Internship Report No.3/2018-19

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Internship Report

on

‘A Comparative Study of Fiscal Reforms in Karnataka and Maharashtra State’

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January, 2020

Certificate

This internship report titled *"A Comparative Study of Fiscal Reforms in Karnataka and Maharashtra State"* is a report on the study taken up at the Fiscal Policy Institute (FPI) in 2019-20.

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All opinion and conclusions expressed in the internship report are of the Intern and usual disclaimer applies.

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Institute's Seal.

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ACKNOWLEDGEMENT

I would like to express my profound gratitude to all those who have been instrumental in the preparation of this report. I wish to place on record, my deep gratitude to **Sri. Sujit Kumar Chowdhury,** Director, FPI, Government of Karnataka, for giving me this opportunity as an Intern at FPI, and for his support in this project.

I would like to extend my indebtedness and gratitude to my project guide **Dr. Anantha Ramu M R**, Consultant (A&R), Fiscal Policy Institute, Government of Karnataka, a highly-esteemed and distinguished guide, for his expert advice and help.

I would like to thank **Smt. Nelleri Umeshwari**, Special Officer, Fiscal Policy Institute for her invaluable support and guidance.

I want to thank **Mr. Ashok H,** Probationary Audit Officer, KSAAD, Bangalore, for suggesting to me to take up this internship at FPI.

I am indebted to all the Librarians for their guidance and invaluable help and co-operation while conducting this study.

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ABSTRACT

Fiscal situation of India worsened during 1990s and early 2000s. Even after many policy initiatives, the fiscal situation of the country has not improved. To bring back the fiscal situation on track, the Government of India adopted rule-based fiscal correction mechanism in 2003 by enacting Fiscal Responsibility & Budget Management Act. Following the Central government, many state governments have enacted Fiscal Responsibility Legislations. Karnataka is the first state to enact the fiscal responsibility legislation even before the Central Government. This report analyses the impact of fiscal reforms on fiscal indicators in the state of Karnataka & Maharashtra.

The study focuses on fiscal policies adopted at the central and state-level for the correction of fiscal imbalance. It also attempts to analyse the performance and effectiveness of these policies at Karnataka in comparison with Maharashtra, which is one of the developed states in India. The report concludes that both states are performing well in the post-fiscal reform period. However, the quality of Karnataka's fiscal consolidation path is better than that of Maharashtra.

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LIST OF ABBREVIATIONS

SR. NO.	ABBREVIATION	EXPANSION
1.	**BoP**	Balance of Payments
2.	**OPEC**	Organisation of the Petroleum Exporting Countries
3.	**IMF**	International Monetary Fund
4.	**GDP**	Gross Domestic Product
5.	**GoI**	Government of India
6.	**GoK**	Government of Karnataka
7.	**GoM**	Government of Maharashtra
8.	**GSDP**	Gross State Domestic Product
9.	**GST**	Goods and Services Tax
10.	**USD**	United States Dollar
11.	**MODVAT**	Modified Value Added Tax
12.	**CENVAT**	Central Value Added Tax
13.	**MTFP**	Medium Term Fiscal Plan
14.	**REPOS**	Repurchase Agreements
15.	**RBI**	Reserve Bank of India
16.	**VAT**	Value Added Tax
17.	**FRBM**	Fiscal Responsibility and Budget Management
18.	**KFRA**	Karnataka Fiscal Responsibility Act
19.	**MFRBM**	Maharashtra Fiscal Responsibility and Budget Management
20.	**MNNREGA**	Mahatma Gandhi National Rural Employment Guarantee Act
21.	**FRL**	Fiscal Responsibility Legislations
22.	**INR**	India Rupee

CHAPTER – 1

INTRODUCTION

The Economic Crisis of 1991 caused the Indian Economy to run into a twin deficit. India's trade balance was in deficit at a time when the government was running on a large fiscal deficit. In addition, the Gulf War situation became so serious and impacted Indian foreign exchange reserves where the nation could barely finance three weeks' worth of imports while the government came close to defaulting on its financial obligations.

This impacted the Indian states where they also faced the crisis effect and were not performing well. States were having the burden of high-interest payments and were engaged in compensating their employees through pay revisions and were also not able to generate enough revenues which caused a difficult situation towards the nation's survival.

In order to overcome this situation, State Governments, in association with the Central Government, adopted Fiscal Reforms in order to curb the effects of these crises. States agreed to take prescribed measures to control their Revenue and Fiscal Deficit to bring the economy to stable levels.

Such measures were crafted to correct the fiscal errors in the long-term to bring the Indian economy on the path of growth.

The study focuses on the Fiscal Reforms adopted by Karnataka and Maharashtra State as Karnataka was the first to undertake fiscal measures among the Indian States and has shown growth since. Maharashtra has been chosen as the state had adopted the fiscal measures in 2005 when compared to Karnataka in the year 2002 and was able to reach among the top states in terms of improvement of Fiscal stability.

CHAPTER – 2

FISCAL SCENARIO IN INDIA

Economic Crisis of 1991

India had experienced a series of macroeconomic crisis in the nineties mainly because of supply shocks, both internal and external. At the end of the 1980s, India faced Balance of Payments (BoP) crisis, due to higher expenditures and unsustainable borrowing where the Current Account Deficit in 1990-91 had been massively weakened in being able to finance the deficit. Also, in the 1970s and the early 1980s, OPEC price hike and inconsistent oil supply was one of the major factors that led to the rise of inflation in India. Being the net importer of oil, exogenous supply shock had a cascading impact on prices of inputs and deteriorated balance of payments. In the 1980s and the early 1990s, supply shocks were accompanied by demand pressures of high fiscal deficit in the 1980s and growing GDP in the 1990s.

The main causes which led the economic crisis of 1990-91 were,

Break-up of the Soviet Bloc, which happened due to the introduction of Glasnost and Perestroika, and the break-up of the Eastern European countries that led to the termination of several rupee payment agreements causing a decline in the flow of new rupee trade credits in 1990-91. This caused a decline in India's exports to Eastern Europe. Also, the Gulf war was one of the reasons for rise in oil prices. And it subsequently resulted in widening Current Account Deficits & Fiscal Deficits.

In addition, credit rating agencies like Standard & Poor's, and Moody's, who had downgraded India's long-term foreign debt rating to the bottom of investment grade in 1991 also caused denial in accessing the external commercial credit market.

Political instability was another important reason for growing fiscal imbalances. The resignations of Prime Ministers VP Singh and Chandra Shekhar between 1990 and 1991 created a political imbalance. Former Prime Minister Rajiv Gandhi was assassinated in May 1991, adding to the overall volatility. Slow growth in trading partners caused deterioration of the current account which was induced by slow growth in economies of important trading partners such as the United States.

Increase in external debt in the second half of the 1980s, the current account deficit was on a rising trend and became unsustainable, reason being, it was financed with costly external

sources of finance which were external commercial borrowings, NRI deposits, etc. This caused the Indian foreign currency assets to deplete rapidly to the extent that it could barely finance just two weeks of imports. To counteract this situation, the Government of India immediately secured an emergency loan of USD 2.2 billion from the International Monetary Fund (IMF) by pledging 67 tonnes of India's gold reserves as collateral. The Reserve Bank of India had airlifted 47 tonnes of gold to the Bank of England and 20 tonnes of gold to the Union Bank of Switzerland to raise USD 600 million (Chikodikar, 2012).

It was only after this crisis, India realised the need to initiate the process of fiscal reforms as a part of economic reform measures in 1991-92.

Fiscal Reforms Scenario

GOI initiated a comprehensive fiscal reform programme in 1991-92 at the Central-level aimed towards reducing the financial burden. The important initiatives adopted under fiscal reforms were revenue reforms, expenditure reforms, and borrowings process reforms.

A. Revenue/Tax Reforms

Restructuring the tax system played a vital role in fiscal reforms with a focus on improving the revenue collection, removing inconsistencies and inefficiencies in the existing tax structure (Kaur, 2011). The primary focus of tax reform was to simplify and rationalise the direct and indirect taxes due to their complicated structure and rates. For this, the recommendations for simplification was mainly cited from the suggestions of Tax Reforms Committee (Raja Chelliah Committee on Tax Reforms), 1991. The important taxation reforms were:

- Reduction in the personal income tax rate from 50% during the 80's to the present level of 33% (includes 3% of health and education cess).
- Corporate tax rate, on both domestic and foreign companies, has been brought down to the present level of 33% and 40%, respectively, from a level of 55% and 65% during '80s.
- Drastic reduction in peak rate of customs duty on non-agricultural products were reduced to 10% in 2007-08 from a massive 355% in 1990-91.
- Services such as– insurance, telephones, etc. were subjected to taxes.
- Simplification of Income-tax filing procedures.
- Rationalisation in Sales Tax was done by replacing it with Value-Added Tax in 2005.

