IMPACT: International Journal of Research in Humanities, Arts and Literature (IMPACT: IJRHAL)
ISSN (P): 2347-4564; ISSN (E): 2321-8878
Vol. 6, Issue 8, Aug 2018, 497-506
© Impact Journals

FISCAL MANAGEMENT OF SUB NATIONAL GOVERNMENTS OF INDIA

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Received: 27 Jul 2018 **Accepted:** 22 Aug 2018 **Published:** 30 Aug 2018

ABSTRACT

It is the prime focus of the state governments to keep fiscal deficit, public debt, and inflation in limits. Though fiscal sustainability is essential but it is not sufficient condition for growth. The design of fiscal policy and it's transmission channel through which fiscal policy affects economic growth and welfare also needs to be focused. This necessitates that focus should also be shifted to the possible outcome of a level, composition, the effectiveness of public expenditures and efficiency of public revenue system. According to IMF (2006), fiscal policy, that neglects these dimensions face the risk of fiscal instability and emphasize low economic growth and standard of living of people. Therefore, we decided to incorporate the likely dimensions of a fiscal policy i.e. level, composition, and effectiveness of public expenditures and efficiency of public revenue system in this study.

KEYWORDS: *The Effectiveness of Public Expenditures and Efficiency, Fiscal Performance of State Governments*

INTRODUCTION

Fiscal Health of Sub National Governments

State finances, since the late 1980s, have revealed a sharp deterioration. Primarily, this problem was serious only for poorer states, but later on, a sluggish decline in fiscal performance of state governments became the state level fiscal crisis in the late 1980s and 1990s. Several factors contributed towards the deteriorating fiscal positions of state governments i.e. losses of states public sector units, increase in salaries and wages due to the implementation of public sector borrowings, decrease in state own tax revenue, the decline in transfers from central government (Raju, 2008). State governments' fiscal position, unlike the central government, did not show any improvement till the second half of the 1990s. Comptroller Auditor General (CAG) in 1988 also presaged that in India debt to GDP ratio was increasing. Bajpai (1999) stated that basic flaws of state finances were: unproductive capital expenditures, increased interest burden, huge revenue deficit and a sluggish increase of tax and non- tax revenue. Kurian (1999) also stated that fiscal performance of state governments was deteriorating. Brian (2004) explained that fiscal positions of state governments declined sharply in 1997-98 as compared to 1991. of the state governments was a reason for concern.

Rao (2004) explained that fiscal stance of state governments was worsening as primary, revenue and fiscal deficits had the adverse impact on state finances. Kishore (2007) also stated that deteriorating fiscal position In academic and profession sphere, concern regarding the sustainability of fiscal position has emerged as a significant issue to be focused (Rao, 1986). Initially, the focus of researchers remained on the attaining sustainability of the central government. Consequently, a large number of related literature on the sustainability position of the Indian government was available. All these studies concluded that attaining sustainability is a prime condition for achieving economic growth. While on the other hand, Rangarajan (2007) argued that keeping the fiscal numbers in control is the essential to condition but it is not sufficient. We need to focus not only to the attaining targets in quantitative terms but also to the quality of fiscal adjustments. This will improve the allocation and efficiency of public expenditure. According to Quintanilla (2009), in a more inclusive term and from a social welfare approach, the most significant notion of sustainability of sub-national governments was to ensure the development of people. He further suggested that development of people can be assured with appropriate level and efficient usages of public expenditure. Rangarajan (2007) stated that attaining the deficit target alone was a partial approach unless the level of expenditure and revenue was specified. He further argued that the targeted level of fiscal deficit can be achieved at any level of revenue and expenditure but the important task was to maintain the sufficiently high level of revenue and expenditure. High level of revenue and expenditure can make sure the development of the people. Kishore (2007) explained that in order to improve the fiscal performance, the government should produce fiscal space through revenue-raising efforts. Bhargava (2001) stated that government should try to enhance revenue through putting more tax efforts.

Therefore, the study of fiscal management should include the interlinkage between these dimensions i.e. level and composition of expenditures, efficiency and effectiveness of the expenditures, level of revenues, structure, and efficiency of revenue system, fiscal position & sustainability and fiscal governance. Therefore, in order to analyze the various aspects of public finance, it is very essential to discuss all these dimensions.

