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Savitha N
Research Scholar, Jain University, Bengaluru, Karnataka, India

Dr S Soundar Rajan
Research Guide, Jain University, Bengaluru, Karnataka, India

Correspondence
Savitha N
Research Scholar, Jain University, Bengaluru, Karnataka, India

The impact of fiscal reforms on selective fiscal indicators of Karnataka

Savitha N and Dr S Soundar Rajan

Abstract
This paper is an effort to study the fiscal situation in Karnataka before the implementation of Karnataka Fiscal Responsibility Act, 2002 of and how the implementation of this act has affected the fiscal parameters of the state. Karnataka is one of the progressive states which have initiated many reforms for the fiscal progress of the state. The main reform initiated is the Karnataka Fiscal Responsibility Act (KFRA), which was a major and very important reform initiative. After the implementation of the KFRA, Karnataka has been able to adhere to the fiscal and revenue deficit targets and has improved the performance for development and capital expenditure. This paper examines the impact of fiscal reforms on selective fiscal indicators of Karnataka and the results show that the fiscal situation of Karnataka has improved after the implementation of Karnataka Fiscal Responsibility Act.

Keywords: Fiscal Reforms, Fiscal Indicators

1. Introduction

Karnataka is one of the progressive states which have initiated many reforms for the fiscal progress of the state. The main objectives of the Karnataka Fiscal Responsibility Bill is to bring revenue deficit to zero, contain fiscal deficit to 3% of the GSDP, to bring in transparency in all the fiscal operations of the centre and the state, requiring a bi annual review of the receipts and expenditure of the centre and to prepare Medium Term Fiscal Plan

The main objective of the fiscal reforms is to aim at reducing the deficit and the debt as a proportion to the GDP. A major step was taken towards decentralising the economy during the reforms programme. The functions were divided into categories like socio-economic, national policy, centrally sponsored, state sponsored, infrastructure etc. The main determinants of the New Economic Policy were the taxation policy, to understand and modify the growth patter and the public expenditure and public borrowings. Therefore fiscal reforms encompass issues like tax reforms, the process of borrowing of the central government, expenditure reforms and issues related to debt.

There have been several attempts to improve the tax structure both the direct taxes and the indirect taxes since the time of independence and the main focus of revenue reforms lies in the taxation reforms. The objective was to raise the level of investment and savings and the redistribution of the resources from the private to public sector. Many attempts have been done to remedy the different aspects of the taxes with regard to income taxes; there was a reduction in corporate and personal income taxes. In the federal system of India the resources that are available in the state and centre is significantly decided by the transfer of resources from the centre to the state. The centre to state transfers reached the peak during the Ninth Finance commission at 40.33 % in the year 1989-95.

State governments have an important role to play in all the economic activities in India mainly because of the federal setup which India follows. In the process of restructuring the economy and restoring macroeconomic balance in the economy state governments have an important role to play. In an open economy state governments have an important role to play than in a closed economy. Fiscal decentralisation plays a very important role when it comes to the efficient working of the local and rural bodies and state governments have to augment the resources efficiently in order see efficient development. Fiscal reform is a necessary condition to enable the governments to be an efficient agent of development in the country. The improvement of transparency, efficiency and effectiveness of all the government operations is very important.

Though the reforms of the nineties made for the various state level reforms the state level reforms did not progress until the late 1990’s when there was a state level crisis. There was slowdown in most of the states and the growth of the states was relatively low compared to the previous years. The competition for private investments has led to the tax concessions and other incentives which have led to the fiscal imbalances of the late 1990’s. There was a lot of political compulsion for the states to bring in a hike in the user charges (Rao, 2002) [28]. Less productivity of the non-tax revenue and it was not possible for the state governments to increase the tax ratio.

