect critical service delivery. The state will have to device means of identifying slack and develop alternative means of ensuring service delivery. But this reduction should not be by way of transferring employees to GIAs.

Pension has also been a worrisome expenditure. Arresting the growth of pension would not be an easy task. New initiatives in this regard should be taken which can be in terms of introduction of 'Funded Pension Schemes' for the new employees. Though the government has already taken an initiative on this, a long-term pension policy can also be considered taking into account the hidden pension liability and take appropriate policy steps for its reduction.

Rapid reduction in the debt-servicing obligation both by reducing the fiscal deficit and also by a reduction in the cost of debt servicing is another area of focus. In the prevailing low interest rate regime, an active debt management policy should try to alter the high cost debt structure to low cost through large scale retiring of expensive debt introducing debt swapping. As mentioned, in the reform scenario, the fiscal deficit as a percentage of GSDP is expected to reduce from 3.64 per cent in 2002-03 (RE) to 2.25 per cent in 2009-10. This would largely depend on the reduction in the effective rate of interest to 9 per cent during this period. It should also be noted that the effective rates of interest in Maharashtra government's outstanding debt is much higher than that of all state effective rates of interest. In other words, Maharashtra has relatively high cost debt structure compared to other states.

In order to achieve the targeted reduction of fiscal deficit during the medium term suggested by the reform scenario, expenditure compression is essential along with higher revenue mobilisation. But such expenditure reduction should not hamper the productive capital expenditure of the economy and that is only possible if the resources can be released through reduction in revenue deficit.

The debt management policy should examine the reasons for the high effective rates of interest of the Maharashtra Government and undertake steps to alter the debt structure towards low cost debt so that effective rates of interest comes down. As mentioned, this task is relatively less difficult in the context of current low interest rate regime if a debt swapping can be undertaken.

One of the major reasons for the very high effective rates of interest in Maharashtra is the transfer of debt servicing liabilities of very high cost government debt in the form of government guarantee given to various state level public sector units. It was seen that state public sector enterprises had an increasing interface with the budget of the government. It may be reiterated that these organisations are to provide functions on commercial lines, and so should provide adequate return on capital invested. But actual performances of these public sector enterprises have been far from being satisfactory. These public sector enterprises have been drain on the government finances. Government has to undertake an assessment of their role. Key areas for such assessment or appraisal would be:

a) Goods or services pricing rationalisation to ensure financial viability of the enterprises;
b) Explicit and transparent subsides from the budget to the enterprises in case goods or service provisioning are at reduced rates;

c) Assessment for closing down or liquidation of sick undertakings with adequate measures to enhance skills and capacities of employees;

d) Procedures to ensure that decisions for additional government investment are based on sound economic criteria.

On this issue of contingent liabilities management, as we have seen large number of guarantees being given by Maharashtra Government, it is suggested that rationale for extending guarantees should be carefully examined and underlying risks documented. Some states have introduced legislation to curb the growth of guarantees. Such limits will also be an appropriate step for Maharashtra.

In the above context we can also recall that the Eleventh Finance Commission had set up an incentive fund, called Fiscal Reform Facility. Under this Facility the states were to achieve a minimum improvement of 5 per cent in the revenue deficit as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-00. Maharashtra's performance in this respect can be stated to be improving now, though there was deterioration in its performance when the Facility started. But it still has along way to go. In nutshell we can suggest the following to be the medium term framework of its reforms programme:

- Adoption of VAT
- Computerisation of the tax department, setting up a database for collation and quick retrieval of tax data
- Improving tax administration and introducing tax audit on the basis of third party information
- Increasing the recovery rates for non-merit services provided by the state government
- Full computerisation of treasuries for better expenditure management and debt management
- Better cash management and eliminating access to overdrafts from RBI
- Mandatory financial viability analysis of every project – ongoing and new
- Formulating expenditure ceilings for each agency
- Identifying high risk programmes including contingent liabilities
- Identifying programmes and projects that can be considered for scaling down or closing down
- Streamlining pensions and considering reduction in employees numbers without compromising on the service delivery which are critical to the functions of the state

Maharashtra has been a key state with high infrastructure and human development indices. It has potential for higher growth rate, provided urgent measures are taken to correct the fiscal imbalance. This would need a medium term framework, strict compliance and discipline towards this framework, economies in expenditure through rationalisation measures, and improved delivery of services through decentralised decision-making. These measure would put in place a growth oriented fiscal policy that would help it achieve a sustainable fiscal regime in the medium term.