Levels and Composition of Expenditure in Indian States

There are two components of total expenditure i.e. revenue expenditure and capital expenditure. Revenue expenditures are those expenditures which do not create an asset to the government and used for administration and maintenance of government. Classification of revenue expenditures includes development expenditure, non-development expenditure and grants in aids on the recurring base of one year. Development expenditure includes, expenditure occurred on providing social services to the people of the nation (education, medical, family welfare, water supply and nutrition, etc.) and expenditure occurred by the government on granting economic services like agriculture & allied services, rural development, energy, etc. Non-development expenditures include expenditure on fiscal services, interest payments on the loan, administrative services, etc. These are called non-development expenditures because these do not contribute in the development of people directly. Grants in aids include compensation & assignments to local bodies & Panchayati raj institutions and aid materials and equipment.

Capital expenditure includes the expenditures which enhance the productive capacity of the economy. A composition of capital expenditure includes development expenditure, non-development expenditure, discharge of internal debt, repayments of loans to the central and loans & advances by state governments.

Table 1 presents the trend of revenue and capital expenditure of Indian sub-national governments for the last 25 years starting from 1991 to 2015 (being the latest published actual data by Reserve Bank of India). In order to have a general idea about the level and composition of public expenditure of Indian states, we have taken five-year average values converted into GDP ratio. The table 1 indicates that Indian state governments have not shown any improvement in terms of expenditure rather if we exclude interest payments from revenue expenditures, the level of public expenditure has been almost static over the study period. In fact, it has come down slightly since 2011 onwards. Notably, the capital expenditure showed an upward tick between 2001 and 2015. Interestingly, the findings are in contravention of the Wagner's law which predicts the expenditure level to increase with the increase in income level. It is noteworthy to mention here that during the study period the GDP of the country and almost all the states have gone up by almost 18 times.

Table 1: State Governments Public Expenditure as Per Cent of GSDP

Years	Revenue Expenditure	Interest Payment	Capital Expenditure	Total Expenditure
1991-95	14.25	1.98	2.73	16.99
1996-00	14.41	2.34	2.29	16.70
2001-05	15.22	3.15	2.48	17.71
2006-10	13.94	2.33	3.09	17.03
2011-15	13.39	1.49	3.28	16.67

Source: RBI State Finance Reports (various issues)

In order to have a more detail understanding, we further categorized the expenditures into social, economic and general expenditure. While analyzing the revenue and capital expenditure in detail, we found that Indian state governments have not increased expenditure on social services for the last 25 years as social sector revenue expenditure to GSDP ratio was static at near about 5 per cent and social sector capital expenditure to GSDP ratio varied between the narrow range of 0.25 to 0.53 per cent. Further, it is clear from table 2 that Indian state governments have reduced the revenue expenditures on economic sector. This way, it seems that Indian state governments are not increasing expenditure on basic requirements of people i.e. education, health, sanitation, nutrition, agriculture and allied services etc. Similar is the case with economic services, where revenue expenditure on economic services by the state governments is decreasing since 1991.

Figures of non- development expenditure of both revenue and capital sectors showed that these expenditures increased continuously. One of the reasons for the increase in non-development expenditure may be that within the increase in economic development, the need for better government services in terms of policing, administration, justice also goes up. Similarly, to regulate economic and social activities in the private sector, the government need to expand its services. While, on the other hand, there is no surprise that in India inadequacy of police forces and delay in justice delivering has become endemic. The second reason behind the increases in non- development expenditure can be increase in interest payments of state government as a large proportion of non development expenditures are interest payment. All these lead to increase in non-development revenue and capital expenditures. Moreover, a ratio of social services expenditure to GSDP ratio and ratio of non-development expenditures to GSDP was near about same throughout the period of study. So, we can conclude that the share of non- development expenditure in total expenditure for the last 25 years was approximately 35 per cent.

Table 2: Contribution of Different Sectors in Revenue and Capital Expenditures as Percentage of GSDP

	Revenue Expenditure			Capital Expenditure		
Years	**Social Services**	**Economic Services**	**General Services**	**Social Services**	**Economic Services**	**Administrative Services**
1991-95	5.13	4.15	4.82	0.25	1.43	0.05
1996-00	5.25	3.43	5.53	0.25	1.25	0.06
2001-05	5.10	3.29	6.77	0.35	1.43	0.07
2006-10	5.13	3.12	5.53	0.53	2.11	0.11
2011-15	5.39	3.58	4.22	0.47	1.68	0.10

Source: RBI State Finance Reports (various issues)

It is clear from the table 2 that Indian state governments have not increased the expenditures on social and economic sectors which are known as welfare enhancing expenditures. Public expenditures on social and economic services play a significant role in determining the quality of social and physical infrastructures.