Operational Definition

- Fiscal Policy: Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply
- Fiscal Indicators: A thing that indicates the state or level of fiscal policy

Literature Review

Kaur and Kaur **(**2015) [20] aims to assess the fiscal performance of Punjab state by examining the major fiscal policy indicator in the pre and post reform period and investigating the performance of state on the fiscal front after the implementation of FRBM act. The present empirical investigation is based on the secondary data compiled in the form of regular time series of 34 years from (1980-81 to 2013-14) for the state of Punjab. The data on various policy indicators the ratios and trends is analysed and concludes that the government has been using the borrowings for debt servicing and leaving only 10 percent for development purpose. This problem has created a vicious cycle. Revenue deficit is found to be the major factor affecting the fiscal situation of Punjab. As far as the quality and impact of FRBM is concerned, it has not fully realized its targets yet.

Tax Reforms in EU Member States (2015) is discussed in which reviews the most important tax reforms recently implemented in EU Member States and discusses a number of challenges relating to tax policy that may affect macroeconomic performance, in terms of growth, employment, public finances and macroeconomic stability. The report provides a basis for dialogue on the role of tax policies in promoting sustainable growth, employment and social equity. In this context, it also encourages a valuable exchange of best practice in the area of tax reforms and the report contributes to an informed dialogue with civil society on what is generally considered a sensitive topic. This is particularly relevant and important in the current economic context. Although the levels of inequality, as measured by market income (income derived from work and capital), rose significantly in the EU during the crisis years 2007-2013, income inequality after taxes and benefits changed relatively little. At least until 2013, tax and benefit systems were able to contain a significant part of the increase in market inequality in most Member States. There is, however, significant variation between countries, and the level of inequality increased in some Member States even taking into account the effect of taxes and benefits. Furthermore, low-income households in some Member States have seen their living standards deteriorate disproportionately.

The IMF policy paper (2015) explores how fiscal policy can affect medium- to long-term growth. It identifies the main channels through which fiscal policy can influence growth and distils practical lessons for policymakers. The particular mix of policy measures, however, will depend on country-specific conditions, capacities, and preferences. The paper draws on the Fund’s extensive technical assistance on fiscal reforms as well as several analytical studies, including a novel approach for country studies, a statistical analysis of growth accelerations following fiscal reforms, and simulations of an endogenous growth model. Fiscal policy is an effective tool for supporting growth. While it is difficult to disentangle the impact of fiscal reforms from other factors and to determine causality with certainty, the analysis suggests that they could lift medium- to long-term growth by ¾ of a percentage point in advanced economies and even more in developing economies. Fiscal policy promotes growth through macro and structural tax and expenditure policies. At the macro level, it plays an important role in ensuring macroeconomic stability, which is a prerequisite for achieving and maintaining economic growth. At the micro level, through well-designed tax and spending policies, it can boost employment, investment, and productivity.

Kaur (2014) [21] discusses the impact of fiscal reforms on fiscal performance of the central Government and compares revenue and expenditure position of the central government in pre and post-reform period. The fiscal performance of the central government for the period of 1975-76 to 2007-08 has been analysed. With the initiation of fiscal reforms process, the immediate impact was the sharp reduction but thereafter there was a steady reduction and the reduction was sharper after the enactment of the Fiscal Responsibility and Budget Management Act (FRBMA), 2003 in both the revenue and fiscal deficits of the central government. This improvement in the fiscal position of the central government has been achieved on the strength of higher revenues. Due to lesser efforts being made to compress expenditure during the first decade of economic reforms process, expenditure continuously increased and grew by sixty-four times during the study period. What is more disturbing is that revenue expenditure shot up only at the cost of capital expenditure. It constituted more than 60 per cent and even reached to cent per cent of the total expenditure of the central government. While capital expenditure of the central government constitutes merely 4 to 37 per cent of the total expenditure during pre as well as post-reform period. So there is an urgent need to restrain the growth in revenue expenditure.

