Chapter 11

Fiscal Reform Facility

11.1 Para 8 of our terms of reference requires us to "review the Fiscal Reform Facility introduced by the Central government on the basis of the recommendations of the Eleventh Finance Commission, and suggest measures for effective achievement of its objectives".

Background

11.2 As a part of its additional term of reference, which was notified on April 28, 2000, the Eleventh Finance Commission (EFC) was asked to draw a monitorable fiscal reform programme aimed at reduction of revenue deficit of the states and recommend the manner in which the grants to the states to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme. In its interim report submitted in January 2000, the EFC had recommended a lumpsum provision of Rs. 11000 crore in the central budget 2000-01 for revenue deficit grants to states. Thereafter, in its main report submitted in July 2000, the EFC recommended a revenue deficit grant of Rs. 35359 crore during 2000-2005 for 15 states. The remaining 10 states were assessed to be in revenue surplus.

11.3 With regard to the mandate assigned through the April, 2000 notification, the EFC submitted a supplementary report on 30th August, 2000. Although only 15 states were assessed to be in revenue deficit and consequently, the fiscal reforms programme could have covered these states, the majority view in the EFC favoured making fiscal performance based grants available to all (then 25) states through an incentive fund. The incentive fund was recommended to be set up in two parts, one by withholding 15 per cent of the Rs. 35359 crore deficit grants for 15 states and the other, by an equal matching contribution by government of India, with year-wise phasing as shown in Table 11.1.

Table 11.1

Composition of the Incentive Fund

(Rs. in crore)

Year	Withheld Portion of the Revenue Deficit Grants	Contribution of the Centre	Total Fund
2000-01	1523.06	598.48	2121.54
2001-02	1080.43	1041.11	2121.54
2002-03	994.64	1126.91	2121.55
2003-04	861.74	1259.81	2121.55
2004-05	843.99	1277.55	2121.54
Total	**5303.86**	**5303.86**	**10607.72**

11.4 In view of the overall objective of bringing down the revenue deficit of all states at the aggregate level to zero by 2004-05, the EFC identified five indicators as a measure of the fiscal performance of the states and recommended weights for each, as indicated below :

S.No.	Indicator	Weight (per cent)
(i)	Growth of tax revenue	30
(ii)	Growth of non-tax revenue	20
(iii)	Growth of non-plan revenue expenditure on salaries and allowances	30
(iv)	Interest payments	10
(v)	Reduction of subsidies	10

It was stated that the areas indicated for monitoring were only suggestive and so were the weights. These could be suitably modified, while drawing state specific programmes. For assessing the overall performance, excess achievement in some areas could be balanced against shortfall in others, keeping the broad contents of the reform, indicated in the EFC's main report, in view.

The Scheme of Fiscal Reform Facility

11.5 As recommended by the EFC, an incentive fund in the form of Fiscal Reform Facility (FRF) was set up by the Ministry of Finance leaving 85 per cent of the revenue deficit grant recommended by the EFC to be released to the states without linking it with performance. The remaining 15 per cent, which constituted part A, has been linked with the improvement in fiscal performance. As far as part B is concerned, the initial share of the states was worked out pro rata, on the basis of the population, as per the 1971 census. The amount was to be made available to a state on achieving an improved level of performance in regard to various fiscal indicators.

11.6 While introducing the scheme of FRF, government of India prescribed a single monitorable indicator for the purpose of making releases from the incentive fund. The indicator expected each state to achieve a minimum improvement of 5 per cent in the revenue deficit/surplus as a proportion of its revenue receipts each year till 2004-05 measured with reference to the base year 1999-2000. The revenue deficit was to be inclusive of:

(i) contingent liabilities such as guarantees and letters of comfort due in that year, which would directly constitute budget liabilities; and

(ii) subsidies due to public sector enterprises (PSEs), whether or not the state pays such a subsidy upfront; thus, a budget subsidy payable to a state electricity board (SEB) would be "recognized" as a revenue expenditure, for the purpose of computing revenue deficit.

11.7 Under the scheme, if a state was unable to get the amount initially earmarked for it in any year, this amount would not lapse but would continue to be carried forward upto the fourth year i.e. upto 2003-04. If the state was still not able to draw in full the amount indicated on the basis of the performance of the first four years, the undisbursed amount would become a part of the common pool, to be shared by the performing states in the fifth year on a pro rata basis, in addition to the amounts to which they would otherwise be entitled.

