ADB INDIA Economic Bulletin

September 2003

Volume I, Number 3

ASIAN DEVELOPMENT BANK

India Resident Mission

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ADB INDIA
Economic Bulletin

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India: Key Economic Indicators

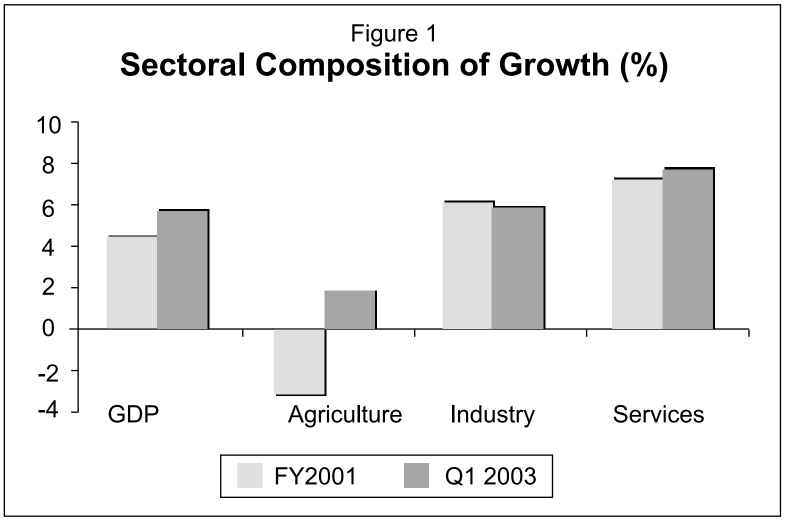
Variables	Unit	Reporting Date	Current	Percentage Change[1]
GDP at Factor Cost (1993-94 prices)	Rs. Billion	April-June 2003	5,752	5.7
• GDP in Agriculture	Rs. Billion	April-June 2003	1,322	1.7
• GDP in Industry	Rs. Billion	April-June 2003	1,538	5.8
• GDP in Services	Rs. Billion	April-June 2003	2,891	7.6
Industrial Production – General (1993-94 = 100)	Index	April-August 2003	178.8	5.6
Industrial Production – Manufacturing (1993-94 = 100)	Index	April-August 2003	185.7	6.2
Wholesale Price – All Commodities (1993-94 = 100)	Index	April-September 2003	173.7	5.3
• Primary Articles	Index	April-September 2003	181.0	5.2
• Manufactured Articles	Index	April-September 2003	154.2	5.0
Consumer Price (Industrial Worker) (1982-83 = 100)	Index	April-August 2003	497	4.3
Broad Money (M3)	Rs. Billion	19 September 2003	18,377	12.0
RBI's Credit to Commercial Sector	Rs. Billion	19 September 2003	30	3.0
RBI's Credit to General Government	Rs. Billion	19 September 2003	631	-50.8
Consolidated Fiscal Deficit / GDP	Per cent	FY2002	10.1	–
Domestic Public Debt	Rs. Billion	FY2002	18,666	14.4
Exports	$ Billion	April-June 2003	13.5	12.2
Imports	$ Billion	April-June 2003	19.4	30.8
Trade Balance / GDP	Per cent	April-June 2003	-7.6	–
Current Account Balance / GDP	Per cent	April-June 2003	-1.6	–
International Reserve	$ Billion	26 September 2003	85.6	43.9
External Debt	$ Billion	end-March 2003	104	5.5
External Debt to GDP Ratio	Per cent	end-March 2003	20.0	–
Debt Service Ratio	Per cent	end-March 2003	14.7	–
Foreign Exchange Rate, Spot	(Rs./$)	29 September 2003	45.9	-5.9
Nominal Effective Exchange Rate (1985 = 100)	Index	July 2003	36.8	2.2
Real Effective Exchange Rate (1985 = 100)	Index	July 2003	74.5	2.1

[1] Percentage change over the corresponding reporting date a year ago.

Contents

I. Macroeconomic Growth Scenario

1. The Indian economy is poised for a strong recovery in FY2003[1] after registering low average growth during three consecutive years ending in FY2002. The economy grew at 5.7% in the first quarter of FY2003 (April-June, Figure 1). This is a significant improvement over



Source: www.mospi.nic.in/stat_pr.htm

2.3% growth in the third quarter and 4.9% in the fourth quarter of FY2002. Annual growth in FY2002 was 4.3%. The turnaround in growth is mainly on account of a recovery in agriculture and higher growth of services.