- The cascading effect of Central Indirect Taxes was reduced by the introduction of Modified Value-Added Tax (MODVAT) which was then restructured into Central Value-Added Tax (CENVAT), where a manufacturer of a final product or provider of taxable service shall be allowed to take credit of duty of excise as well as of service tax paid on any input received in the factory or any input service received by a manufacturer of a final product.

B. Expenditure Reforms

The expenditure reforms were aimed at reducing government expenditure. Expenditure Reforms Commission was appointed under the Chairmanship of Shri K.P. Geetha Krishnan to look into for the areas of Expenditure Correction (Kaur, 2011). Based on their recommendations, these important reform measures were undertaken:

- Measures were adopted to check the built-in growth in expenditure and all the ongoing government schemes were subjected to zero-based budgeting.
- Assessment of manpower requirements of all government departments were performed to optimise the government staff strength through a ban on the creation of new posts till a specified period.
- Voluntary Retirement Scheme and the redeployment of surplus staff in various government departments were introduced.
- In addition, the government undertook measures to control growth in non-developmental expenditure which included, a mandatory 10% cut in the budgetary allocation for non-plan, non-salary expenditure of all ministries/departments and autonomous institutions.
- Creation of a national food security buffer stock and minimisation fertilizer subsidies through the dismantling of controls in a phased manner was initiated.
- Dismantling of the Administered Price Mechanism in the petroleum sector and the Oil Pool Account which became effective from April 2002 in order to make a gradual shift towards pricing based on market dynamics and reduce subsidies on crude oil products.

C. Reforms under Government Borrowings

Significant changes in the process of central government's borrowing were adopted to meet the budgetary deficits and temporary mismatches as a part of the fiscal reforms (Kaur, 2011). The important reform measures were:

- Switchover by the government to raise borrowings at market-related interest rates from the public through issue of bonds, debentures, and various national saving schemes.
- The system of Ways and Means Advances (WMA) was started which requires repayment of advances made by the RBI to the government within a specified period of time. The limits of such advances were fixed by RBI. In such a manner, the limits were imposed on the government's borrowings and so it made them responsible for managing their own ways and means of funds position.
- GoI offered to sell dated securities on an auction basis in June 1992, for the first time. In addition, treasury bills were introduced for 364-days and 91 days on an auction basis from April 1992 and December 1992, respectively. Besides, auctions of repurchase agreements (REPOS) of dated securities were also introduced from December 1992

These measures of reduction in monetisation and allowing market borrowings helped to solve the challenging fiscal deficit situation by inducing a fall in government expenditure.

Fiscal Consolidation

This policy aimed towards reducing the government's deficit and debt accumulation are among the important indicators of fiscal health. India had witnessed deficits in central government accounts since the 1970s on almost all indicators like fiscal deficit, primary deficit, revenue deficit, and this situation became worse in the mid-1980s. Fiscal consolidation, then, was the major focus of the reform process which was introduced in 1991-92. The period 1991-92 to 1996-97 with the exception of 1993-94 had experienced an improvement in the situation with a decline in the fiscal deficit as well as other indicators. However, in the later 1990s and the early 2000s, there was a reversal in this trend and the major deficit indicators reached back almost to their levels in 1991-92 with revenue deficit showing the continued bad situation. Accordingly, greater attention was being diverted towards the size of these deficits and actions were taken towards the management of the deficit by incorporating the Fiscal Responsibility and Budget Management Act (FRBM), 2003.

The Act imparts the responsibility on the Central Government to ensure equity in fiscal management and long-term macroeconomic stability. The fiscal sustainability is sought to be achieved through limiting the Government borrowings, debt, and deficits, greater transparency in fiscal operations of the Government (GoI, 2003). The important provisions of the Act are as follows:

- The FRBM Rules imposes limits on fiscal deficit and revenue deficit. Hence, it will be the duty of the Union government to stick to the deficit targets. As per the target;
    - Revenue deficit has to be reduced to nil by 2008-09 which was extended by one year.
    - Every year, the government was required to reduce the revenue deficit by 0.5% of the GDP.
    - The fiscal deficit was required to be reduced to 3% of the GDP by 2008-09. It meant a reduction of fiscal deficit by 0.3 % of GDP every year (GoI, 2003).
- The Act, however, provides relaxation from deficit reduction targets to deal with unforeseen demands on the finances of the Central Government on account of national security or natural calamities of national dimension. The deficit was monitored through the rules on mid-year targets for fiscal and revenue deficits. The rules were framed to restrict the government's fiscal and revenue deficit to 45% of budget estimates at the end of September (the first half of the financial year). In case of breach of either of the two limits, the Finance Minister will be required to explain to Parliament the reasons for the breach, the corrective steps, as well as the proposals for funding the additional deficit.
- The Act also prohibits the Central Government from borrowing from the Reserve Bank of India (that is, deficit financing, involving the printing of money) to meet its deficit, except for temporary cash advances. This effectively rules out a cheap source of borrowing and forces the government to borrow at much higher rates.
- The Act provides that the central government shall specify the annual targets of assuming contingent liabilities in the form of guarantees and the total liabilities as a % of GDP.
- The Act provides for the improvement in the transparency of budgetary policy through Quarterly progress review reports that have to be placed before Parliament, annual publishing of government's asset register. The government is also required to place three documents before Parliament every year: one is the assessment of economic prospects; second, is its strategy with regard to taxation and expenditure; and the final

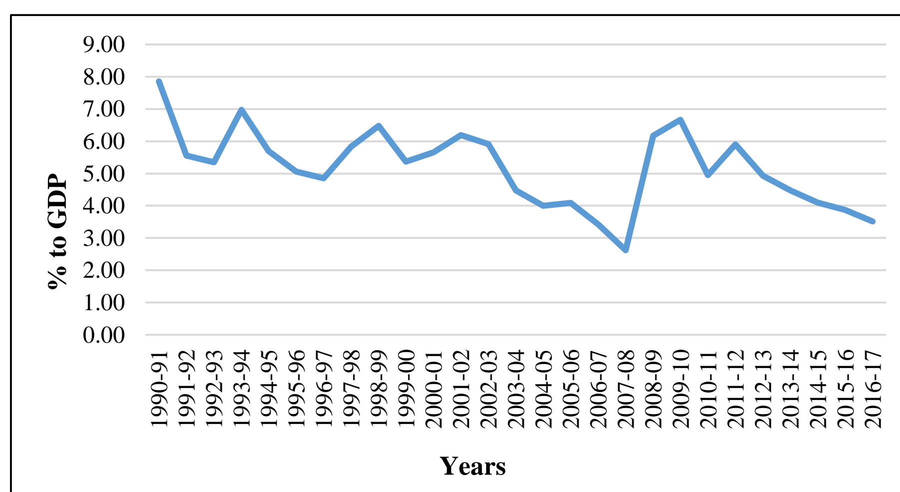
one giving a three-year rolling target for the revenue balance and the overall fiscal balance.

The implementation of the FRBM Act, 2003 created a required mandate and lent credibility to the fiscal reforms process. The Act involves significant reforms to both revenue and expenditure.