Chakraborty and Bharatee (2013) [8] have examined whether the introduction of fiscal rules has helped in bringing fiscal discipline at the sub national level in India and how the fiscal rule has impacted on development spending at the sub national level. Using the data from Handbook of Statistics on Indian Economy 2010-11, RBI, State Finances: A Study of Budgets (various. issues), RBI and using panel-correcting standard errors (PCSE) and feasible generalized least squares (FGLS) estimation methods it has been found that it needs to be emphasized that fiscal reforms have largely been revenue driven growth. Although, there has been an improvement in the aggregate fiscal position of the states till 2007-08, there has been disparities in fiscal performance across states. Increasing disparities in per-capita spending has increased in recent years. The econometric exercise reveals that the state level fiscal policy and fiscal rule has been successful in reducing fiscal imbalance even when we control for other policy shocks and other standard determinants of fiscal balance. However, it is clear that fiscal targets under fiscal rule have been achieved through a cut in discretionary development spending also shows that cut in spending has been partially offset by higher central transfers.

Research Gap

After an extensive review of literature it is found that there is no study on the impact of Fiscal Reform in Karnataka and its analysis on pre and post reform period. This is an honest effort to study the fiscal situation in Karnataka before the implementation of Karnataka Fiscal Responsibility Act, 2002 of and how the implementation of this act has affected the fiscal parameters of the state.

Data and Methodology

This chapter gives an overview of the data collected and the type of methodology used in the study for the data analysis along with the different operational definitions which is used in the study. The main objectives, data sources, statement of problem, Variables used, hypothesis and the limitations of the study are discusses here.

The data considered in the study is mainly secondary data collected from various budget documents, RBI- State Finances, Karnataka Accounts Reckoner and Medium Term Fiscal Plan-Karnataka. The data period is considered from 1990-2016 where 1990-2003 is considered as the pre Karnataka Fiscal Responsibility Act period and from 2004-2016 it is considered as post Karnataka Fiscal Responsibility Act period for the analysis.

Objective

The main objective of the study is:to trace and compare the trends and patterns in the revenue, expenditure indicators after the implementation of Karnataka Fiscal Responsibility Act of Karnataka.

Hypothesis

- H_0: There is no significant difference between the pre Karnataka Fiscal Responsibility Act and post Karnataka Fiscal Responsibility Act
- H_1: There is a significant difference between the pre Karnataka Fiscal Responsibility Act and post Karnataka Fiscal Responsibility Act

Data Interpretation and Analysis

A state's revenue resources constitute of state own revenue which comprises of tax revenue and non tax revenue and also the transfer of resource from Central government by different form of taxes and grants. There was a severe crisis in the late 1980's which was revived with the help of the revenue resources of the state which has played a prominent role. Own Tax revenue constitutes major share of revenue in the state. We can observe that for the period of study own tax revenue takes away the major share of revenue constituting for about 9-11% of the total GSDP and Non Tax revenue contributes only around 0.3-2% of the GSDP, which has reduces considerably over the years from 2003 to 2016, where the data for 2014-15 is Revised Estimate and the data for 2015-16 is the Budget estimate. Non Tax revenue has always been an area of concern for the policy makers and ministers. There are many debates and studies which are discussing different ways to increase the share of non tax revenue in the total revenue. The Non tax revenue is almost halved in the year 2006-07 to 2007-08 and has since then reduced further below 1% of the GSDP

The main expenditure indicators of the state include the Revenue Expenditure, the capital expenditure, development expenditure and non development expenditure. The development expenditure includes the social services and the economic services whereas the non development expenditure includes the general services. The social services expenditure include water supply sanitation, housing, rural development. This expenditure is generally considered for the development expenditure and non development expenditure consists of items like defence and other general services. A states development can also be measured through development expenditure generally.

The revenue expenditure constitutes a major proportion of expenditure in the expenditure items. The revenue expenditure, capital expenditure, expenditure on general services, social services and economic services is calculated as a percentage of GSDP for the pre and post reform period from 1990-91 to 2015-16 where 2014-15 is revised estimate and 2015-16 is budget estimate.