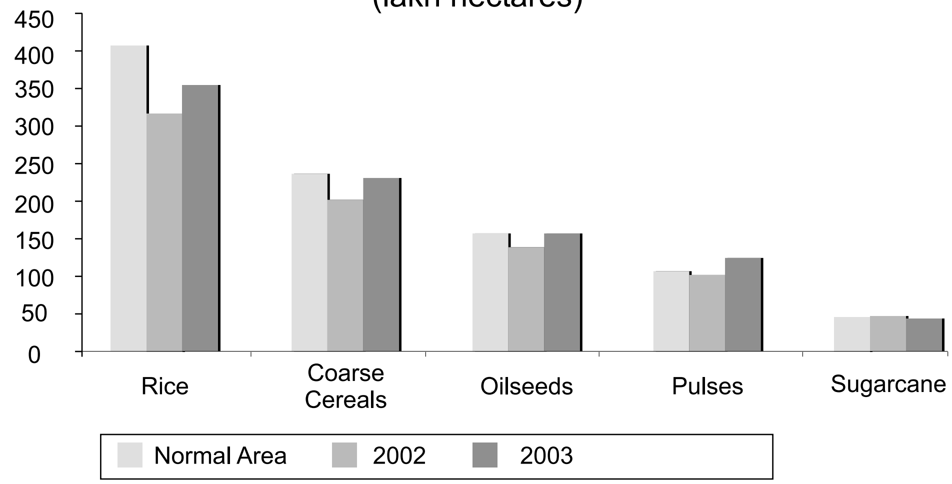
II. Sectoral Performance

2. A good monsoon suggests there could be a bumper crop in 2003 as against a decline in agricultural production in the previous year.[2] Advance estimates of the Ministry of Agriculture indicate that total foodgrain production declined by 13.89% in 2002, with an 18.9% and 8.3% decline in the *kharif* (summer) and *rabi* (winter) crops respectively. In the current year rainfall during the southwest monsoon (1 June 2003 – 30 September 2003) was estimated at 102% of its long period average, with 33 out of 36 metereological subdivisions receiving normal to excess rainfall. Excess rainfall was reported in the 4 subdivisions of Saurashtra and Kutch, Western Rajasthan, Haryana including Delhi, and Western Uttar Pradesh. Widespread monsoon rains have facilitated agricultural operations during the current season with normal to above normal sowing of

[1] Year ending 31 March 2004.

[2] The agricultural year in India runs from July to June.

Figure 2
Area Covered under Kharif Production
(lakh hectares)



Source: http://www.agricoop.nic.in/ncfcweather/ncfc.htm

major *kharif* crops. Ministry of Agriculture estimates show that the area sown is well above area coverage reported during 2002 (see Figure 2). According to official estimates, foodgrain production in 2003 is expected to be over 220 million tones.

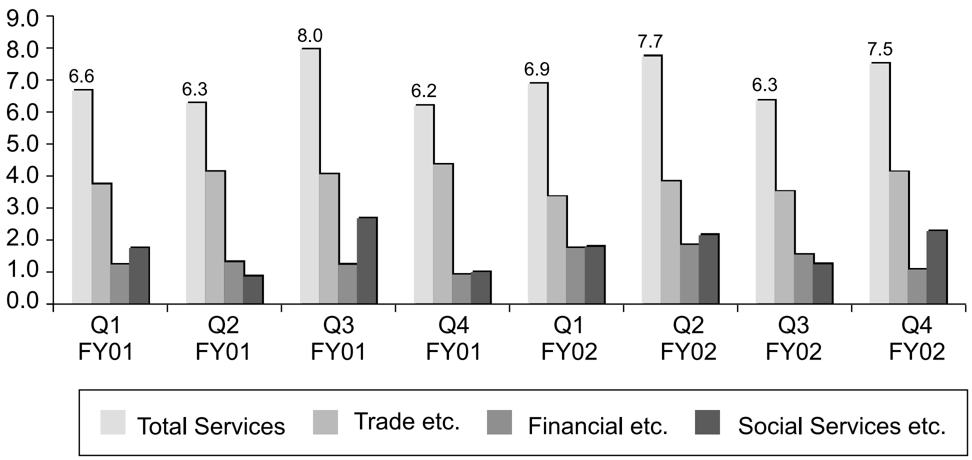
3. The services sector is the second sector which accounts for the growth recovery in FY2003. After growing at 7.1% in FY2002 services growth improved further to 7.6% during April-June 2003. Trade, hotels/restaurants, transport and communications registered the highest growth rate during the first quarter of FY2003 at 9.6% as against 4.3% growth in social, community and personal services, including public administration and defence, and 7.1% in financial services, real estate and business services including software. An ADB-INRM decomposition exercise[3] shows that trade, hotels/restaurants, transport and communications contributed to over 50% of services growth during FY2001 and FY2002 (Figure 3). Despite the highly visible growth of software services, their contribution to total service sector growth is still limited. Moreover, the emergence of services as the largest sector in the economy is not just a statistical artifact arising from recent pay hikes and the growth of the wage bill in public administration. It is largely a reflection of real growth in trade, hotels/restaurants, transport and communications.

[3] Decomposition of service sector growth shows the extent to which sectoral growth will change consequent upon changes in one subsector and subject to other components remaining unchanged. The contributions of all subsectors add up to the sectoral growth rate.

Figure 3

Contribution to Services Growth

(%)



Source: www.mospi.nic.in/stat_pr.htm

4. The industrial sector continued to register robust growth during April-August 2003. Within the sector, manufacturing grew at 6.2%, mainly on account of the high growth of consumer goods (8.9%) and capital goods (7.8%). In particular, production of consumer durables grew by 4.8%, up from (–)5.4% during April-August 2002. Improved growth was evident across most manufacturing subsectors during the period (Table 1). Significant among them are basic metals, food products, beverages and tobacco, jute and mesta, transport equipment, paper and paper products, rubber and plastics, wood and wood products, and other industries. Machinery production also registered significant improvements in growth after growing at only 1.8% during FY2002. However, production of chemicals, cotton textiles and textile products, and leather manufactures registered negative growth. Core infrastructure also grew at a much lower rate of 3.8% during April-August 2003 compared to 7.3% during the same period in FY2002. The slowdown in core infrastructure growth was evident across subsectors, especially in crude petroleum and electricity generation. Weak growth in some industrial subsectors notwithstanding, the NCAER Business Confidence Index, which was subdued between January-April 2003, started rising soon thereafter (Figure 4). This is mainly on account of good monsoons, a favourable macro-economic outlook, strong performance in agriculture and services, and expectations of higher corporate profitability.