11.8 The EFC also recommended that in addition to the incentive for better performance, central government was also to consider a fiscal reform programme linked assistance, by way of extended ways

and means advance and additional open market borrowings. The scope and dimension of these facilities were to be decided by the central government, bearing in mind their macro-economic implications and the centre's fiscal position. The facilities were to be linked to the monitorable fiscal reform programme drawn up by the states.

11.9 The EFC recommended setting up of a monitoring agency to review the progress in the utilization of EFC grants. Accordingly, a monitoring committee headed by Secretary (Expenditure) was set up in the Ministry of Finance. In terms of the guidelines issued by the Ministry of Finance, each state was expected to take effective steps for revenue augmentation and expenditure compression over the five-year period so as to broadly achieve the following objectives with reference to the base year 1999-2000, as laid down in the main report of the EFC :

(i) gross fiscal deficit of the states as an aggregate to reduce to 2.5 per cent of GSDP;

(ii) revenue deficit of all states, in an aggregate, to fall to zero;

(iii) interest payments as a percentage of revenue receipts of the state sector as a whole to remain between 18 to 20 per cent.

The supplementary report of the EFC had also recommended that the increase in wages and salaries should not exceed 5 per cent or the increase in consumer price index whichever is higher, increase in interest payments should be limited to 10 per cent per year and explicit subsidies should be brought down by 50 per cent over the next five-year period, with a view to eliminating subsidies completely by 2009-10. Given the contours of these fiscal objectives, state governments were asked to dovetail time bound action points covering fiscal objectives and reforms, power sector reforms, public sector restructuring and budgetary reforms. Based on these guidelines, each state was to draw up a Medium Term Fiscal Reform Programme (MTFRP) and enter into a Memorandum of Understanding (MOU) with the central government.

11.10 The scheme mentioned above was subjected to certain changes after its inception. For states that were already in revenue surplus, it was felt that it would be adequate, if, with improving revenue balance, the state shows a commensurate improvement in its balance from current revenue (BCR). It was, therefore, decided that the revenue surplus states would be expected to achieve a minimum improvement of three percentage points in the BCR, as a percentage of non-plan revenue receipts in each year. Further, in the case of special category states, a two percentage point improvement in the ratio of revenue deficit to total revenue receipts with effect from 2002-03 entitled them to releases from the incentive fund. With effect from September 2003, government of India also decided to finance the cost of reforms, such as voluntary retirement scheme (VRS) etc. in states through a blend of grants and open market borrowings. In the case of the special category states, government of India would finance 80 per cent of such costs. For non-special category states, 60 per cent of such costs would be met by the centre. Counter-part funds for these measures are to be provided by the states from their own

revenues. This facility is not available to states which are beneficiaries of any structural adjustment loans from multilateral/bilateral agencies in that particular year. For different reform initiatives, the assistance extended by government of India has a different composition of grants and additional open market borrowings. The assistance of the government of India has also been made available to the states for restructuring of debt with financial institutions, to take advantage of the low interest regime. The "debt restructuring" included `debt re-schedulement' or 're-financing' but not 'debt pre-payment' or exercise of any put option. Re-schedulement or re-financing could involve payment of premium on account of lower interest on the new debt vis-a-vis the old debt. It was decided that government of India, through the FRF, would share a part of a state's share of the premium cost of the restructuring by allocation of additional open market borrowing. We have been informed that Nagaland and Himachal Pradesh have been assisted under this facility.

11.11 As of 31st August, 2004, the Medium Term Fiscal Reforms Programme of 25 states has been finalized by the monitoring committee and memoranda of understanding have been signed with 19 states. MOUs of two states – Uttaranchal and Madhya Pradesh are in final stages of discussion and are expected to be signed soon. Uttar Pradesh and Sikkim have asked for amendments in their MOUs and are yet to furnish the revised ones. The total amount released from the incentive fund of Rs. 10607.72 crore till mid-November, 2004 was Rs. 5029.51 crore. This included an amount of Rs. 40.65 crore released for voluntary retirement schemes (VRS) etc. The releases pertained to the years 2000-01 to 2002-03 except for Tripura, Orissa, Rajasthan and Karnataka, which have been granted the releases for 2003-04 also. The performance of individual states in terms of the ratio of revenue deficit/surplus to total revenue receipts and the total releases made from the fund to individual states is indicated in annexure 11.1. Annexure 11.2 indicates the year-wise releases made to states from part A and part B of the fund.