Public Revenue

A volume of expenditure is possible if it is corresponding with the equal amount of receipts; consequently, the government has to mobilize revenue to fulfill the spending requirements. It is the prime responsibility of the government to take a decision that how, how much and when to elevate revenue from its existing resources. It also includes the ways to raise the revenue, principles, and problems of the taxation. Receipts of the government include tax revenues; own non-tax revenues, grants in aids and central assistant. It is very essential for a government to make proper utilization of its resources. The power to allocate the amount of grants and central assistance is owned by the Finance Commission. Own non-tax revenue includes user charges and is again rule-based. Major source of public revenue is taxation. The structure and level of taxation affect the development of an economy by creating fiscal space. Therefore, the government should put appropriate efforts to increase the revenue through maximizing its tax efforts. Low level of taxation can shrink fiscal growth by not creating adequate income to finance vital public sectors.

According to the classification by Comptroller and Auditor General (CAG) of India total receipts of state government consist of revenue receipts and capital receipts. For analytical purpose, the revenue receipts are further categorized as States Own Tax Revenue (SOTR), States Own Non-Tax Revenue (SONTR), Share in Central Tax (SCT) and grants in aids (GIA). The first two are sources are under the control of the state government while remaining two are allocated by the union government as therefore are beyond policy control of the state government. The SOTR are states own tax revenue that comprises taxes on income, taxes on property and capital transactions (which include land revenue, stamps and registration fees and urban immovable property tax) and taxes on commodities and services which includes Sales tax, state excise duty, taxes on vehicle, goods and passengers, taxes and duties of electricity and entertainment tax. The SONTR includes interest receipts, general services, dividends and profits, social services and economic services. Further, the SCT is part of the formula based allocation, while the union government has a certain amount of discretion in allocating GIA to the individual states. These two revenue sources are formula based and decided by the recommendation specified by the Finance Commission. Joint committee of IMF and World Bank (2006) stated that funds received as grants is an attractive way to finance public expenditure as it does not involve any cost but one issue in this source is that grants are generally grossly inadequate to serve the desired purpose of the public expenditure. Therefore, at best the grants can be used as a compliment to other sources of financing. Another revenue source within the state's control is SONTR that basically involves user charges for various services provided by the government to the public. In theory this is a very important source of revenue, however, in the present competitive political environment the governments have become a medium of handing out doles to the public and therefore no government has the political courage to charge even the token amount for the services. Governments in fact, have failed in recovering even the maintenance cost of services provided by them and therefore expecting them to charge economic price from the users is really a tall order. Over the last almost two decades user charges of services provided by state governments are either unchanged or in some of the cases declined. For instance, a large number of state governments have been offering free electricity to farmers and ignoring pilferage of power by other users for political considerations. Similarly, the public transport of most of the state governments is running in losses. The case of all other services is even worse. A number of studies have advocated the government to charge economic prices of government services that can potentially generate a massive amount of resources, however, the state governments of almost all political shades have simply decided to ignore such advice and continue to make available various government services to the public at a nominal rate.