Table 1: Sectoral Performance: Manufacturing (%)

Increasing Output				Declining Output			
Sector	**2001-02**	**2002-03**	**2003-04@**	**Sector**	**2001-02**	**2002-03**	**2003-04@**
Non-metallic Mineral Products	1.1	5.0	4.4	Chemical & Allied Products	4.8	4.0	-0.3
Man-made Fibres etc.	4.4	3.8	4.7	Textile Products	2.4	15.6	-0.4
Machinery (except Transport Equipment)	1.3	1.8	5.7	Metal Products	-10.0	6.4	-1.7
Jute and Mesta	-5.9	8.4	5.7	Cotton Textiles	-2.2	-2.4	-7.2
Rubber, Plastic etc.	11.1	4.9	8.5	Leather & Leather Products	5.3	-2.9	-16.2
Other Industries	8.9	-0.5	9.2				
Food Products	-1.6	10.7	9.3				
Wood & Wood Products	-11.0	-17.8	12.3				
Basic Metal	4.3	9.2	12.4				
Paper & Paper Products	3.0	5.6	14.0				
Beverage, Tobacco etc.	12.2	27.3	16.6				
Transport Equipments	6.8	14.9	23.7				
Overall Manufacturing	2.9	6.0	6.2				

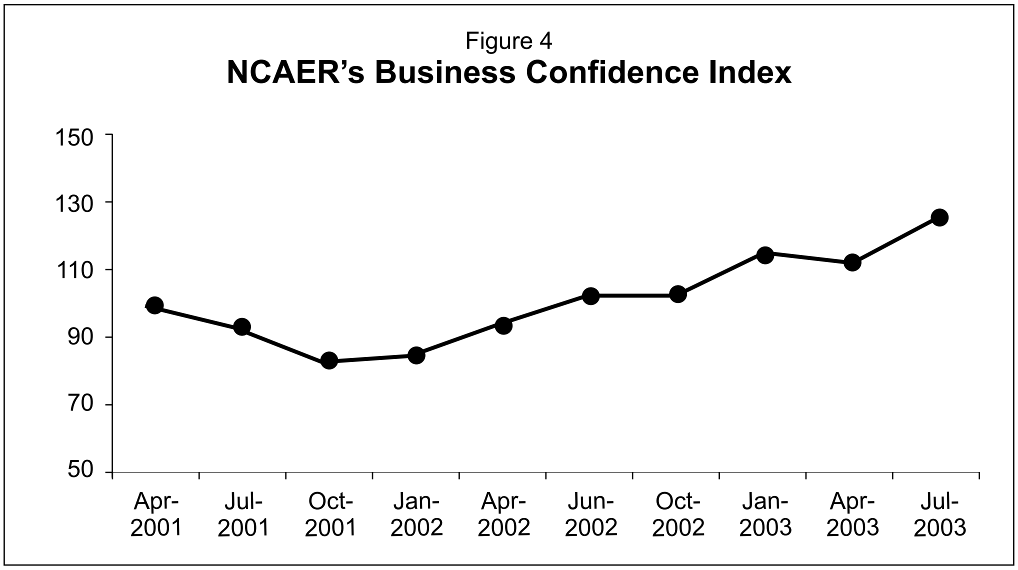
Note: @ denotes April-August 2003

Source: Compiled from www.mospi.nic.in/stat_pr.htm

III. Fiscal Developments

5. The fiscal situation remains a cause for concern. The combined gross fiscal deficit[4] of the center and states was higher at 10.1% of GDP during FY2002 compared to 9.9% in FY2001. This is despite improvements in the combined revenue position during the year,

[4] Gross fiscal deficit is the difference between aggregate disbursements net of debt repayments and recovery of loans and revenue receipts and non-debt capital receipts.



Source: NCAER, 2003. *Quarterly Review: Business Expectations Survey,* July, New Delhi.

and mainly attributable to an increase in public expenditures. The consolidated total expenditure of the center and the states as a per cent of GDP rose from 28.5% in FY2001 to 30.4% in FY2002. Domestic public debt increased from 67.9% of GDP in FY2001 to 72.9% of GDP in FY2002. Total public debt, inclusive of external public debt, now amounts to 75.5% of GDP. The debt position of the central government has also deteriorated, with the debt-GDP ratio rising from 59.5% in FY2001 to 63.2% in FY2002 on account of increasing outstanding liabilities arising from significant market borrowings.

6. The deterioration in the overall deficit situation between FY2001 and FY2002 occurred despite some reduction in the central government fiscal deficit-to-GDP ratio. This is because the fiscal deficit-to-GDP ratio of the states deteriorated further from 4.2% in FY2001 to 4.7% in FY2002. The deterioration is primarily on account of an increase in total expenditure of the states from 16.4% of GDP in FY2001 to 17.9% in FY2002. Because of the high level of gross fiscal deficit at the state level, outstanding debt as a percentage of GDP of the states is increasing. Reserve Bank of India (RBI) estimates show an increase in states' debt-to-GDP ratio from 25.7% to 28.1% between FY2001 and FY2002.[5]

7. The state debt-to-Gross State Domestic Product (GSDP) ratio varies over a large range across states and is over 60.0% for

[5] Reserve Bank of India, *Annual Report 2002-03*, Chapter IV, Table 4.15.

Himachal Pradesh and Orissa (Table 2). The total debt stock of most of the states would be significantly higher if the contingent liabilities of the states are added.[6] For instance, the state debt-to-GDP ratio would be 75.6% for Himachal Pradesh if contingent liabilities are entirely devolved on the state. Outstanding guarantees of the state governments increased from 4.4% of GDP as of end-March 1996 to 8.1% of GDP as of end-March 2001. In view of the serious fiscal implications of this rising level of guarantees, several states have taken initiatives to place statutory/administrative ceilings on guarantees. While Gujarat, Karnataka and West Bengal have instituted statutory ceilings, states such as Assam, Orissa and Rajasthan have used administrative ceilings on guarantees.