11.12 The guidelines issued by the Ministry of Finance on states' FRF envisage that if the state sector, on an average achieves a five percentage point reduction in revenue deficit (RD) as percentage of revenue receipt (RR) consistently each year, by the financial year 2005-06, the sector as a whole would come into revenue balance. Against this objective, the performance of the states as reported by the Ministry of Finance has been as shown in Table 11.2.

Table 11.2

Ratio of Revenue Deficit/Surplus to Total Revenue Receipts (TRR)

RD/TRR ratio	1999-00	2000-01	2001-02	2002-03	2003-04 BE/RE	2004-05 BE
FRF objective	-27.40	-22.40	-17.40	-12.40	-7.40	-2.40
Performance	-27.23	-23.85	-24.49	-21.00	-22.89*	-

Source : Ministry of Finance

*** : RE for 24 states/BE for 4 states**

It is observed from this table that states have achieved a 6.23 percentage point reduction in RD/RR ratio by 2002-03 as against the targeted 15 percentage point reduction over the base year, 1999-00. In 2003-04, the position deteriorated by 1.89 percentage points. The data collected by the Commission, however, show a slightly different outcome in each year with the ratio (including net lotteries) of revenue deficit/ surplus to total revenue receipts for states declining by 6.24 percentage points from 1999-00 to 2002-03, as indicated in the Table 11.3. There was a further deterioration of the order of 2.05 percentage points in 2003-04.

11.13 We have been informed that, as per the scheme envisaged by the EFC for fiscal reform programme linked assistance by way of extended ways and means advances and additional open market borrowings, additional amounts by way of open market borrowings are being allocated to the states for (i) meeting a structural adjustment burden, necessitating voluntary retirement/ severance payments for downsizing public sector enterprises and core civil service and (ii) steps linked to fiscal reforms programme, if these have an initial 'reform cost' that impacts upon the budget. Seven states, namely, Nagaland, Kerala, Mizoram, Andhra Pradesh, Tamil Nadu, Orissa and Sikkim were allowed additional open market borrowings to the tune of Rs. 2363 crore to fund ongoing reform initiatives. Medium term loans of Rs. 3151 crore were extended to six fiscally stressed states, namely, Manipur, Orissa, Assam, Rajasthan, West Bengal and Nagaland, to fund 66 per cent of their opening deficit for 2002-03 after they had drawn up MTFRPs and entered into MOUs with government of India. An amount of Rs. 40.65 crore has so far been released as grant from Part B of the incentive fund for the purpose of structural reforms. This includes Rs. 29.91 crore released during the financial year 2003-04 to Jammu and Kashmir, Manipur and Kerala and Rs. 10.74 crore released during the current financial year to Nagaland and Punjab. During the financial year 2003-04, an amount of Rs. 255.99 crore has been allocated as additional open market borrowings to Manipur (Rs. 5.20 crore), Kerala (Rs. 200.00 crore), Nagaland (Rs. 0.81 crore) and Himachal Pradesh (Rs. 49.98 crore).

Mid Term Review by the Ministry of Finance

11.14. Ministry of Finance has carried out a mid term review of the facility in early 2004. Some of the points, highlighted in the review and relevant to our terms of reference, are as follows :

(i) On both tax and non-tax revenues, the performance of the states has been in line with the projections of the EFC. The problem lies with the trends for revenue expenditure, particularly on account of the rising interest burden;

Table 11.3

Ratio of Revenue Deficit/Surplus to Total Revenue Receipts

All States	1999-00	2000-01	2001-02	2002-03	2003-04 RE	2004-05 BE
RD/TRR ratio	-27.53	-23.59	-25.19	-21.29	-23.34	-13.99

(ii) On the basis of performance, 5 states could be classified as consistently improving (Kerala, Uttar Pradesh, Goa, Sikkim, and Chhattisgarh), 4 States as consistently deteriorating (Gujarat, Himachal Pradesh, Uttaranchal and Jharkhand), 12 states as showing initial improvement and then deterioration (West Bengal, Rajasthan, Punjab, Bihar, Tamil Nadu, Manipur, Madhya Pradesh, Assam, Haryana, Karnataka, Tripura and Meghalaya) and the remaining states as showing initial deterioration and then improvement (Maharashtra, Jammu and Kashmir, Andhra Pradesh, Mizoram, Nagaland, Arunachal Pradesh and Orissa);