In India, there are several studies which have indicated that revenue receipts of state governments have been much less than potential leading to high revenue deficit and fiscal deficit. Rao (1992) asserted that Non-Tax Revenue (NTR) of the state government for the period of 1970 to 1980 was decreasing which had an adverse affect on the total revenues. Dholakia (2000) noticed the similar trend for Gujarat during the period between the year 1990 and 2000. The decline of revenue receipts from ONTR was observed in case of almost all the states in the country. Arya (2004) also observed the decreasing growth rate of revenue receipts from 1980 to 2001 for all state governments. He explained that reasons for low NTR growth rate were low irrigation taxes, various exemptions to industries, low irrigation charges etc. While reasons for low tax revenue growth rate were tax evasion, under valuation of property, complex tax structure and exemptions on agriculture tax. Chaudhry (2000) argued that the reason for low revenue receipts as a percentage of total revenue of state governments for the period of 1980- 2000 were the low contribution of ONTR as a percentage of total revenue. She found the reason for low ONTR of the state government was various concessions provided in sales tax. Misra (2000) highlighted that from 1986 to 1998 revenue receipts of the state Andhra Pradesh declined and the main reason for this decline was low tax buoyancy. Zaidi (2002) found that total revenue receipts of the state governments for the period of 1990-91 to 1998-99 were average increased by 10.93 percent per annum whereas revenue expenditure increased by 14.57 percent per annum. This gap between revenue receipts and revenue expenditure resulted in a massive jump in state borrowings. Rao (2015) indicated that the reasons for inefficient and ineffective fiscal management at sub-national level were complex tax structure, unproductive public expenditures including the rise of expenditures in terms of salaries, interest, and pensions. To sum up we can conclude that tax and non-tax revenue of state governments had been at the relatively low level in comparison to their potential. In order to analyze the public revenue of the state government, it is pertinent to examine the trend and composition of revenue.

Trends of Total Receipts of State Governments

We have presented total receipts from 1991 onwards in table 3 and The combined revenue receipts of the state governments in the country have increased significantly by 1.11 percentage point of GSDP for the period of 1991- 2015. Total receipts of the state governments were at around 18 percent of GDP during the 90s and jumped up to 20 percent of GSDP during the period 2001-05. However, thereafter it came down back to 18 percent of GSDP as evidenced in table 3. After 2005, we can see the impact of the FRBM Act on state governments. The capital receipts of the state were contained within a restricted limit. Interestingly, reduction in capital receipts in terms of GSDP was almost fully compensated by the improvement in revenue receipts of the state governments as it increased from 12.89 percent of GSDP in 2001-05 to 14.3 percent of GSDP from 2006 onward. The total receipts of state governments were at its maximum level above 20 percent of GDP during the period 2001-05 that was simply the reflection of the higher level of borrowings by the state governments. In fact, this unsustainably higher borrowing compelled the union government to introduce FRBM for the states in 2003. This way total receipt of governments was unchanged for the period 1991-95 to 2011-13. For more detail, we have examined the revenue and capital receipts of Indian state governments in the next section.

Table 3: Total Receipts of Sub National Governments (As Per Cent of GSDP)

Years	Revenue Receipts	Capital Receipts	Total Receipts
1991-95	13.42	4.61	18.03
1996-00	12.24	5.27	17.51
2001-05	12.89	7.57	20.46
2006-10	14.29	4.23	18.52
2011-15	13.04	3.72	16.76

Source: State Finance Report (Reserve Bank of India)

Composition of States Revenue and Capital Receipts as Percent of GSDP

As stated earlier, revenue receipts of the state governments include own revenue receipts which include OTR and ONTR and funds received from central which include SCT and GIA. The table 4 shows that in total revenue receipts of the state governments, the share of states' OTR was 60 percent and share of funds received from the central was 40 percent for the entire period of study. Further, table 4 shows that in the total own revenue, the contribution of OTR has increased from the period 1991-95 (44 per cent) to 2011-15 (51 per cent) and share of ONTR fell down from 15 per cent to 9 per cent for the same period. This means that ONTR could not keep pace with the total mobilization of the state governments. The reason behind the decline of states ONTR was that governments did not increase user charges of the services provided by them, while cost of services continued to go up during the period due to general rise in price level as well as hike in government employees that is indexed to cost of living as well as periodic revision of their pay and allowance. Therefore, state governments are required to increase user charges to reflect the economic price of the services provided. Increase in user charges would also compel the governments to improve service quality as public would demand superior quality of government service in the wake of higher charges. Presently, the system is stuck in low level equilibrium of low service charge and poor quality of government services including physical infrastructure such as roads, water supply, sewerage system, sanitation etc. in urban and rural areas. In fact, given the extremely low level of user charges for social service and resultant poor quality of service, requires a nuanced approach to charge at least more realistic prices from relatively well-off sections of society.