Table 2: Outstanding Debt and Guarantees (as of end-March 2001): Selected States

(Rs. billion)

State	Total Debt	Guarantees (Provisional)
Himachal Pradesh	7871 (60.8)	1921 (14.8)
Orissa	22015 (60.5)	217 (0.6)
Punjab	27830 (40.7)	6060 (8.9)
Rajasthan	30641 (40.1)	11954 (15.6)
Kerala	23919 (35.6)	8759 (12.7)
Assam	10199 (34.0)	1100 (3.7)
West Bengal	47249 (33.7)	6982 (5.0)
Gujarat	29786 (26.6)	17301 (15.4)
Andhra Pradesh	35651 (25.9)	13138 (9.5)
Haryana	13179 (24.5)	8209 (15.3)
Karnataka	22158 (21.0)	12989 (12.3)
Tamil Nadu	28686 (20.9)	12388 (9.0)
Maharashtra	44680 (17.3)	11954 (4.6)
All States	**498092 (23.9)**	**169562 (8.1)**

Note: Figures in parentheses are per cent of Gross State Domestic Product (GSDP) for states and Gross Domestic Product (GDP) for all states.The states are arranged in descending order of the total debt-to-GSDP ratio.

Source: Calculated from Reserve Bank of India, 2003. *State Finances:A Study of Budgets of 2002-03*, Mumbai.
Reserve Bank of India, 2002. *Report of the Group to Assess the Fiscal Risk of State Government Guarantees*, July, Mumbai.
EPW Research Foundation, 2003. *Domestic Product of States of India 1960-61 to 2000-01*, CD-ROM, Mumbai.

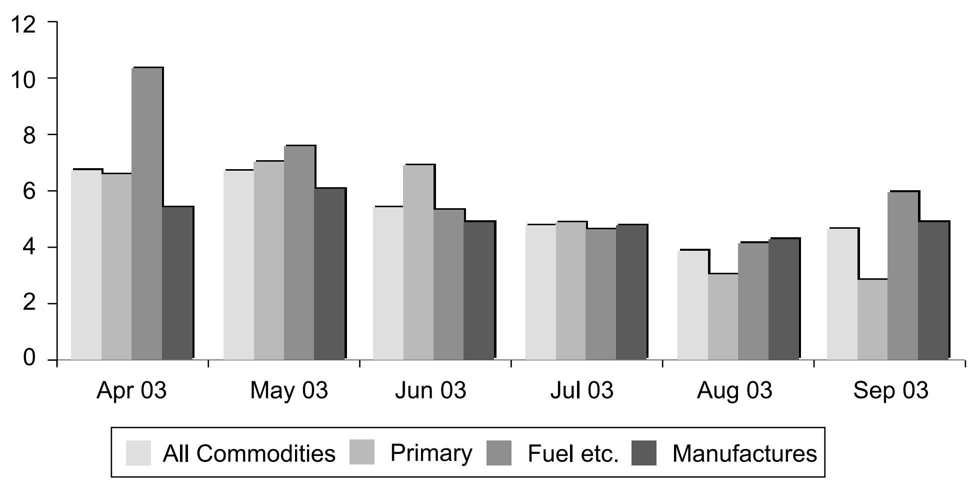
[6] In terms of Article 293(1) of the Constitution of India, the state governments can give guarantees within limits fixed by the legislature of the concerned states.

IV. Inflation, Money and Financial Market Developments

8. Money supply (M3) was growing at 12.0% as of 19 September 2003, down from 17.2% during the corresponding period in FY2002. Lower M3 growth is largely on account of a significant drop in growth of time deposits with banks. Money supply growth has decelerated despite the RBI easing its monetary policy stance since 2001. The central bank has done an excellent job in keeping inflation under control, and at the same time effectively building up a large foreign exchange reserve of over $85 billion. However, some analysts are now questioning whether maintaining such large reserves is efficient. This issue is discussed further below.

9. Inflation[7] has remained moderate, fluctuating around the average rate of 5.3% during April-September 2003 (Figure 5). Inflation, as

Figure 5
Inflation in India (%)



Source: www.eaindustry.nic.in

measured in terms of consumer price index (CPI) for industrial workers, has hovered around the average rate of 4.3% during April-August 2003. In terms of individual products, wholesale prices of primary products have been declining in recent months, following normal monsoons. However, inflation of manufactured products has not declined, and inflation of fuel and related products has been accelerating, especially in September 2003.

[7] As measured by the Wholesale Price Index (WPI).

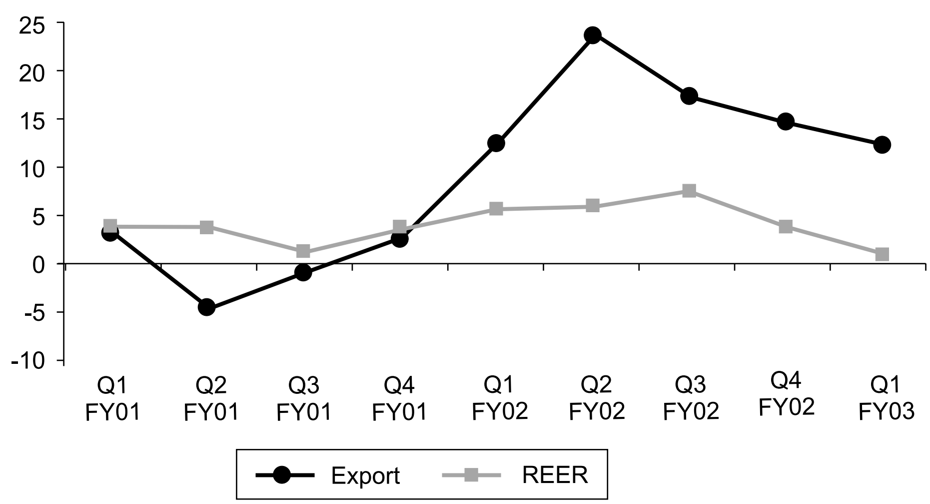
V. Balance of Payments and Foreign Exchange Management

10. The external sector has continued to remain buoyant during the current year, but the current account has turned negative after remaining surplus for six consecutive quarters since FY2001. While merchandise exports grew at 12.2% during April-June 2003, imports grew at a significantly faster rate of 30.8% indicating larger domestic absorption during the quarter. Consequently, the trade deficit increased to $ 5.9 billion during April-June 2003, and the current account turned into a deficit of $1.2 billion during the same period.