(iii) There was 'admittedly' a design failure in prescribing a uniform five percentage point improvement in the ratio for all states. At the beginning of the reform period, 1999-2000, states had different magnitudes of revenue deficits as a percentage of revenue receipts. While the average revenue deficit as a percentage of revenue receipts was 27 per cent, individual states had much higher ratios ranging from 10 per cent (Tripura) to (West Bengal) 90 per cent. A design alternative could have been to prescribe an 18 percentage point improvement for West Bengal annually, and a 2 percentage point improvement for Tripura. If states start off with larger base year deficits, it is relatively easier for them to make huge improvements in the initial years. West Bengal, for example, was able to reduce the ratio to 52 per cent in one year, a 38 percentage point improvement. The state has thus achieved in one year, what it was expected to achieve in 5 years;

(iv) Although the gross fiscal deficit (GFD) and revenue deficit (RD) have come down and are projected to improve further, the "strong reforms" objectives of a GFD at 2.5 per cent of GDP and a zero revenue deficit by 2004-05 are not likely to be achieved. A programme that does not fully address the problem of a plan revenue deficit will not be able to eradicate revenue deficit altogether;

(v) The facility has largely failed to address the need for a steady convergence to a stable, sustainable debt path. The ultimate aim of any medium term fiscal reforms is to bring down debt to sustainable levels. The stock of consolidated debt (including guarantees) to total revenue receipts should not exceed 300 per cent. It must be the aim of every state to ultimately reach this objective through its MTFRP;

(vi) Corrective measures in regard to states' debt such as debt-swap arrangement, special relief for severely debt stressed states etc. need to be considered.

Views of the States

11.15 States have submitted divergent views regarding the FRF including suggestions to discontinue the facility, to increase the size of the incentive fund and to change the criteria. The views, as

submitted by the states in their memoranda are summarized as follows :

(i) The scheme goes against the spirit of article 275 of the Constitution, as it extends the facility to even states which are not in deficit, and hence not in need of grants.

(ii) The scheme should be reviewed in the light of the provisions under article 275 of the Constitution. If the Commission feels that conditional release of grants is constitutionally tenable, the scheme should have a built-in flexibility and due allowance be given for external factors over which the states have no control.

(iii) The single monitorable factor should be removed and a medium-term-matrix-based program instituted.

(iv) There has been a significant shortfall in devolution of central taxes as compared to the estimates by the Eleventh Finance Commission. As such, states have not been able to achieve the prescribed target due to centre's poor performance in revenue collection.

(v) The size of the fund is insignificant and does not provide a proper incentive.

(vi) Assistance should be given as a proportion of the level of correction.

(vii) In case of states that achieve a reduction in the ratio of revenue deficit to revenue receipt by more than 25 per cent before five years, the year to year reduction clause should be modified.

(viii) The assessment of performance of a state in the fiscal reforms programme should be primarily based on its achievement with regard to the reduction of the primary revenue deficit, wherein the policy variables (such as state's own revenue, non-plan revenue expenditure excluding interest payment on account of past loans, etc.) are within the control of the state government.

(ix) The monitorable objective (i.e. reduction of revenue deficit as percentage of revenue receipt by 5 per cent every year) in terms of which the performance of a state under the medium term fiscal reform programme is judged needs to be reviewed and reduced to 2 per cent.

(x) The incentive fund should be discontinued and all the criteria laid down as a precondition to the release from the fund, should be in-built into the performance parameters on which the formula for devolution will be based.

(xi) The FRF in its present form should be scrapped and all the withheld revenue deficit grants should be released forthwith to the states.

(xii) Separate central funds should be earmarked as incentive funds for fiscal reforms. Another scheme which takes into account the inherent backwardness and circumstances of the special category states should be framed for such states.

Views of the Ministry of Finance

11.16 The Commission called for the specific views of the Ministry of Finance on the functioning of the facility. The Ministry of Finance has drawn our attention to some of the key lessons learnt from the implementation of the facility, as summarized below:

(i) The facility encouraged the states to draw MTFRPs for the first time. It is an important development in managing state finances inasmuch as the states have started thinking about fiscal matters on a medium-term framework.