Graphical Representation of Fiscal Indicators of Central Government

a) Gross Fiscal Deficit from 1991-2017

Figure- 2.1: Gross Fiscal Deficit of India: 1990-91 to 2016-17 (% of GDP)



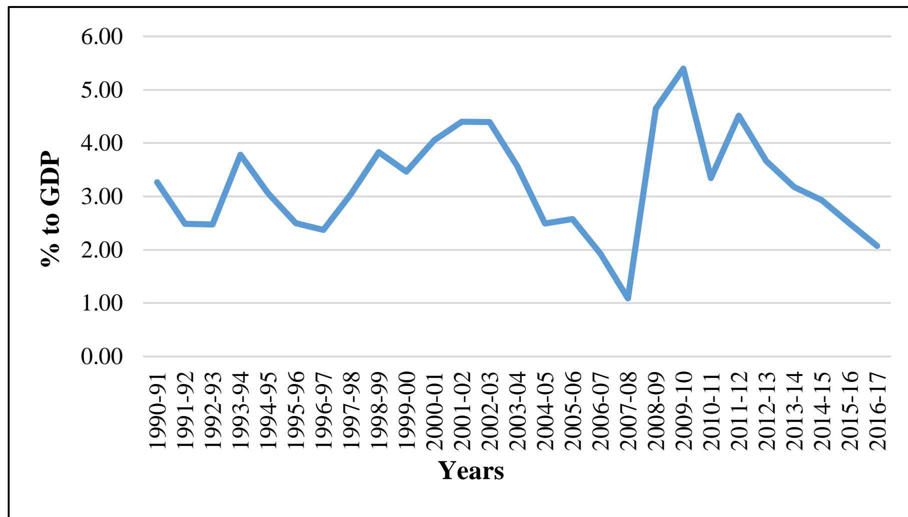
Source: RBI, Handbook on Indian Economy, 2018

From the above graphical representation it can be implied that the post-reforms period experienced a higher fluctuation in the Fiscal Deficit levels from 1991-2001 reason being the economic crisis was a contributing factor to the increasing debt, inflation, pay revisions, etc. To control this condition, the FRBM Act was implemented in August 2003 by the Central Government. The post-fiscal reforms period, i.e., after implementation FRBM Act, the Fiscal Deficit has been observed reaching to 2.62% in proportion GDP proving the success of the fiscal management legislation. It can be observed that from 2008-09 onwards the nation faced the fiscal situation like the early 1990s due to the crisis of US market, payment of off-budget liabilities, non-payment of subsidies accrued in the previous year, loan waivers and additional investment for MGNREGA which was not budgeted well (Rao, 2009) which impacted the fiscal deficit to rise up to 6.66% in 2009-10 which was later brought down to 3.51% in 2016-

2017. The average gross fiscal deficit was brought down to 3.13% during the post-reform period from 3.32% in the pre-reforms period.

b) Revenue Deficit from 1991-2017

Figure- 2.2: Revenue Deficit of India: 1990-91 to 2016-17 (% of GDP)

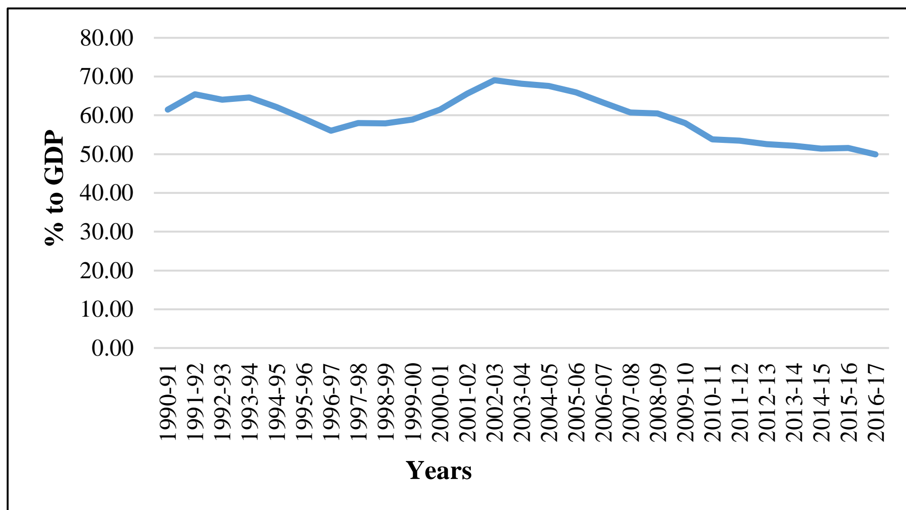


Source: RBI, Handbook on Indian Economy, 2018

From the above graphical representation it can be observed that the Central Government was able to maintain the revenue deficits to a lower level in the initial phase of fiscal crisis till the year 1992-93 to 2.47% and saw an upward trend reaching to 4.40% in 2001-2002, the reason being the decline in the revenues from customs and excise duties, increased burden on interest due to increased indebtedness and high interest rates and rapid increase in subsidies and transfers by the Centre to State (Rao, 2009). It can be seen in the trend that from 2002-03 onwards there has been a turnaround in the previous situation due to the implementation of FRBM Act which aimed to reduce or eliminate the revenue deficit to nil. In 2009-10, the revenue deficit reached 5.40% due to the effects of the sub-prime mortgage crisis that came from the United States which led to liquidity and solvency problems all around the world, interest burdens, non-payment of subsidies, and additional investment in MGNREGA and pay revisions (Rao, 2009). It can be observed that the revenue deficit has been taken care of since 2011-12. The average revenue deficit during the pre-reforms period was around 5.90% from 1990-2003 which was then brought down to 4.51% after the enactment of FRBM Act.

c) **Total Liabilities from 1991-2017**

Figure- 2.3: Total Liabilities of India: 1990-91 to 2016-17 (% of GDP)



Source: RBI, Handbook on Indian Economy, 2018

From the above representation one can imply that the Central Government has experienced a peak of 69.10% during the pre-reforms period due to reasons such as external market shocks, downgrading of nation's creditworthiness by credit rating agencies, and increased high interest rates due to indebtedness lasting till 2001-02. The situation was reversed after the enactment and implementation of FRBM Act, 2003 which proved to be an effective measure. The level liabilities have been brought to 49.93% during the post-reforms period where the government swapped the high-interest debts with low-interest rates. This shows that the fiscal reforms have helped the government to turnaround the economic situation of the nation post-reforms period.

In terms of Gross Fiscal Deficit, States such as Chhattisgarh, Goa, Gujarat, Karnataka and Maharashtra have maintained the limit of the fiscal deficit under prescribed limit of 3% under fiscal management.

While outstanding liabilities section implies that some states were able to control and reduce the liabilities in 2017 compared with 2010. Also, a few states such as Goa, Haryana, Jharkhand, and Rajasthan have shown an increase for the same.

Comparison of Deficit Indicators of State Governments for 2010-11 & 2016-17

Table - 2.1: Deficit Indicators of Central Government

Sr. No.	Comparison of Deficit Indicators of State Governments for 2010-11 & 2016-17 (As at end-March)						
	States	Revenue Deficit		Gross Fiscal Deficit		Outstanding Liabilities	
1	Andhra Pradesh	-0.4	2.5	2	4.4	23.9	23
2	Bihar	-3	-2.5	1.9	3.8	31.2	27.9
3	Chhattisgarh	-2.9	-1.9	-0.3	1.4	14.3	14.6
4	Goa	-2	-1.1	1.7	1.5	28.4	35.4
5	Gujarat	1	-0.5	2.9	1.4	27.4	22.5
6	Haryana	1	2.9	2.7	4.8	17.8	25.9
7	Jharkhand	0.1	-0.8	4.4	4	22.2	23.6
8	Karnataka	-1.1	-0.1	2.8	2.5	22.8	16.9
9	Kerala	1.3	2.5	2.8	4.3	31.8	27.2
10	Madhya Pradesh	-2.5	-0.6	1.9	4.3	28.7	22.8
11	Maharashtra	0.1	0.4	1.8	1.7	22	17.6
12	Odisha	-2	-2.5	0.3	2.5	23.8	16.4
13	Punjab	2.4	1.7	3.2	12.3	33.1	32.9
14	Rajasthan	-0.3	2.4	1.3	6.1	29.4	31.1
15	Tamil Nadu	0.5	1	3.2	4.3	19.6	17.9

Source: RBI, Handbook on Indian Economy, 2018

The above tabulation implies that the States such as Bihar, Chhattisgarh, Goa, Gujarat, Jharkhand, Karnataka, Madhya Pradesh and Odisha have been reflecting revenue surpluses during the post-reforms period along with drop in trend for the specific durations from 2010-2017. Punjab, on the other hand, has been able to reduce the revenue deficit from 2.4% in 2010 to 1.7% in 2017.

CHAPTER – 3

FISCAL POSITION OF KARNATAKA STATE

Karnataka's economy was strong in the 1990s as compared to other major states. The growth rate was comparatively high per year as against the other 14 major states between 1995–96 and 1999–2000. Karnataka also gained the largest share of Foreign Direct Investment (FDI) from the first half (3%) to the second half (19%) of the 1990s among the six major states of India (Sarkar, 2018).

Irrespective of strong indicators, the state's fiscal crisis started appearing from 1995-96 onwards where the revenue receipt decreased from Rs 159 Cr. (surplus) to – Rs 2,325Cr. (deficit), and the fiscal deficit had also escalated from Rs 513 Cr. to Rs 4,276 Cr. between 1990-91 and 1999-2000 (Sarkar, 2018). The pressure on the state revenue generation avenues and dependency on loans from the external market and at the risk of debt trap condition pushed the state to formally adopt fiscal reform measures.