11. High export growth during the first quarter of FY2003 reflects buoyancy in world demand, especially the growth rebound in the East and Southeast Asian countries, and China. Though this is high relative to traditional rates of export growth in India, it has to be noted that there is a decline in export growth after it peaked in the second quarter of FY2002 (Figure 6). This is often attributed to real exchange rate appreciation during the period. However, export growth is primarily determined by the state of world demand.

Figure 6

Export Growth and Changes in Real Effective Exchange Rate (%)



Source: www.rbi.org.in

12. Going forward, the recent agreement on greater market access between India and ASEAN in the direction of a future free trade pact, and the Indo-Thai free trade agreement will significantly step up India-ASEAN trade. Growing India-ASEAN engagement should in due course lead to industrial restructuring in these countries, boost the potential for cross-border investments, and improve transport linkages between

these countries.[8] However, improved market access in developed countries continues to remain elusive. The recently held WTO Ministerial meeting at Cancun failed to provide any improved market access for India and other developing and least developed countries. At the Cancun meeting, India focused on core market access issues, especially relating to agriculture, and wanted to carry forward the gains that were achieved in the Doha Development Round. In a bid to negotiate on various multilateral issues at the meeting, several like-minded countries formed G22 - a strategic coalition of 22 developing countries. In agriculture, India along with other developing countries wanted a negotiating mandate on phasing out trade distorting subsidies in developed countries. On the other hand, with respect to industrial goods, the developing countries did not agree to provide further market access that the developed countries were hoping for. The G-22 countries also opposed the inclusion of the so-called Singapore Issues such as investment and competition policy, transparency of government procurement, and trade facilitation in the negotiating agenda. India and other developing countries did not accept the draft declaration on the grounds that it did not pay enough attention to developing country concerns. These cross currents between groups of countries resulted in a deadlock at the Cancun meeting without any win-win conclusion.

13. Foreign exchange reserves increased to $85.6 billion as of 26 September 2003. There have been some qualitative changes on the sources of accretion to foreign exchange reserves during the first quarter of FY2003 as compared to those in the previous year (Table 3). In FY2002, the foreign exchange reserve build up was

Table 3: Sources of Accretion to Foreign Exchange Reserves ($ billion)

	FY2002	Q1 FY2002	Q1 FY2003
Current Account Balance	4.1	0.4	-1.2
Net Capital Account	12.1	1.8	6.1
Foreign Investment	4.6	1.1	2.8
Banking Capital	8.4	0.7	1.9
Loans[a]	-3.8	-0.5	1.2
Other Capital	3.4	0.9	0.5
Errors & Omissions	0.7	-0.5	0.3
Valuation Change	3.9	2.0	1.5
Additions to Reserves	20.8	3.7	6.7

Note: [a] Loans comprise of external commercial borrowings, short-term credit and external assistance.

Source: RBI, 2003. *Sources of Accretion to Foreign Exchange Reserves in India: Updated Figures for 2002-03* (www.rbi.org.in/sec4/37412.pdf and www.rbi.org.in/sec4/39338.pdf), 1 July and 30 September respectively, Mumbai.

[8] N. Kumar, 2003. "India-ASEAN Partnership," *The Hindu*, October 7.

attributable to the current account surplus, along with positive and high net banking capital flows in the form of non-resident deposits, and net other capital on the capital account, and significant valuation gains. In contrast, the foreign exchange accrual in the first quarter of FY2003 is on account of net foreign investment inflows, especially portfolio investment, banking capital, and loans in the form of external commercial borrowings. Portfolio investment witnessed a quantum jump from $(-)0.3 billion to $ 2.0 billion between April-June 2002 and April-June 2003, while net FDI inflows declined from $1.3 billion to $ 0.7 billion during the same period. Net other capital flows also declined during this quarter.[9] On the other hand the surge in net banking capital flows has continued. External commercial borrowings also increased from $(-)0.7 billion in the first quarter of FY2002 to $0.6 billion in the first quarter of FY2003, while short-term loans to India have increased from $0.2 billion to $0.9 billion during the same period. On balance, net capital account inflows increased from $1.8 billion during April-June 2002 to $6.1 billion in April-June 2003. However, it is accompanied by higher risks at the margin on account of the rising share of reversible portfolio investments and short-term loans in the capital account. Also, managing the rapid growth in foreign exchange reserves while at the same time maintaining a competitive exchange rate has emerged as a major challenge for the central bank.

14. The continuing decline in FDI through FY2002 as well as the first quarter of FY2003 is a cause of concern. The recent data on India are particularly striking when benchmarked against growing FDI flows to the People's Republic of China (PRC).[10] There are various reasons that account for this performance. Even though India has the most transparent and liberal FDI regimes among the emerging economies, structural weaknesses such as the weak regulatory systems, the conflicting role of government agencies at various levels, complex post-approval procedures and implementation delays, Urban Land Ceiling and Rent Control Acts, archaic labour laws, small scale reservations, and poor quality infrastructure limit FDI inflows to India.[11] The quantity and quality of FDI across developing countries also depends on host country policy regimes with regard to openness

[9] Net other capital is a residual item on the capital account which includes all capital transactions such as funds held abroad, India's subscription to international institutions, quota payments to IMF, delayed export receipts, remittances towards recouping the losses of branches/subsidiaries etc.. It also includes monetization of gold by the RBI.