(ii) As fifty per cent of the incentive fund was contributed from the withheld portion of the non-plan revenue deficit grant of 16 states and the remaining 50 per cent from government of India, the revenue deficit states contributed disproportionately to the fund and the remaining 12 states made no contribution. In a way, while 16 revenue deficit states stood to lose fiscal resources to cover their non-plan deficits, in case they did not bring about the necessary correction, other states only had to gain from the Fiscal Reform Facility and there was no negative incentive for them.

(iii) The size of the incentive fund at Rs. 10600 crore over a period of 5 years and Rs. 2120 crore per annum was relatively small, considering the fact that the total transfers to the states including tax devolution, grants (plan and non-plan) and small savings transfers/plan loans average Rs. 60000 crore, Rs. 40000 crore and Rs. 90000 crore respectively per annum. Some other reforms facilities like Accelerated Power Development and Reforms Programme (APDRP) have larger financial allocation.

(iv) The states were expected to draw up an MTFRP, which was expected to have fiscal projections, factoring in the effect of various measures suggested by the Eleventh Finance Commission and the measures which, in the opinion of the states and the central government were required to be taken to achieve the necessary correction of reduction in revenue deficit of 5 percentage points per annum on an average. For making reforms scenario projections, the states should have drawn a baseline scenario, on the basis of the trend and the operating policy framework in 1999-2000. An assessment of the fiscal impact of various measures, suggested by the Eleventh Finance Commission and agreed to be taken by the states would have given the programme of reforms. The states did not prepare either baseline or reform based projections. The MTFRP of many states did not even project achievement of 25 per cent revenue deficit reduction/improvement, leading to the inference that the states did not have any plan/ programme to enable them to achieve the target.

(v) Initially, a uniform criterion of 5 percentage points improvement in RD ratio was prescribed for every

state, including the special category states. For the revenue surplus states, a 3 percentage point annual improvement in the balance from current revenue as a percentage of their non-plan revenue receipt was adopted as the criterion for the release from the incentive fund. In the third year, guidelines were amended to provide that special category states could achieve a minimum improvement of 2 percentage points (from 2002-03 onwards). This criterion for special category states could further be modified to link their performance to their own revenues and expenditures, as the overall fiscal performance of these states depended disproportionately on the central transfers.

(vi) The definition of revenue deficit presented problems. Some states argued for consolidated revenue deficit including the deficit of the power sector utilities. Some states wanted revision of the definition of revenue deficit, mid-stream. This led to adoption of different definitions of revenue deficits for different states. Release criteria also led some states to resort to window dressing in numbers.

(vii) The reform programme and conditionalities, agreed to by the states in their MOUs, were not linked to the release of incentive. There was no effective way of monitoring the achievements or lack of that for states in relation to the agreed reforms. Moreover, the disconnection between reform conditionality and any reward/ punishment framework based thereon, made the structure of MOUs quite weak. MOUs were neither disclosed for public information nor were they shared with other states.

(viii) The facility of financing reforms was not available to those states which were beneficiaries of any structural adjustment loans from multilateral/ bilateral agencies in that particular year. There has been very limited use of the window that provides for structural adjustment costs, which is a part of the FRF.

11.17 The Ministry of Finance has suggested that the incentive from the central government through the FRF could be a two-part facility, with part A of the incentive fund (comprising 60 per cent of the total fund) being released on achievement of agreed path/targets of fiscal correction based on multiple but separate criteria, and part B (comprising the remaining 40 per cent of the total fund) of the incentive fund, being released on the states taking certain agreed reforms action. It has further been stated that there are five most prominent indicators of fiscal performance, namely,

(i) ratio of interest and pensions to total tax revenues of the state (comprising own tax revenues and share in central taxes), indicating clearly what part of the tax revenues of the states go in funding currently unproductive expenditure;

(ii) ratio of salaries, wages and other costs of personal benefits to

employees to states' total tax revenues, which captures current personnel delivery cost of government;

(iii) ratio of present debt and liabilities of the state to states' acceptable level of debt and liabilities; the acceptable level of debt and liabilities should be determined by working out what debt at currently effective rate of interest can be supported by assuming an ideal interest to tax revenues ratio of 20 per cent in Indian situation;

(iv) ratio of consolidated revenue deficit (inclusive of deficits/losses of all state owned entities) to revenue receipts; and

(v) ratio of fiscal deficit to GDP.