Table 4: Revenue Receipts of Sub National Governments (As Per Cent of Total Revenue)

	Own Tax Revenue			Funds From Central Government			
Years	States Own Tax Revenue	State's Own Non Tax Revenue	State's Total Own Revenue	State's Share in Central Tax	Grants From Central Government	Total Funds From Central Government	Total Revenue
1991-95	44.41	15.52	59.93	21.35	18.71	40.06	100
1996-00	47.60	15.00	62.60	22.74	14.67	37.41	100
2001-05	49.96	2.75	62.71	21.28	16.13	37.41	100
2006-10	47.19	11.87	59.06	22.80	18.39	41.19	100
2011-15	50.92	9.37	60.29	23.33	16.38	39.71	100

Source: State Finance Report (Reserve Bank of India)

Regarding funds from central government, the GIA as percent of total receipts has come down during the study period (1991 to 2015) from 18.71 percent to 16.38 percent but the SCT has improved from 21 percent to 23 percent. In fact, during the period, there have been some structural changes that have taken place in a union-state fiscal relationship including the reduction in central sales tax and the abolition of octroi and increase in central grant in lieu thereof. Further, the funds from the central are primarily formula based and are given to state governments on the recommendation of a central government. Under such circumstances, focus on OTR to improve the receipts of the state governments seems to be a practical and useful method.

Table 5 describes the composition of capital receipts of state governments of India for the period of 1991 to 2013. Capital receipts consist of internal debt, loans and advances, recovery of loans, and advances, small savings & provident funds and miscellaneous receipts. Inter-state settlement (net), contingency fund (net), reserve funds (net), deposits & advances (net), suspense & miscellaneous (net), remittances (net) were added and these were named as miscellaneous capital receipts.

Table 5: Components of Capital Receipts of State Governments (As Percent of total Capital Receipts)

Years	Internal Debt	Loans and Advances From the Central Government	Recovery of Loans and Advances	Small Savings and Provident Fund (net)	Miscellaneous Capital Receipts(net)	Total Capital Receipts
1991-95	35.07	27.98	9.04	11.79	16.13	100
1996-00	41.16	21.38	5.93	13.06	18.48	100
2001-05	59.72	14.98	5.10	6.76	13.44	100
2006-10	72.65	4.14	4.87	8.91	9.43	100
2011-15	72.07	4.06	3.54	9.62	10.71	100

Source: State Finance Report (Reserve Bank of India)

It is clear from table 5 that in capital receipts of the state governments, the importance of capital receipts have been increasing as a share of internal debt in capital receipts exhibited excessive growth as it was 35.07 per cent for the period 1991-95 and increased to 72.07 per cent in 2011-15. On the other hand, a share of loans and advances from the central government came down sharply from 27.98 to 4.06 per cent for the same period. Recovery of loans and advances in total revenue receipts was 9.04 per cent for the period 1991-95 and it came down to 3.54 per cent of total capital receipts in 2011-13. A share of small savings and provident fund in capital receipts did not follow any trend.

Analysis of Public Debt

After deciding the level, composition, and effectiveness of public expenditure and scrutinizing the revenue mobilization process, the next step in the study of state finance is examining the public debt. Accumulation of debt reflects the outcome of government fiscal operations on the revenue and expenditure sides of its budgets. If expenditures are more than the revenues, the excess can only be financed through new borrowings. If the difference between expenditures and revenues is temporary, borrowing acts as an instrument by which the gap among the two can be reduced. However, if the difference continues over a long period and grows in magnitude and increase in revenue receipts turns out to be insufficient to pay the interest liabilities then this will lead to increased revenue and fiscal deficits. This, in turn, would result in unsustainable debt.