There were a number of reasons which led to the fiscal pressure in Karnataka. As per the first Medium Term Fiscal Plan (MTFP), 2001, fiscal deficit, revenue deficit (both tax and non-tax), increasing debt servicing, mounting losses in public sector enterprises, tacit subsidies in the social sector (urban health, education) and irrigation projects, slow growth of tax and non-tax revenues, revision of salary and pensions as per Fifth Pay Commission and escalating fiscal pressure at state-level local bodies were the main causes for fiscal stress(GOK, MTFP, 2001 and 2005).

Apart from the above-mentioned factors, the situation further worsened due to the practice of off-budget borrowing at regular intervals to finance its loss-making public sector units and big infrastructure projects.

To counteract these reasons Karnataka adopted the below-mentioned reforms,

Fiscal and Public Expenditure Reform

The Karnataka State government created structural bindings for fiscal management by enacting the Fiscal Responsibility Legislations (FRL) and operation of administratively-improvised policy instrument. Karnataka Ceiling on Government Guarantee Act, 1999, was enacted for putting a cap on increasing contingent liabilities and Karnataka Fiscal Responsibility Act (KFRA), 2002 were the two statutory laws enacted to manage the fiscal position in state's

finance activity. KFRA, 2002 was the first initiative taken by the state in the country to eliminate revenue deficit and limit fiscal deficit within 3% by 2005- 06.

Revenue management, expenditure management, debt management, public finance management, and procurement transparency were the outcomes of fiscal and public expenditure reform initiatives (Sarkar, 2018).

The Three Major Agendas of Fiscal Reform in Karnataka were;

- **Revenue reforms** were started by constituting a Tax Reform Commission in 2000 to improvise and rationalise the tax base and tax rates, accordingly (GoK, MTFP, 2001). Afterwards, the VAT (Value-Added Tax) system was also introduced on April 01, 2005 to replace the sales tax (GoK, MTFP, 2006). Concerning non-tax sources of revenue, the government took initiative to withdraw itself from 'implicit subsidies' because of the poor cost recovery system, mainly in secondary and tertiary healthcare services, irrigation, and drinking water supply, higher and technical education (GoK, MTFP, 2001). As a result, cost recovery in the health sector was moved to higher limits during 1999-2008. Revenue deficit was brought down to nil by 2004-05 against the target of March 31, 2006. Subsequently, the state revenues were always in surplus. However, the gap between revenue receipt and revenue expenditure was shrinking. In later years, ever-increasing subsidy burden, continuous hike in committed expenditure, and slow-moving growth in non-tax revenues brought the fiscal pressure back (Sarkar, 2018).
- **Expenditure reforms** were focused on reducing the financial burden on salary, pension, and interest payments. Major reform that happened were in the power sector to unload the subsidy burden. Simultaneously, Karnataka Transparency in Public Procurement Act, 1999, was enacted against the backdrop of reforms to bring transparency, competition and standardise the cost as well as the procurement process.
- **Debt management reform** was adopted by taking an important decision at the beginning of the reform process that government should shift from short-term loan to long-term loan from multilateral and bilateral agencies (GoK, MTFP, 2001). Thus discouraging the practice of off-budget borrowings by opting for budgetary grants and restricting the mounting debt servicing payments. With the help of FRLs and successful implementation of MTFPs, the fiscal deficit was reduced and maintained within 3% of GSDP by 2004-05 (GoK, MTFP, 2005).

After the implementation of KFRA, 2002, Karnataka has been consistent in meeting the fiscal responsibility-associated obligations unless there is any direction from the Union government

to cross the fiscal deficit limit. As per the Thirteenth Finance Commission's recommendation, The KFRA, 2002 had been amended as KFR (Amendment) Act, 2011 to follow the new set of ceilings on fiscal deficit, revenue deficit and outstanding debt as % of GSDP.

An Overview of the Karnataka Fiscal Responsibility Act, 2002

It is an Act enacted by the State Government to ensure fiscal stability and sustainability, and to enhance the scope for improving social and physical infrastructure and human development by achieving sufficient revenue surplus, reducing fiscal deficit and removing impediments to the effective conduct of fiscal policy and prudent debt management through limits on State Government borrowings, debt and deficits, greater transparency in fiscal operations of the State Government (KFRA, 2002).

In order to maintain efficiency and smooth functioning of these regulations, MTFP has been the most important reform apparatus devised for fiscal management and has been utilised as both policy tool and operational instrument to keep the reform on a steady path. It was introduced in 2001 and thereafter regularised within the Fiscal Management System. MTFP usually serves two purposes.

- The draft MTFP is exercised as an operational instrument of internal-guiding documents to various departments before the budget preparation.
- The final MTFP is used as a policy tool for larger stakeholders to discuss the fiscal plan and performances.

Medium-Term Fiscal Plan to be laid before the Legislature –

1) The State Government shall in each financial year lay before both Houses of the Legislature a Medium-Term Fiscal Plan along with the annual budget.
2) The Medium-Term Fiscal Plan shall set forth a four- year rolling target for the prescribed fiscal indicators with specification of underlying assumptions

Few Fiscal Management Principles highlighted in the Act are:

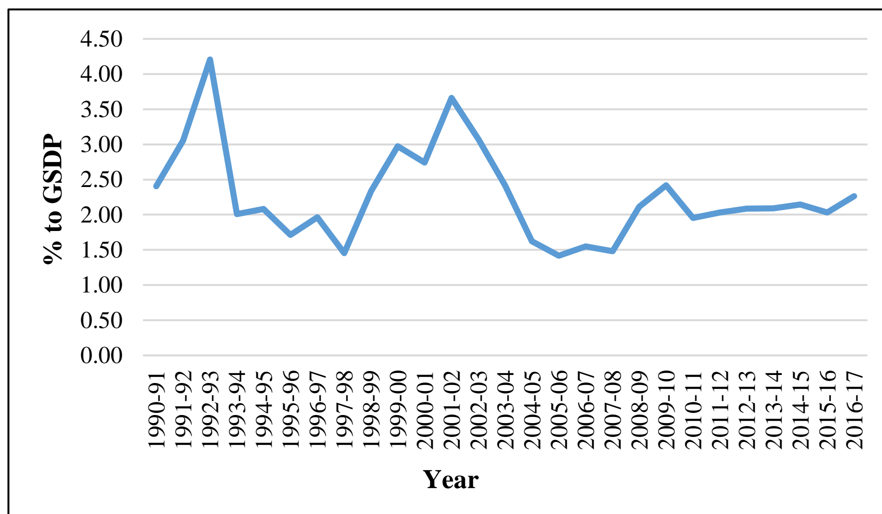
- Maintain Government debt at prudent levels;
- Manage guarantees and other contingent liabilities prudently, with particular reference to the quality and level of such liabilities;
- Ensure that policy decisions of the Government have due regard to their financial implications on future generations;

- Ensure that borrowings are used for productive purposes and accumulation of capital assets, and are not applied to finance current expenditure;
- Ensure a reasonable degree of stability and predictability in the level of the tax burden;
- Maintain the integrity of the tax system by minimising special incentives, concessions and exemptions;
- Ensure that the Government uses resources in ways that give best value for money; and also ensure that public assets are put to best possible use;

Analysis of Fiscal Indicators

a) Gross Fiscal Deficit

Figure- 3.1: Gross Fiscal Deficit of Karnataka: 1990-91 to 2016-17 (% of GDP)