Part A of the incentive fund could be linked to performance vis-à-vis these five indicators, each of which may be given a weight. The states should be asked to draw a medium-term reform programme for closing the gap between the base year (2004-05) ratio and the target ratios (to be recommended by the TFC) expected to be achieved. Proportionate releases can be made on the basis of annual achievements every year. Part B of the incentive fund should be meant for incentivising specific fiscal reforms action. Certain key reforms actions, which have been suggested as part of the reforms programme are :

a) enactment of fiscal responsibility legislation;

b) eliminating access to overdrafts from RBI;

c) streamlining of pensions by converting unfunded pensions into a pensions fund;

d) mandatory financial viability analysis of every project and upfront provision of the viability gap;

e) delinking wage and inflation increases for the state employees from the central system;

f) adoption of VAT; and

g) full computerization of treasuries, fiscal transactions management and debt recording and management.

Every specific action could be incentivised by providing a specified amount of fiscal grant. If the state does achieve the same, incentive can be released.

Our Analysis and Approach

11.18 We have analyzed in detail the functioning of the facility from the point of view of assessing whether it has met its objectives. While doing so, we have considered the points brought out in the mid term review of the Ministry of Finance and the submissions of the central and state governments to the Commission. We note that as per the stated objectives of the facility, the fiscal targets mainly relate to reduction in GFD of states, revenue deficit of states, interest payments, wages and salaries, and subsidies together with the achievement of reform objectives in the power sector, public sector etc.

11.19 The mid term review has termed the various fiscal reform initiatives and reform initiatives in public sector restructuring, power sector and budgetary reforms taken by states as a positive outcome of the facility. Although the

introduction of the scheme seems to have imparted a certain measure of discipline in the states in that they have been persuaded to draw up MTFRPs and sign MOUs and has sensitized them to the need for fiscal consolidation, in terms of actual fiscal performance the scheme has not been as effective. The percentage of revenue deficit to total revenue receipts of all states in the aggregate was to be reduced to 7.40 per cent in 2003-04 based on an annual 5 percentage point improvement. Data provided by Ministry of Finance, however, indicates that the percentage in 2003-04 was 22.89 per cent. Further, an amount of Rs. 2121.54 crore was expected to be released from the fund in each of the 5 years starting from 2000-01. The amounts actually released are Rs. 2006.67 crore for 2000-01, Rs. 1691 crore for 2001-02, Rs. 1037.52 crore for 2002-03 and Rs. 253.67 crore for 2003-04. The releases actually made in respect of the years 2000-03 work out to 74.4 per cent of the expected releases. This comprises 87.88 per cent of the expected releases from part A and 56.85 per cent of expected releases from part B.

11.20 As part of the reform scenario, the EFC had projected that the fiscal deficit of states in the aggregate would be 2.94 per cent in 2003-04 and fall further to 2.5 per cent of GDP by 2004-05. Similarly, the revenue deficit in the aggregate was to fall to 0.59 per cent of GDP in 2002-03 and become zero in 2004-05. The mid term review states that out of 28 states, 12 have been either consistently improving or have shown an improvement after initial deterioration. The remaining states have not shown an improvement. As far as the aggregate position of all states is concerned, Table 11.4 brings out the actual performance vis-à-vis the projections made by the EFC. It may be noted that the actual fiscal deficit in 2003-04 (RE) is higher than that in 1999-2000.

11.21 The performance of all states with reference to interest payments (which were to be 18-20 per cent of revenue receipts of the states as a whole and were to grow at rates limited to 10 per cent per year) and expenditure on salaries (whose growth was to be limited to 5 per cent per annum in

Table 11.4

Revenue and Fiscal Deficit of States

(per cent of GDP)

		1999-2000	2000-01	2001-02	2002-03	2003-04
(i)	**Fiscal Deficit**					
	Eleventh Finance Commission Projections	4.71	4.27	3.83	3.38	2.94
	Actual position	**4.64**	**4.16**	**4.09**	**3.94**	**4.97**
(ii)	**Revenue Deficit**					
	Eleventh Finance Commission Projections	2.96	2.37	1.78	1.18	0.59
	Actual position	**2.82**	**2.61**	**2.68**	**2.29**	**2.67**
(iii)	**Outstanding debt (including reserve funds and deposits)**					
	Eleventh Finance Commission Projections	25.07	26.46	27.24	27.49	27.27
	Actual position	**25.20**	**27.42**	**29.37**	**31.15**	**31.23**

Table 11.5

Profile of Expenditure on Interest Payments and Salaries of States

	1999-00	2000-01	2001-02	2002-03	2003-04
Interest payment as a % of total revenue receipts	22.46	22.42	25.23	26.04	26.07
Annual growth rate of interest payments (%)	24.06	15.95	18.31	13.09	19.27
Annual growth rate of salaries and allowances (%)	18.44	2.36	3.23	5.64	12.58

terms of the objectives of the facility), has been indicated in Table 11.5. Clearly, the objectives set out by EFC and envisaged in the MTFRP in regard to the fiscal deficit, revenue deficit and the targets relating to growth of interest payments and salaries have not been and are not likely to be met.