[10] R. Nagaraj, 2003. "Foreign Direct Investment in India in the 1990s: Trends and Issues", *Economic and Political Weekly*, 38 (17): 1701-1712; UNCTAD, 2003. *World Investment Report 2003*, New York: United Nations.

[11] Planning Commission, 2002. *Report of the Steering Group on Foreign Direct Investment (Chairman: N. K. Singh)*, New Delhi: Academic Foundation, August.

to trade, local content requirements, investment and tax incentives, and various geopolitical factors.[12] In order to bypass these structural constraints and emerge as a preferred destination for FDI, India is now promoting special economic zones (SEZs) like many of its East Asian neighbours (see Box 1).

Box 1: India's policies towards Special Economic Zones

Indian exports are burdened by high transaction costs despite significant simplification of trade procedures. Even though the FDI regime has undergone substantial liberalization, structural weaknesses continue to remain. With a view to augmenting infrastructure facilities for export production, and bypassing structural constraints to attract FDI, special economic zones were introduced in the Exim Policy 2000-01. These are meant to provide an enabling environment for exports in terms of duty free imports, incentives for FDI and adequate export infrastructure. The Exim Policy 2002-07 carried the SEZ scheme forward by permitting the setting up of offshore banking units, hedging of commodity price risks and sourcing of short external commercial borrowings. SEZs are designated duty free enclaves where manufacturing, trading and service activities are allowed. In the SEZs, 100% foreign direct investment is allowed in the manufacturing sector under automatic route and there is no cap on foreign investment for items reserved for small-scale production. In setting up SEZs, extensive lessons have been drawn from the success of Special Economic Zones set up in Southeast China and other East Asian countries.

SEZs have evolved in India after a careful evaluation of the potential and limitations of Export Processing Zones (EPZ). These zones are special in the sense that the investment structure, labour laws, and management practices are different from rest of the economy. Key features of SEZs in India include the following:

- private sector, joint sector or state government involvement in setting up the zones;
- development of infrastructure facilities within the zone through private sector participation. For instance, private units have been permitted to invest in generation and distribution of power to ease the power situation in the zones;
- special windows under existing rules have been created to reduce procedural delays in setting up of SEZs;
- subcontracting procedures, including those abroad, have been simplified;
- in-house customs clearance, with routine examination of trade cargo not required by custom authorities;
- various tax incentives such as exemptions from central sales tax for sales from domestic tariff area to SEZs, service tax, and 100% of income tax for the first 5 years and 50% for 2 years thereafter.

The erstwhile EPZs in India were converted into special economic zones. There are now 8 functional SEZs in the country, and many more in the pipeline. India's exports from SEZs increased from Rs. 85.5 billion to Rs. 100.5 billion between FY2000 and FY2002.

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[12] N. Kumar, 2003.*Globalization and the Quality of Foreign Direct Investment*, New Delhi: Oxford University Press.

VI. Short-Term Outlook

15. The short-term outlook for the economy has improved significantly in recent months. ADB-INRM is now forecasting a GDP growth of 6.7% in FY2003 (Table 4). This forecast is based on the resumption of strong agricultural growth following a good monsoon, sustained growth in industry, buoyant services growth, and rising business confidence. Inflation is expected to remain moderate at 5.3% during the year. The consolidated fiscal deficit of the center and the state governments is expected to remain at the average level of 9.5% of GDP during FY2003. With higher projected growth and appreciation in the exchange rate, import growth is also expected to be high at 19.7% during the year, leading to the re-emergence of a current account deficit of 0.3% of GDP in FY2003.

Table 4: Short-Term Projections of Major Economic Indicators: India (%)

Indicators	FY2003	FY2004
Real GDP Growth	6.7	6.2
Inflation	5.3	5.2
Gross Domestic Investment/GDP	24.0	24.0
Gross Domestic Saving/GDP	23.7	23.8
Money Supply (M3) Growth	15.0	15.0
Consolidated Fiscal Balance[a]/ GDP	-9.5	-9.0
Export Growth	15.1	16.6
Import Growth	19.7	14.6
Current Account/ GDP	-0.3	-0.2
External Debt/GDP	18.0	16.0

Note: [a] This includes the combined fiscal deficit of the central government and all state governments.

16. Comparative growth projections of different agencies for FY2003 are reported in Table 5. The consensus growth forecast is in the range of 6.7–6.8% for the current year.

17. In FY2004, the economy is expected to grow at 6.2% since the current recovery in agriculture will have worked itself out by then.

Table 5: Projections of India's GDP Growth in FY2003 (%)

Agency	Growth Rate
ADB	6.7
Ministry of Finance, Government of India	7.0
Reserve Bank of India	6.5-7.0
IMF[a]	5.6
International Institute of Finance	6.5
Confederation of Indian Industry	7.2
National Council of Applied Economic Research	7.1
Investment Information and Credit Rating Agency	6.5-6.9
Credit Rating Information Services of India Limited	7.1
Consensus Forecast	6.7-6.8

Note: [a] refers to the calendar year.