From this analysis we can understand that revenue expenditure constitute the major share of the expenditure, it has reduced over the years from 17.04% in 1990-91 to 14.64% in 2015-16 BE but the capital expenditure has reduced from 5.04% in 2003-04 to 3.43% 2015-16 BE. The capital expenditure here is a matter of concern. As a developing nation we should be investing more in the capital investment for the infrastructure development. The graph reaffirms the same idea and it is easy to identify the variation pictorially.

Regression analysis (t-test)

H_0: There is no significant difference between the pre Karnataka Fiscal Responsibility Act and post Karnataka Fiscal Responsibility Act

H_1: There is a significant difference between the pre Karnataka Fiscal Responsibility Act and post Karnataka Fiscal Responsibility Act

The sig level is less than 0.01 and since the p- value is zero, the alternate hypothesis is accepted proving that there is a significant impact of KFRA on the fiscal performance of the state.

The sig level is less than 0.01 and the p-value is zero. Therefore the alternate hypothesis is accepted proving that there is a significant impact of KFRA on the fiscal performance of the state.

Limitation of the Study

There is no study without any limitation. Since all the studies have to accept the limitations of the study and further improvise on the limitations in the studies followed by the previous ones. This study too is not an exception and does posses some of the limitations which is highlighted in this section:

1. The study period is only for 26 years. The result discusses here only reflects the time period of 26 years so the variations and results of other years are not included in the study.

2. The econometric analysis also was based on the previous studies and is limited to the specific objective of the study.
3. There is an inbuilt cost constraint for study which is carried out.

Conclusion

Karnataka is one of the progressive states which have initiated many reforms for the fiscal progress of the state. The main reform initiated is the Karnataka Fiscal Responsibility Act (KFRA), which was a major and very important reform initiative. After the implementation of the KFRA, Karnataka has been able to adhere to the fiscal and revenue deficit targets and has improved the performance for development and capital expenditure.

The main objectives of the Karnataka Fiscal Responsibility Bill is to bring revenue deficit to zero, contain fiscal deficit to 3% of the GSDP, to bring in transparency in all the fiscal operations of the centre and the state, requiring a bi annual review of the receipts and expenditure of the centre and to prepare Medium Term Fiscal Plan which will estimate the next four year target for the state in terms of fiscal consolidation.

The Commission for centre-state relations observed in a large country and diverse for unitary form of government, another important fiscal instrument is the borrowing powers of the state and centre governments, the Government can borrow internally and also externally. The states have very limited borrowing power and if a state has to pay any debt to the centre, it shall not borrow from another source without prior permission from the central government. From the centre to the states fiscal transfers are done through the Finance Commission which is constituted every five years whose primary functions are to recommend allocations of the central taxes to the states.

During the 1980’s there was deterioration in the fiscal situation of the country, more so in the late 1980’s which was characterised by high fiscal and revenue deficits. This condition of the country had resulted in the widening of current account deficit and other during the 1990’s. India had also faced severe macro-economic crisis in the 60’s, 70’s and 80’s.

The main objective of the fiscal reforms is to aim at reducing the deficit and the debt as a proportion to the GDP. The main determinants of the New Economic Policy were the taxation policy, to understand and modify the growth and the public expenditure and public borrowings. Therefore fiscal reforms should encompass issues like tax reforms, the process of borrowing of the central government, expenditure reforms and issues related to debt.

After the implementation of the KFRA the Karnataka states fiscal consolidation has further improved and the revenue deficit and fiscal deficit have been contained to the stipulated level much before the targeted time. Though there can be an improvement in the increasing the revenue sources by getting more revenue from non-tax revenue and improving the capital expenditure for better infrastructure development and asset creation.

State governments have an important role to play in all the economic activities in India mainly because of the federal setup which India follows. In the process of restructuring the economy and restoring macroeconomic balance in the economy state governments have an important role to play.

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