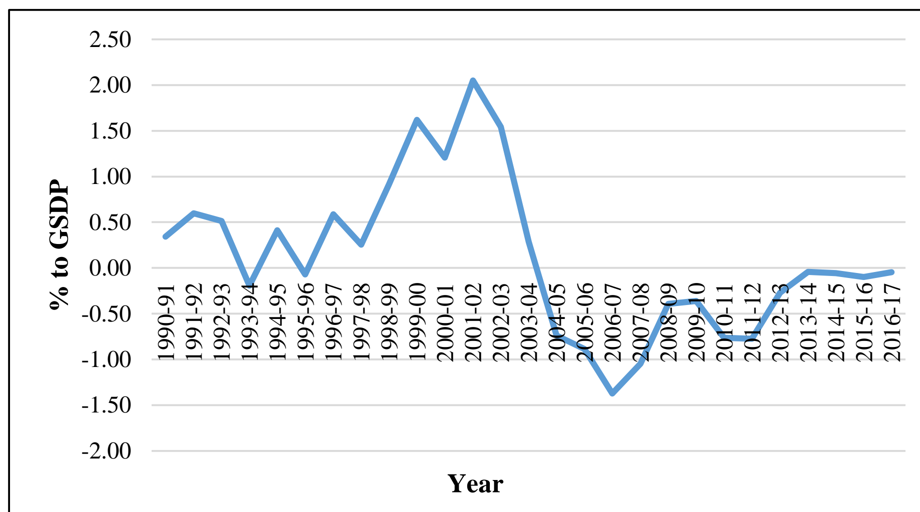


Source: RBI, Study on State Finance

The above analysis implies that the Karnataka Government's Gross Fiscal Deficit as a percentage to GSDP has reached a level of 4.21% in 1992-93 during the pre-reforms period due to the combined effect of nation-wide economic crisis which was then brought down to a level of 1.46% in 1997-98. It can be observed that the fiscal deficit started to move up from 1998-99 due to various reasons such as low and declining cost recoveries from non-merit public services and poor performance of public enterprises, investment in implicit subsidies due to uneconomic pricing of irrigation and drinking water supply, higher and technical education and urban health services and many other (GoK, MTFP, 2001), which lasted till 2001-02, making the government adopt the fiscal correction mechanism. Since the adoption of fiscal measures it has been observed that the State has been successful in maintaining the fiscal deficit level understated norms of KFR Act, 2002 by limiting the fiscal deficit below 3%.

b) **Revenue Deficit**

Figure- 3.2: Revenue Deficit of Karnataka: 1990-91 to 2016-17 (% of GDP)

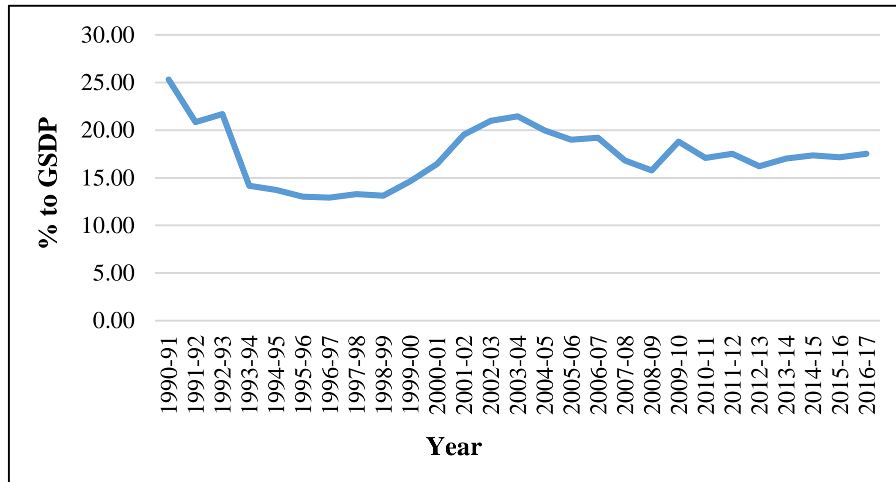


Source: RBI, Study on State Finances

The above trend analysis depicts that the Karnataka Government has been able to sustain its revenue deficit during the pre-reforms period, i.e., from 1991-1997. It has been observed that the revenue deficit started to increase from 1998-99 onwards due to implementation of pay revisions, payment of ₹914 crore to Karnataka Electricity Board by way of explicit subsidy, the revival of loss-making public entities, a declining share of revenues to GSDP, reduction in own-tax revenue collections, etc. causing the deficit level to reach a peak value of 2.05% in 2001-2002. The post-reforms trend depicts that the implementations of fiscal correction measures have helped the state to correct the revenue imbalances and allowed to generate and maintain revenue surpluses from the year 2006 to date.

c) Outstanding Liabilities

Figure- 3.3: Outstanding Liabilities of Karnataka: 1990-91 to 2016-17 (% of GDP)



Source: RBI, Study on State Finances

The above trend analysis implies that Karnataka state was able to minimise on its outstanding liabilities as a percentage to GSDP from 25.32% in 1990-1991 to 12.90% in 1996-1997. Later on, it followed an upward movement in the trend from 1997-98 due to the increase in off-budget borrowings, poor maintenance of public assets, increase in indebtedness resulting in a higher amount being spent for debt servicing which lasted till 2003-04 at 21.47%. After the adoption of fiscal correction measures by the state, it can be observed that in post-reforms period an effective control over the outstanding liabilities is seen which allows maintaining the revenues in surplus.

CHAPTER – 4

FISCAL POSITION OF MAHARASHTRA STATE

Maharashtra saw a sharp deterioration in the fiscal position during the 1990s, particularly since 1995 where the World Bank went to the extent of commenting that "Better known for its fiscal conservatism, Maharashtra is now faced with a fiscal problem of unprecedented magnitude". The Economic Survey for 2002-03 of the Maharashtra Government states that for the few years during pre-reforms condition, finances of State Government were under severe strain. In fact, the World Bank Report has indicated that the State was heading towards insolvency by 2005-06 unless its revenue and deficits, besides debt, including the off-budget borrowings were controlled (Jadhav, 2009).

All the major deficit indicators showed sharp deterioration, particularly after the mid-1990s e.g., fiscal deficit as a proportion to State Domestic Product, which hovered around 2.0% till the mid-1990s rose sharply to 4.9% by the end of the decade and were estimated to be 4.1% for 2001-02. Considerably, the balance on the revenue account that indicated surplus till 1994-95, displayed a negative trend in the mid-1990s. The reasons for the sharp deterioration since the mid-1990s had been caused due to;

- The sharp increase in the spending on salaries and pensions on account of Fifth Pay Commission;
- Huge off-budget borrowings;
- Market intervention by the State Government in case of commodities like sugar, cotton or onion;
- High subsidies on public services.

Furthermore, as per the Indian federal structure almost all the taxes collected by the Central Government are sharable – and that included both direct and indirect taxes like those on personal & corporate income, excise & customs duty. The Central Government, on account of these shares, failed due to the Crisis of 1990s.

During the 1990s, nearly half the fiscal gap was financed through borrowings from the Central Government, about 40% derived from sources like small savings and provident fund collections, and the remaining 10% through market borrowings. Reflecting on the alternative sources employed by the Maharashtra Government, for financing their resource gap. This has resulted in greater dependency and fiscal stress on the State Government. Growing fiscal deficit

and resultant borrowings led to a steep rise in the outstanding liabilities of the State Government (Jadhav, 2009). The outstanding debt of the State Government as a proportion to GSDP was as high as 20.23% in 1999=2000 (RBI, Handbook of Statistics on Indian States, 2018).

In order to bring fiscal stability and sustainability by eliminating revenue deficit and reducing the fiscal deficit and to bring transparency in fiscal operations, the Twelfth Finance Commission recommended the enactment of fiscal responsibility legislation by the States. Accordingly, Maharashtra Government enacted its own "Fiscal Responsibilities and Budget Management Act (FRBM)" in April 2005 and framed relevant rules in February 2006.

An Overview of Maharashtra Fiscal Responsibility and Budgetary Management Act, 2005

This Act was enacted to provide for the responsibility of the State Government to ensure inter-generational equity in fiscal management, fiscal stability by achieving sufficient revenue surplus and prudential debt management consistent with fiscal sustainability, greater transparency in fiscal operations of the State Government (GoM, MFRBM, 2005).

Fiscal Policy Statement to be laid before State Legislature

The State Government shall lay, in the Budget Session of each financial year, before both Houses of the State Legislature, the following statements of fiscal policy, namely;

a) The Medium-term Fiscal Policy Statement,
b) The Fiscal Policy Strategy Statement.

1) The Medium-term Fiscal Policy Statement states that,
    - It shall set forth a three-year rolling target for prescribed fiscal indicators with the specification of underlying assumptions.
    - The Medium-term Fiscal Policy Statement shall include an assessment of sustainability relating to,
        - the balance between revenue receipts and revenue expenditures;
        - the use of capital receipts for generating productive assets
2) The Fiscal Policy Strategy Statement shall contain,

- The policies of the State Government relating to taxation, expenditure, borrowings and other liabilities, lending and investments, description of other activities such as underwriting and guarantees which have potential budgetary and fiscal implications
- The strategic priorities of the State Government for the ensuing financial year in the fiscal area;
- The key fiscal policies and rationale for any major deviation in fiscal measures pertaining to taxation and expenditure;
- An evaluation as to how the current policies of the State Government are in conformity with the fiscal management principles.