Special Feature

State Finances in India

Dr. C. Rangarajan
Chairman, Twelfth Finance Commission

Dr. C. Rangarajan is currently the Chairman of the Twelfth Finance Commission. Prior to the current assignment, Dr. Rangarajan was Governor of the Reserve Bank of India and also Governor of the state of Andhra Pradesh. Dr. Rangarajan has held several academic positions in India and abroad. He has taught at the Wharton School of Finance & Commerce, University of Pennsylvania; Graduate School of Business Administration, New York University; Indian Statistical Institute, New Delhi, and for well over a decade and a half at the Indian Institute of Management, Ahmedabad. He was Fellow at the International Food Policy Research Institute, Washington D.C.. As a policy maker, in addition to his tenure as Governor, Reserve Bank of India, Dr. Rangarajan was also Member, Planning Commission, Government of India; Member, Tenth Finance Commission; Deputy Governor, Reserve Bank of India; and Chairman, National Statistical Commission. He was also a member of the Economic Advisory Council for the Prime Minister. He has been a President of the Indian Economic Association and Indian Econometric Society. He has to his credit numerous articles in professional journals and several books. His prominent publications include *Agricultural Growth and Industrial Performance in India* (1982); *Indian Economy: Essays on Money and Finance* (1998); *Perspectives on Indian Economy* (2000); and *Structural Reforms in Industry, Banking and Finance* (2000). Dr. C. Rangarajan is the recipient of several awards such as Honorary Fellow, Indian Institute of Management, Ahmedabad 1997; Finance Man of the Decade 1998; The Financial Express Award for Economics at the Annual Conference of the Indian Economic Association 1998; *PADMA VIBHUSHAN* (the second highest civilian award of the country) by the President of India in January, 2002; among others.

Introduction

1. Under the constitutional arrangements in India, as in most federal countries, resources are more centralized while the responsibilities are more decentralized. The Union and the State Lists of the constitution clearly spell out the resources and responsibilities assigned to the central and the state governments. In addition, there is a Concurrent List specifying concurrent jurisdiction for some of the responsibilities. Most of the social and economic services fall within the purview of the state governments.

2. There are 28 states in India. Three of these, viz., Uttaranchal, Jharkhand, and Chhattisgarh were created as recently as November 2000. States differ in size as well as in their economic and fiscal capacities. For example, Rajasthan has more than 90 times as large an area as that of Goa. The population of Uttar Pradesh is more than 300 times that of Sikkim. Bihar has a per capita income which is only one-fifth of that of Punjab and only one-tenth of that of Goa. Due to growing disparities in the growth rates, the differences in per capita incomes have widened over time.

3. Recognizing that there is a built-in vertical imbalance in the assignment of resources and responsibilities, and that there is a horizontal imbalance due to differences in the needs and capacities of the states, the Indian constitution has provided for the sharing of resources between center and the states. Although the Finance Commission addresses this issue at intervals of five years as per the constitutional provisions, resources also flow to the states through the Planning Commission and directly through the central ministries.

Growth in the Nineties

4. During 1993-2000, states like Goa, Gujarat, and Karnataka from the group of better off states and West Bengal and Rajasthan grew at an average annual rate of more than 7%. Table 1 classifies the states in terms of their growth performance over 1993-94 to 1999-00.

5. While most of the states had an average growth rate above 5%, some of the large states like Uttar Pradesh and Bihar, and low income states like Orissa and Assam, remain on the low growth trajectory. This coupled with continued fiscal stress has considerably reduced their capacity to tackle poverty or improve the standards of health and education services. However, public finances have deteriorated

Table 1: States* Classified According to Growth of GSDP(Average:1993-94 to 1999-00)

Group	Growth rate Below 5%	5 to 6.5%	Above 6.5%
Low income	Bihar, Orissa, Assam, Uttar Pradesh		Rajasthan
Middle Income		Andhra Pradesh, Madhya Pradesh, Kerala	West Bengal, Karnataka
High Income	Punjab	Haryana, Maharashtra, Tamil Nadu	Gujarat, Goa

*Assam and general category states

Source(Basic Data):Central Statistical Organization

even in the better off states some of whom have shown a weak growth impulse.

Trends in State Finances

6. Under article 275 of the constitution, grants are given to states in aid of their revenues. Some have argued that for this reason the states should not have an imbalance on revenue account except in a transitory way. In fact, in the first three decades since 1950-51, the aggregate revenue account of the states oscillated between surplus and deficit almost half and half, with deficit exceeding 0.5% of GDP only once. However, after 1986-87, the revenue account balance has remained persistently in deficit. It became larger than 1% of GDP in 1996-97 and is estimated to be 2.6% in 2001-02.

7. Considering the 15 year period from 1986-87 to 2000-01, and taking three year averages at both ends, that is for 1986-89 and 1998-2001, the following trends are notable:

i. The ratio of own tax revenues to GDP remained almost stagnant at 5.35% of GDP during 1998-2001, falling by a small margin of 0.03 percentage points. In 2001-02, the own tax to GDP ratio showed a marginal improvement to reach 5.82% of GDP as per the revised estimates.
ii. However, due to a fall in the share of central taxes as well as in the non-tax revenues relative to GDP, the total revenue

receipts fell by 1.3 percentage points from 11.6% during 1986-89 to the average of 10.3% during 1998-2001.

iii. Total revenue expenditure, during this period, rose by about 1 percentage point to an average level of 12.9% of GDP during 1998-2001.

iv. Over the same period, interest payments and pensions rose by 0.86 and 0.65 percentage points, respectively, and capital expenditure fell by 0.9 percentage points to reach a level of just 1.8% of GDP.

v. Fiscal deficit increased from an average level of 1.96% of GDP during 1986-89 to 4.27% cent during 1998-2001. In 2001-02 RE, it is estimated to be 4.5% of GDP.

vi. The debt to GDP ratio increased by a small margin of 2.7 percentage points during this period to reach a level of 21.8% of GDP. The deterioration in the next two years was sharp. The debt-GDP ratio is estimated at 27.9% at the end of 2002-03.

vii. The fiscal picture varies strikingly from state to state. For example, in 2000-01, the fiscal deficit as a proportion of GSDP varies from the high of 8.0% for Bihar to a low of 3.1% for Maharashtra among the general category states. Revenue deficit relative to GSDP in this year also varied from a high of 5.0 per cent for Gujarat to a low of 1.1% for Haryana. Similar disparities are noted with respect to other major fiscal indicators.