Status of Fiscal Position of Indian States

Various government authorities like Reserve Bank of India (RBI), Comptroller and Auditor General of India (CAG) and Finance Commission (FC) have constantly warned against the unhealthy fiscal stance of the sub-national governments in India from the period 1991 (Rajaraman *et al*., 2005). Problem of repayment of public debt and fiscal stress was observed in the late 1990s in Indian states which continued in 2000s when all the fiscal indicators showed decreasing trend. Debt to GSDP ratio of state governments in the year 1991 was 21.5 per cent of GSDP, with the passage of time it started increasing from 22.2 per cent of GDP in 1999 to 31 per cent of GSDP in 2003. Fiscal deficit in the year 1999 was 4.1 per cent of GSDP and subsequently for five years it sustained almost at same pace as in the year 2003-04, it was again 4.1 per cent of GSDP. Revenue deficit also showed the same trend as for the period of 1999-2003 it was approx. 2.5 per cent of GSDP. Primary deficit also got increased sharply from 1.7 per cent of GSDP in 1991 to 2.1 per cent of GSDP in 2003. These figures show that during the years 1999-2003 all the fiscal indicators were at their lowest peak, so state governments were in the urgent need of critical fiscal amendments. Central government, on its part, initiated several measures to control this situation; i.e. debt consolidation, debts write off to merge all central loans contracted by the states and implementation of Fiscal Responsibility and Budget Management (FRBM) Act 2003. However, the central government debt writes off facility was linked to the elimination of revenue deficit and adherence to the conditions of the FRBM Act 2003. After identifying the need of fiscal corrections, state governments enacted FRBM Act 2003 the main features of the central FRBM Act 2003 for states included containing the fiscal deficits to 3 per cent of GSDP and complete elimination of revenue deficit by the year 2009. After the implementation of these reforms, all the fiscal indicators improved as debt to GSDP ratio in the year 2008 came down to 26.6 per cent. At present for the year 2013, it was 22.1 per cent of GSDP. Fiscal deficit reduced to 1.8 per cent of GSDP in the year 2006 but once again in the year 2010 it got increased to 2.9 per cent of GSDP before recovering to 2.0 per cent of GSDP in 2013. Revenue deficit started declining from the year 2006 and continuously up to the current year it was in surplus except for one year i.e. 2009. The primary deficit also declined in the year 2006 as it was 0.6 per cent of GSDP and in the year 2009-10 it increased to 1.2 per cent of GSDP before recuperating to 0.5 per cent of GSDP in 2013.

Although recent fiscal indicator figures showed significant improvement but the current growth rate decelerated and financial markets showed fresh concern regarding the slow growth rate as it was reducing continuously from 2010-11 (RBI, 2014). In the year 2010-11, the growth rate of all states at a constant price was 9.32 per cent and it reduced to 4.99

per cent in the year 2012-13 (Planning Commission Report, 2013). The slow growth rate of GSDP referred to low revenue capacity of the states and it might affect the debt repaying capacity (RBI, 2014).

Table 6: State Governments Fiscal Indicators as per cent of GSDP

Years	Fiscal Deficit	Revenue Deficit	Primary Deficit	Outstanding Liabilities
1991-95	3.8	-1.5	1.2	33.8
1996-00	4.8	0.4	1.9	20.4
2001-05	5.3	1.3	1.8	30.8
2006-10	3.0	-2.3	0.1	28.3
2011-15	2.9	-1.4	0.76	21.4

Source: RBI State Finance Reports (various issues)

CONCLUSIONS

State finances in India has clearly shown deteriorating signs since the 1990s. Several factors contributed towards the deteriorating fiscal positions of state governments i.e. losses of states public sector units, increase in salaries and wages due to the implementation of public sector borrowings, decrease in state own tax revenue, a decline in transfers from central government (Raju, 2008). Fiscal indicators of the state government have started improving after the implementation of FRBM, Act (2003). In the recent trends also fiscal indicators i.e. have shown significant improvement.

Kurian (1999); Rao (2004) and Kishore (2007) concluded that attaining sustainability is a prime condition for achieving economic growth. While on the other hand, Rangarajan (2007) argued that keeping the fiscal numbers in control is the essential to condition but it is not sufficient. Rangarajan (2007) stated that attaining the deficit target alone was a partial approach unless the level of expenditure and revenue was specified. He further argued that the targeted level of fiscal deficit can be achieved at any level of revenue and expenditure but the important task was to maintain the sufficiently high level of revenue and expenditure. As shrinking the expenditures in order to keep the fiscal numbers in control is not an optimum strategy. Analysis of expenditures has shown that state government has not increased the social expenditures from last two decade. While analyzing the revenue trends of the state government we found that there are not significant efforts to elevate the revenues of the governments. This is not a right strategy to adopt. Various authors have argued that the high level of revenue and expenditure can make sure the development of the people. Kishore (2007) explained that in order to improve the fiscal performance, government should produce fiscal space through revenue-raising efforts. Bhargava (2001) stated that the government should try to enhance revenue through putting more tax efforts.

Therefore, we can conclude that government should improve its fiscal numbers but not at the cost of expenditures which ultimately will be used in the welfare of the people rather state governments should try to enhance the revenue-raising efforts

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