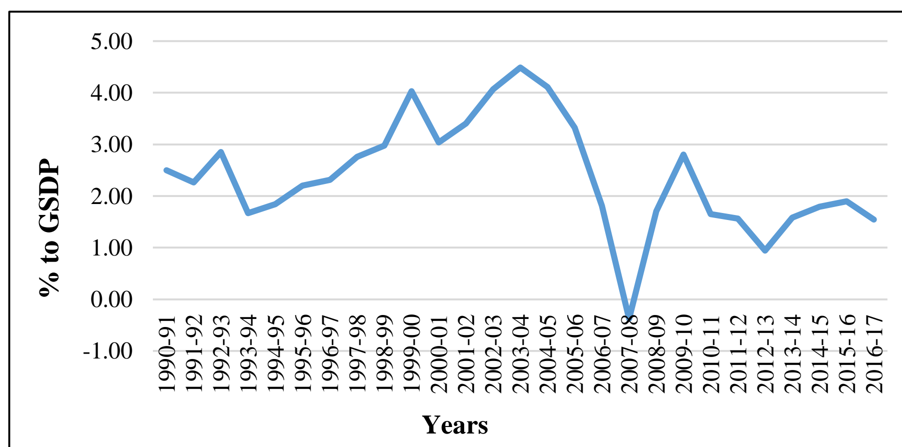
The major fiscal targets for the State are as under:

- Reduce the revenue deficit by 1% or more of the GSDP in the first year, 1.5% or more in the first two years, 2% or more in the first three years, beginning from the financial year 2005-06 and the entire deficit by 2008-09.
- Reduce the fiscal deficit by an amount equivalent to 0.3% or more of the GSDP at the end of each financial year beginning with the financial year 2005-06 until the fiscal deficit is brought down to not more than 3% of the GSDP. The fiscal deficit in 2008-09 and thereafter should not exceed three percent of GSDP.

Analysis of Fiscal Indicators

a) Gross Fiscal Deficit

Figure- 4.1: Gross Fiscal Deficit of Maharashtra: 1990-91 to 2016-17 (% of GDP)

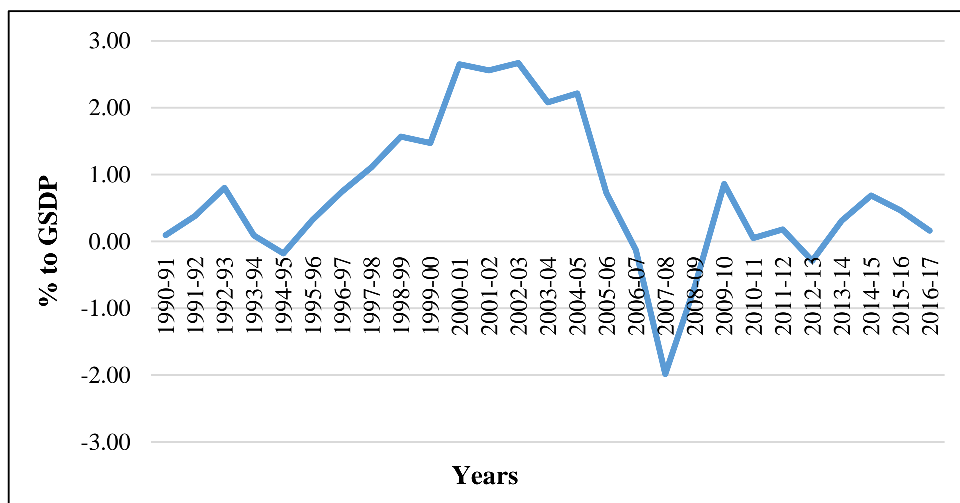


Source: RBI, Study on State Finances

The above analysis implies that Maharashtra State during the pre-reforms period has maintained Gross Fiscal Deficit as a percentage to GSDP below 3% from 1990-1998. The trend shows that from 1999-00 onwards there has been an upward movement causing the fiscal deficit level to reach a peak of 4.49% in 2003-04 due to pay and pension revision by 5th Pay Commission, revenue deficit, capital outlay and high expenditure on interest payments by the state being one of the major reasons. Afterward, during the post-reforms situation, the state has maintained the fiscal deficit level effectively under 3% as prescribed by the State's own FRBM Act, 2005. The state has also seen a situation where the fiscal deficit shows a sign of surplus as it was caused due to the transfer from consolidated funds to the revenues.

b) Revenue Deficit

Figure- 4.2: Revenue Deficit of Maharashtra: 1990-91 to 2016-17 (% of GDP)

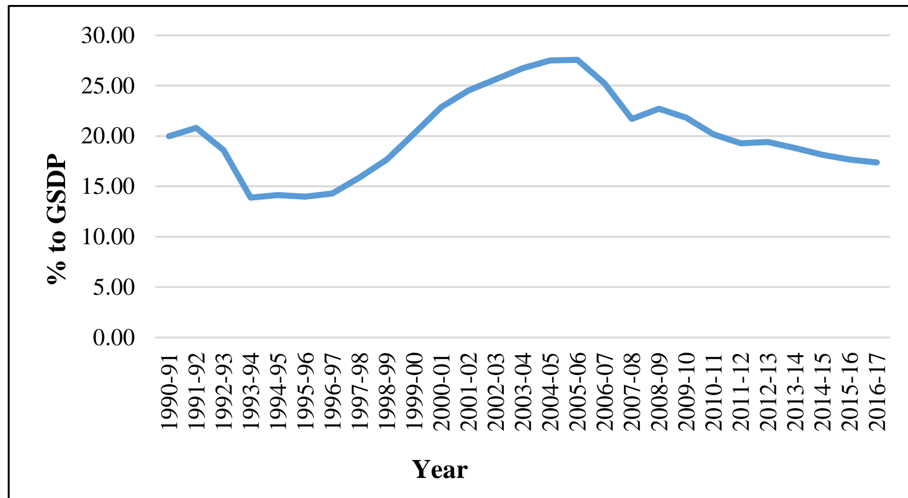


Source: RBI, Study on State Finances

The above analysis implies that Maharashtra State was able to maintain the revenue deficit below 2% till 1999-00 as % to GSDP and experienced a hike in deficit level reaching 2.67% during 2001-02, an effect of high-interest payments and salary expenditures, along with the downgrading of credit rating by CRISIL of four bound programmes by the states also increased the revenue deficit. After the implementation of fiscal reforms, there has been a reduction in the revenue deficit level (Ashok Lahiri, 2001). In addition, it can be observed that since the adoption of the FRBM Act, the state was able to gain revenues from 2006 to 2010 and has been able to maintain the revenue deficit level to a minimum since then (GoM, 2014).

c) **Outstanding Liabilities**

Figure- 4.3: Outstanding Liabilities of Maharashtra: 1990-91 to 2016-17 (% of GDP)



Source: RBI, Study on State Finances

The above trend analysis shows Maharashtra State's outstanding liabilities as a percentage to GSDP which was around 13.87% in 1993-1994. It can be observed that from 1998-99 there has been a rise in the trend which reached to a peak of 27.55%, lasting till 2005-06, the reason being the increasing interest burden, market borrowings, loss in cotton monopoly supply schemes (CMPS) under procurement scheme during 1999-00, and committed liabilities (GoM, 2014). After the adoption of fiscal correction measures, the liabilities were brought down to 17.37% in 2016-17. Here, it can be stated that Maharashtra State has been able to minimise the outstanding liabilities during the post-reform period proving that the reforms were successful.

CHAPTER – 5

COMPARATIVE ANALYSIS OF FISCAL INDICATORS BETWEEN KARNATAKA AND MAHARASHTRA

In this section, a comparison between the fiscal correction Acts for both the states has been performed. Along with this, a comparison of information has been plotted in trend analysis method to observe the performance of both the states with respect to their fiscal indicators as percentages to GSDP. In this analysis, one can see, how both the states are performing in regards to their policies and their implementation. By doing so, one can imply that one state has outperformed another in one or the other fiscal parameters.

The Acts, enacted by both the States pertaining to fiscal corrections, are almost the same but do have certain dis-similarities towards their approach.

When compared with one another, Karnataka has set the rolling target of four year mid-term plan whereas Maharashtra follows a three year mid-term plan.

The KFR Act, 2002 set out that Karnataka should eliminate the revenue deficit and contain the fiscal deficit to 3% of GSDP by 31st March, 2006 whereas Maharashtra set out the annual targets where State Government shall reduce the revenue deficit by 1%, or more of the GSDP in the first year, 1.5 per cent, or more in the first 2 years, 2%, or more in the first 3 years, beginning from the financial year 2005-2006, and the entire deficit by 2008-09. The fiscal deficit by an amount equivalent to 0.3 per cent, or more of the GSDP at the end of each financial year beginning with the financial year 2005-2006 until the fiscal deficit is brought down to not more than 3% of the GSDP.