8. The combination of rising revenue and fiscal deficits in conjunction with rising committed expenditures like interest payments and pensions on the one hand and, fall in capital expenditure relative to their respective GSDPs on the other, indicate the basic weaknesses in the profile of state finances.

9. The main reasons for the deterioration in state finances are considered to be the revision of salaries and pensions of state government employees following the recommendations of the Fifth Central Pay Commission and erosion in the buoyancy of central indirect taxes which led to a fall in tax devolution relative to GDP. As the states tried to make up for the resource gap through additional borrowing, they also faced unusually high nominal interest rates towards the end of the nineties.

10. At around this time, the growth impulses also slowed down. After the peak growth rate achieved in the mid-nineties, there was a general slow down in growth towards the end of the nineties, which

has continued till 2002-03. In the first three years of the new decade, the growth rates have been estimated at 4.0, 5.6 and 4.4% respectively, which are much less than the range of 7 to 7.5% envisaged by the Eleventh Finance Commission. In fact, in spite of the falling nominal interest rates, it has been noted that for these years the growth rate has fallen short of the average interest rate on the outstanding liabilities. This has meant that the growth in the state debt relative to GDP has been due not only to the primary deficit but also to the sign reversal in the growth-interest rate differential.

11. For fiscal sustainability, a rise in fiscal deficit should be matched by a rise in the capacity to service the increased debt. In general, even borrowing for capital assets has remained unviable as the returns on investment have remained negligible. Even the more indirect return through higher growth to match the growing interest liabilities has not been forthcoming.

12. At the level of individual states, fiscal stress can be seen in terms of the ratio of interest payments to revenue receipts. Table 2 highlights the fact that there are 8 states with very high ratios.

State Finances: Restructuring and Reforms

13. The Eleventh Finance Commission (EFC) in its outline for restructuring the finances of the states had suggested that balance on their revenue account should be reached by 2004-05. States, individually and severally, are far from achieving this target. Restructuring has to spell out adjustments both on the revenue and expenditure sides. Important fiscal reforms at the state level should address the following issues among others: (i) revenue augmentation

Table 2: States Classified according to Ratio of Interest Payments to Revenue Receipts

Interest payments to revenue receipts(%):2000-01	
Below 15 %	Arunachal Pradesh, Goa, Meghalaya,Mizoram, Nagaland, Sikkim, Tripura, Uttaranchal
15 to 18 %	Chhattisgarh, Jammu & Kashmir, Karnataka, Assam, Madhya Pradesh, Maharashtra, Manipur, Tamil Nadu
18 to 22 %	Andhra Pradesh, Bihar, Gujarat
Above 22 %	Haryana, Himachal Pradesh, Kerala, Orissa, Punjab, Rajasthan, Uttar Pradesh, West Bengal

Source (Basic Data):*RBI Bulletin on State Finances* through non-distortionary taxation like VAT, (ii) revamping of the planning strategy that emphasizes the quality of expenditure, (iii) improving efficiency through reducing the volume of subsidies and targeting them better, (iv) undertaking capital expenditure for social and economic infrastructure, (v) emphasizing maintenance of assets, and (vi) putting in place an effective strategy for controlling the growth of debt, by a suitable legislation, if necessary.

14. Efficiency in the use of resources should be considered as an integral part of any programme of restructuring. Expenditure efficiency encompasses allocative efficiency as well as process and implementation efficiency. The falling capital expenditure-GDP ratio and the depleting share of maintenance expenditure in the overall revenue expenditure should be considered as priority reforms.

15. For improving the overall tax-GDP ratio the long-term outcome of introducing VAT at the level of states on the overall buoyancy of the indirect taxes would be critical. In most countries, where VAT was introduced, a gain in revenue relative to their respective GDP has been experienced. It has been argued that in a comprehensive regime of VAT, the overall buoyancy should go up as the state level VAT will capture the value added up to the retail stage. One can recognize that there is a vertical interdependence in the regime of indirect taxes and the lower central tax rates both for union excise duties and custom duties may well increase the tax bases for state level indirect taxes.

16. Reforms of State level Public Enterprises, particularly in the power and transport sector, constitute a critical component of the overall restructuring. The performance of the State Electricity Boards is known to constitute the Achilles heel of State Finances. Even other public enterprises whose average return on investment is low, call for a major overhaul. The strategy for dealing with these public enterprises needs to be spelt out by each state separately for the power and transport sectors as also for the other enterprises.

17. Fiscal policies will have to be restructured to facilitate acceleration in growth with macroeconomic stability. Public spending in areas such as roads, water supply, power, primary education and primary health will need to be stepped up to provide the appropriate physical and social infrastructure necessary for accelerating growth. The problem would have been a simple one, had there been some fiscal space for augmenting such expenditure. This unfortunately is not the case. The challenge lies in finding ways of augmenting such

expenditures while reducing the overall fiscal imbalances at the same time. Failure to step up expenditure on the necessary items will dampen the growth momentum of the economy. Failure on the fiscal consolidation front, on the other hand, can come in the way of faster growth.

18. The need to contain the rise in fiscal deficit by augmenting revenues and pruning expenditures is well recognized by all states now. Many of them either have initiated or are contemplating to initiate appropriate legislations to limit the growth of debt relative to GDP. Even as states undertake measures to strengthen the fiscal situation, the newly appointed Finance Commission will evolve a scheme of fiscal transfers which will take into account the available resources of the center and the states and the demands on these resources by both the center and the states. The correction of vertical and horizontal imbalances which is necessary has to be done within a framework of fiscal prudence. A sound fiscal system is a necessary pre-requisite for sustained growth. Resource transfers must be an integral part of such a system facilitating efficient use of resources and accelerating growth with equity.

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