11.22 The primary objective around which the facility has been structured is the elimination of the revenue deficit of states, so that surpluses are available for creation of capital assets. We have suggested elsewhere in our report that each state must enact a fiscal responsibility legislation so as to eliminate the revenue deficit by 2008-09. Our terms of reference require us to suggest measures for the effective achievement of the objectives of the Facility. In our view, the major drawbacks of the present scheme are : (a) the scheme does not provide an adequate incentive for prudent fiscal behaviour, as the size of the fund is relatively small; (b) the withholding of deficit grant itself leads to a deterioration in the finances of the states inasmuch as the additional gap so left open is bridged through borrowings with implications for future; and (c) prescription of a uniform target does not invariably reward prudent behaviour, as it provides a soft and easily achievable target for states with large deficits and a difficult one for the more prudent states.

11.23 In order to provide an adequate incentive for prudent fiscal behaviour, the size of the fund would need to be substantially larger than the present size. The central government may, however, not be able to find resources to create an incentive fund of the required magnitude, particularly in the context of the additional resource transfers recommended by the Commission elsewhere. We are not in favour of setting up of a facility by withholding deficit grants which have been assessed on a normative basis. Further, we find that that the central government has not been able to strictly adhere to the terms and conditions of the facility. For example, the definition of the revenue deficit has not been uniform for all states. Releases have not always been based on credible data such as the finance accounts. Changes seem to have also been made on a selective basis to accommodate states when they faced a fiscal crisis. A scheme which lends itself to such arbitrary flexibility is, in our view, not desirable.

11.24 We have taken note of the observation made by the Ministry of Finance that the facility has failed to address the problem of lack of convergence to a stable and sustainable debt path. A scheme, which incentivises prudent behaviour and simultaneously tackles the problem of debt burden of states, appears to us to be more

conducive to the achievement of the objective of elimination of the revenue deficit. We have, in chapter 12, devised an incentive scheme based on fiscal performance, which will meet the objectives prescribed for the FRF and at the same time provide debt relief to states.

Conclusion

11.25 The Commission notes the efforts made by a number of states to undertake an improvement of their respective medium-term fiscal situations in the period 1999-2000 to 2003-04. There is undoubtedly a need to encourage states to draw up a medium-term programme for fiscal reforms and consolidation. But, after carefully weighing the various arguments and considerations on both sides of the issue, the Commission does not recommend continuation of the FRF over the period 2005-10. As discussed earlier, the following major reasons underlie the Commission's recommendation.

11.26 First, despite the operations of the FRF, the aggregate fiscal deficit of states actually increased from 4.64 per cent of GDP in 1999-2000 to 4.97 per cent in 2003-04 (RE), as compared to the Eleventh Finance Commission reform scenario projection of 2.9 per cent of GDP by 2003-04. Similarly, the states' revenue deficit declined only marginally from 2.82 per cent of GDP in 1999-2000 to 2.67 per cent in 2003-04. Also, the outstanding debt of the states rose substantially from 25.20 per cent of GDP in 1999-2000 to 31.23 per cent in 2003-04. While many other factors were also at work during this period, it is difficult to avoid the conclusion that the FRF did not play a significant role in bringing about an improvement in the states' fiscal position in the past five years.

11.27 Second, it appears that the scale of the incentive fund of the FRF was not able to provide adequate incentives to counter the short-term "rewards" of imprudent fiscal behaviour by the states.

11.28 Third, the operation of such a reform facility necessarily requires judgment and discretion in the application of broad parameters of conditionality. This leads to several dilemmas in a federal fiscal structure. On balance, the Commission takes the view that the finance commission transfers should be as free of subjective and discretionary dimensions as is practically feasible.

11.29 Finally, recognizing the paramount importance of improving the states' medium-term fiscal situation, the Commission has decided to reflect these considerations in the scheme of debt relief, as described in chapter 12. This obviates the need for a separate fiscal reform facility.

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