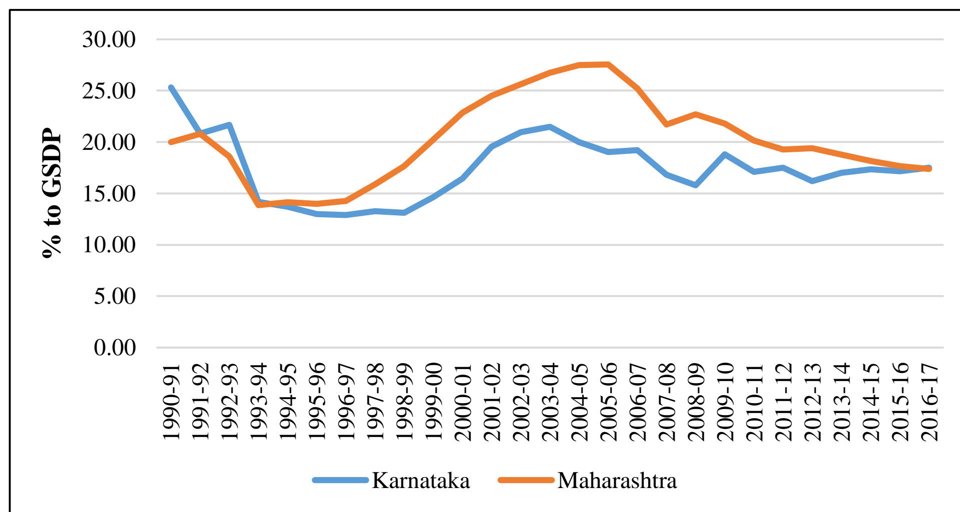
COMPARISON OF FISCAL INDICATORS

The analysis involves comparison of both states on their fiscal indicators such as outstanding liabilities, capital outlay, own tax revenue, revenue expenditure, revenue deficit, the gross fiscal deficit in % to gross state domestic product.

a) **Outstanding Liabilities of Karnataka and Maharashtra State**

Comparative analysis of liabilities between Karnataka and Maharashtra state has been performed to determine which state has been able to reduce the outstanding liability levels since the adoption of fiscal reforms.

Figure- 5.1: Comparison of Outstanding Liabilities: 1990-91 to 2016-17 (% of GDP)



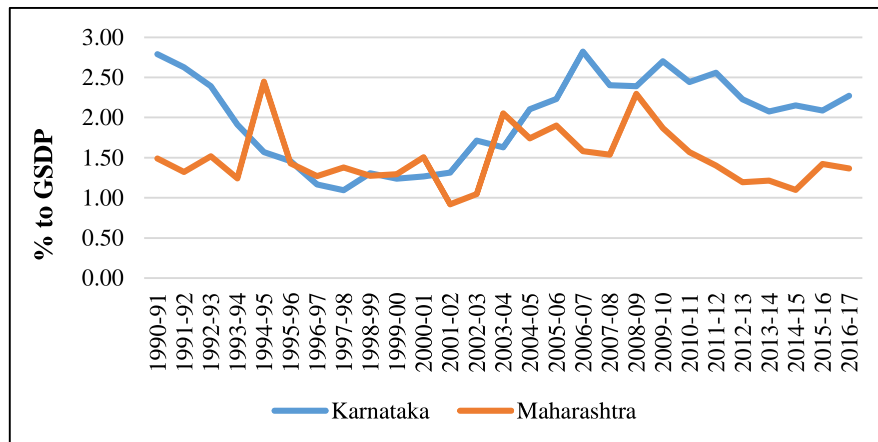
Source: RBI, Study on State Finances

From the 1990s, it can be observed that Karnataka State has been able to keep the outstanding liability on the lower levels as compared to Maharashtra State. Reason for being this is that Karnataka has implemented the fiscal reforms early and has been successful in their implementation as compared to Maharashtra which started the reforms in 2005 as compared to Karnataka in 2003. The analysis also implies that both states have taken effective measures for minimising the outstanding liabilities in the long run.

b) **Capital Outlay of Karnataka and Maharashtra State**

Comparative analysis of capital outlays between Karnataka and Maharashtra state has been performed to determine which state has increased and put efforts in the capital formation process post the adoption of fiscal reforms.

Figure- 5.2: Comparison of Capital Outlay: 1990-91 to 2016-17 (% of GDP)



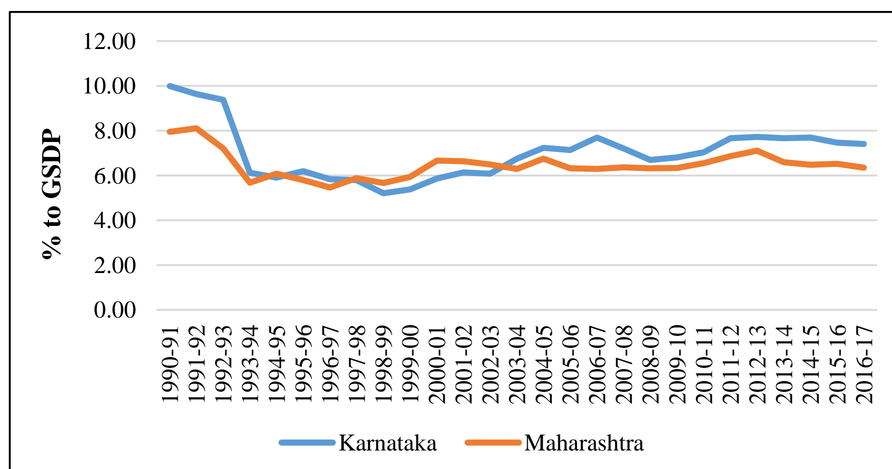
Source: RBI, Study on State Finances

From the above trend analysis, it can be stated that Karnataka has focused on capital expenditure more when compared with Maharashtra. Pre-fiscal reforms for both the states were minimal but shows an upward trend in the post-reform period 2003 and 2005 respectively.

c) Own Tax Revenues of Karnataka and Maharashtra State

Comparative analysis of Own Tax Revenues between Karnataka and Maharashtra state has been performed to understand which state has experienced increased in their revenues excluding the contribution from the central government.

Figure- 5.3: Comparison of Own Tax Revenue: 1990-91 to 2016-17 (% of GDP)



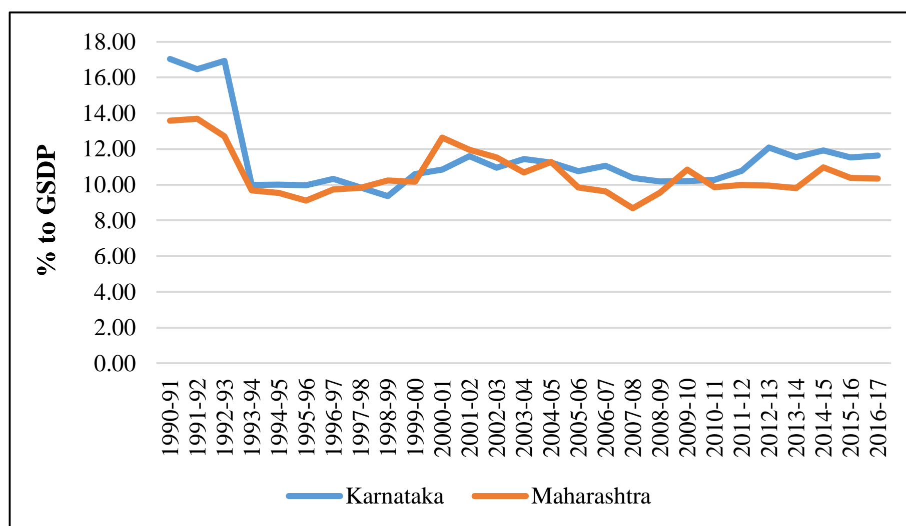
Source: RBI, Study on State Finances

In this trend analysis, it is observed that both the states have faced a drop in collection of revenues due to their taxation policies which were not able to pull in revenues. However, after the implementation of FRBM policies both the states have improvised on the taxation front and were able to generate sustainable revenues. Comparatively, Karnataka has done a great effort in tax revenue collection after the reforms period.

d) Revenue Expenditure of Karnataka and Maharashtra State

Comparative analysis of Revenue expenditure between Karnataka and Maharashtra state has been performed to understand which state has been able to reduce its revenue expenditure to avoid investment in non-asset creating expenses.

Figure- 5.4: Comparison of Revenue Expenditure: 1990-91 to 2016-17 (% of GDP)



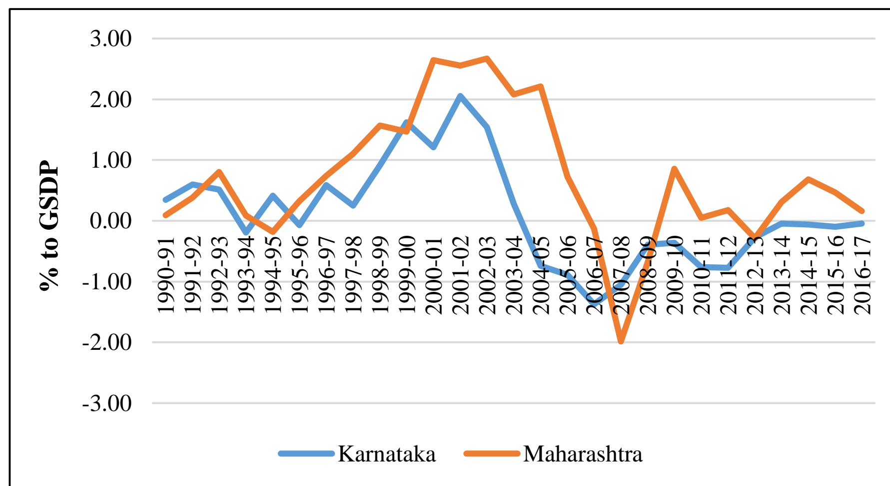
Source: RBI, Study on State Finances

From the above analysis, it can be observed that both Karnataka and Maharashtra were able to reduce their revenue expenditure level during 1990-1995 and have maintained lower levels. The comparative analysis implies that on an average, Maharashtra, when compared to Karnataka was able to reduce revenue expenditure level and have maintained sustainable levels.

e) Revenue Deficit Level of Karnataka and Maharashtra State

Comparative analysis of revenue deficits between Karnataka and Maharashtra state has been performed to determine which state has been able to reduce the revenue deficit levels since the adoption of fiscal reforms.

Figure- 5.5: Comparison of Revenue Deficit: 1990-91 to 2016-17 (% of GDP)



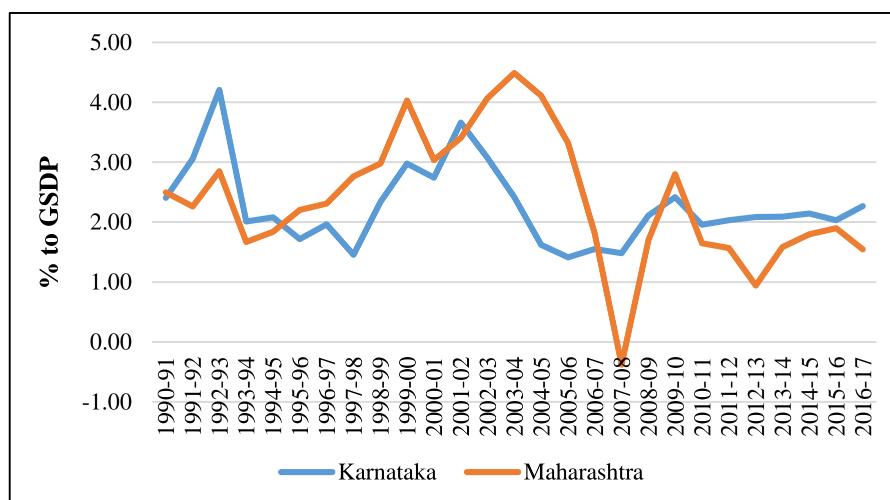
Source: RBI, Study on State Finances

From the comparative trend analysis, one can conclude that Karnataka State has been able to maintain a lower level of revenue deficit when compared to Maharashtra. The data showcases that from 2005-2017, Karnataka state has been in surplus, reason being early adoption of fiscal reforms and reduction in non-planned expenditures. Maharashtra, on the other hand, has done a good job even after late adoption of fiscal reforms and managed surpluses for a specific duration. Also, we can see that in the long run both the states were able to sustain and control their revenue deficit levels under the prescribed limits of their respective fiscal policies and Acts.

f) Gross Fiscal Deficit level of Karnataka and Maharashtra State

A comparative analysis of fiscal deficits between Karnataka and Maharashtra state has been performed to determine which state has been able to manage the fiscal deficit levels under the prescribed limit of 3% by the FRBM Act of both states since the adoption of the reforms.

Figure- 5.2: Comparison of Gross Fiscal Deficit: 1990-91 to 2016-17 (% of GDP)



Source: RBI, Study on State Finances

The above comparative analysis implies that Karnataka State has been able to maintain the fiscal deficit level on an average under 3% of the GSDP whereas Maharashtra has also been able to sustain their fiscal deficits to the level under 3% on the overall average. Both the states in certain periods crossed their specified limits where Karnataka reached 3.66% in 2001-02 (post-reform period) and Maharashtra reached 4.49% in 2003-04 (post-reform period) reason being increased expenditure.

g) Revenue Deficit to Gross Fiscal Deficit for Karnataka And Maharashtra

Table- 5.1: Comparison of Revenue Deficit to Gross Fiscal Deficit

Year	Karnataka	Maharashtra
1990-91	14.29	3.73
1991-92	19.57	16.87
1992-93	12.23	28.19
1993-94	-9.60	5.31
1994-95	19.87	-9.79
1995-96	-4.11	14.70
1996-97	29.90	32.12
1997-98	17.39	40.06
1998-99	39.23	52.68
1999-00	54.44	36.46
2000-01	44.08	87.19
2001-02	56.05	75.14

2002-03	50.19	65.57
2003-04	11.78	46.35
2004-05	-45.56	53.87
2005-06	-62.60	21.78
2006-07	-88.49	-7.01
2007-08	-70.92	524.82
2008-09	-18.67	-39.86
2009-10	-14.90	30.62
2010-11	-39.01	3.13
2011-12	-38.13	11.37
2012-13	-12.96	-30.64
2013-14	-2.07	19.53
2014-15	-2.70	38.14
2015-16	-4.86	24.48
2016-17	-2.03	10.40

Source: RBI, Study on State Finances

The graphical representation implies that Karnataka state has experienced higher fluctuations during the pre-reforms period but managed to control their revenue deficit level and shown surpluses till 2016-17. Maharashtra, on the other hand, experienced higher revenue deficit in 2001-02 due to higher interest payments due to borrowings. This has impacted Maharashtra's economy severely which led to the adoption of fiscal reforms. Since implementation of fiscal correction mechanism, the state has performed well and was able to manage surpluses.

CHAPTER – 5

CONCLUSION

The individual analysis on fiscal indicators of Karnataka and Maharashtra State implies that the states have performed well in their post-reforms periods and have been able to sustain their Gross Fiscal Deficit levels under prescribed limits by their respective FRBM Acts. Most importantly, the states were able to manage the revenue deficits level to a minimum and created revenue which shows that effective measures in terms of fiscal reforms adopted were successful.

Comparative analysis of both the states implies that Karnataka being the first state to adopt the fiscal reforms has performed well and was able to bring down the targeted fiscal deficit under their prescribed limits. On the other hand, Maharashtra adopted the fiscal reforms late compared to Karnataka state and was also able to effectively implement the reforms and managed to control its fiscal deficit level. Karnataka, when compared to Maharashtra in terms of managing the revenue deficit, has been on top due to the improvement in own tax revenue by strengthening their policies at an early stage. Karnataka has shown a revenue surplus till 2016-17 whereas Maharashtra experienced fluctuations in the same duration. On the revenue expenditure front, Maharashtra has been able to maintain sustainable levels when compared to Karnataka State.

On the capital outlay front, Karnataka, in the pre-reforms period saw a decline in capital investments due to increased burden of interest payments. The situation was reversed in the post-reforms period where the state has shown a growth in investment. Maharashtra experienced a decline in its expenditure activities due to an increase in interest payments and wages and salary distributions in the pre-reforms period. The situation improved after implementation of fiscal reforms where the state increased investment in capital formation processes. When compared the revenue deficit with gross fiscal deficit for Karnataka and Maharashtra it can be implied that Karnataka managed to reduce the revenue deficit contribution towards fiscal deficit since the post-reforms period and has also managed to gain revenues opening opportunities for capital formation. Maharashtra has also managed to reduce the revenue deficit level during the post-reforms period and gained surplus on multiple years.

The States are performing well in their post-fiscal reforms period as compared to the pre-reforms period.

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