Welcome Address
by
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Chairman
Twelfth Finance Commission

9th April, 2003

Golden Jubilee Function
to mark the completion of
Fifty Years of Finance Commissions in India
Vigyan Bhavan
New Delhi.

On behalf of the Twelfth Finance Commission, may I extend to all of you a hearty welcome. We are indeed very grateful to Dr. A.P.J. Abdul Kalam, the Hon'ble President of India, for agreeing to inaugurate this Golden Jubilee Function which is being held to mark the completion of 50 years of Finance Commissions. It may be recalled that the First Commission was set up in 1951. The ready acceptance by the President of our invitation shows the deep interest he has in the work of the Finance Commission. Our President is deeply committed to the vision of transforming our country into not only a technologically advanced country but also a truly 'caring' society. The fiscal system of the country must help in bringing about this transformation in a sustained way. We are equally grateful to the Hon'ble Finance Minister, Shri Jaswant Singh, for agreeing to preside over the function and to the Hon'ble Deputy Chairman of the Planning Commission, Shri K.C. Pant, for agreeing to address us. We are also grateful to all the State Finance Ministers, former Chairmen and Members of Finance Commissions and other distinguished invitees for attending this function.

The fiscal relations in our country have evolved over time. These changes have taken place within the ambit of the provisions of the Constitution. Transfer of resources from Centre to federal units is a common phenomenon in all large countries having a federal constitution. This is so because there is always a mismatch between the responsibilities of the federating units and their ability to raise adequate resources. Certain resources are best raised only at the national level, both on grounds of equity and efficiency. This necessitates transfer of resources from the Centre to the States in order to correct what is very often described as vertical imbalance. Apart from this, the overall resources to be transferred to the States have to be distributed among them and the criteria for horizontal distribution are equally important. With the constitution of the Twelfth Finance Commission, we are once again drawn into the issues concerning resource transfers between Centre and the States and among the States.

The roots of fiscal federalism in India go back to the Govt of India Acts of 1919 and 1935. While the Act of 1919 provided for a separation of revenue heads between the Centre and the Provinces, the 1935 Act allowed for the sharing of Centre's revenues and for the provision of grants-in-aid to Provinces. The Indian Constitution carried these provisions a step forward by providing for a Finance Commission to determine the distribution between the Union and the States of the net proceeds of taxes and the grants-in-aid to be provided to the States which are in need of assistance. While the Constitutional provisions relating to the functions of the Finance Commissions have remained unchanged, one notable change in the framework of federal fiscal arrangements was brought out by the 80th Amendment which broadened the ambit of the sharable Central taxes. The enlargement of the sharable pool to cover all Central taxes except those listed in Articles 268 and 269 and earmarked cesses and surcharges, has enabled States to share in the overall buoyancy of taxes. It has also provided greater stability to resource transfers as fluctuations in individual taxes are evened out. With the 73rd and 74th Amendments to the Constitution which have provided constitutional support to the process of decentralization, the Finance Commissions are also required to suggest measures to augment the resources for the panchayats and municipalities.

The issues relating to the correction of vertical and horizontal imbalances have been addressed by every Finance Commission, taking into account the prevailing set of circumstances. The transfers to States through the Finance Commissions in the gross revenue receipts of the Centre after recording a rise upto 1980, have remained on an average around 24 per cent in the last decade. However, there is some concern in the recent period that these transfers have shown a decline as a proportion of gross domestic product. This is in part accounted for by the decline in the tax - GDP ratio of the Central Government.

The task of designing a fair and robust scheme of fiscal transfers has become progressively more demanding in India as both the Centre and the States have continued to nurse mounting deficits on their revenue accounts along with increases in overall fiscal deficits. In 1988-89, which was the year immediately preceding the recommendation period of the Ninth Finance Commission covering six years from 1989-90 to 1994-95, the combined revenue deficit of the Centre and the States was 2.93 per cent of GDP at current market prices. It rose to 3.61 percent in 1994-95, the corresponding base year for the Tenth Finance Commission, and to 6.29 per cent in 1999-00, which was the year immediately preceding the recommendation period of the Eleventh Finance Commission. An exercise of resource transfers and redistribution in the context of all round deficits, is qualitatively different from the situation when the Centre and some States had revenue surpluses. One might wonder as to what the magnitude of revenue imbalance would be in 2004-05, the year immediately preceding the reference period of 2005-06 to 2009-10 for the Twelfth Finance Commission.

The Eleventh Finance Commission, in its outline for restructuring the public finances of the Centre and the States, had suggested a revenue deficit target of 1 per cent in 2004-05 for the Centre, with the States achieving balance on their revenue accounts. The overall fiscal deficit was set at 6.5 per cent. The economy is far from achieving these targets. The data now available for 2001-2002 indicate that the combined fiscal deficit of the Centre and the States was in excess of 10 per cent of GDP with Centre's deficit at 6.1 per cent. The combined revenue deficit of States and Centre amounted to 7.0 per cent of GDP.

In decomposing the change in debt stock, it is seen that there are two factors contributing to the rise in the debt - GDP ratio. One is the primary deficit i.e. fiscal deficit excluding interest payments and the other, the difference between nominal interest rate and nominal growth rate. Except in two recent years, the nominal interest rate has been below the nominal growth rate. Therefore, the major contributing factor for the rise in Debt-GDP ratio has been the primary deficit.

The adverse impact of a large fiscal deficit on the economy should not be underestimated. Despite some initial beneficial effects of deficits, many studies have highlighted the vicious cycle that is set in motion because of rising debt, rising interest payments, fall in the growth rate of development expenditures and the consequent impact on growth rate. It has serious balance of payments implications, if the Government dissaving is not adequately matched by private saving to meet investment. However, this is not an argument for balanced budget or fiscal balance at zero deficit. The attempt should be to maintain the fiscal deficit at a level at which the adverse impact on the system is minimal. This is in no way inconsistent with Keynesian ideas. However, the original Keynesian framework did not specify how the deficit was to be financed and, therefore, did not elaborate what the impact of the different modes of financing would be on the system. A successful effort to raise the growth rate, as envisaged in the Tenth Plan, to an average level of 8 per cent per year, and about 9 per cent towards the closing years of the plan, is predicated on a substantive increase in the public savings rate.

It is obvious that the finances of all State Governments are under strain. Every State has to address the issue of how to contain fiscal deficit within reasonable limits while meeting their responsibilities. Raising the revenues including the non-tax revenues and pruning the non-developmental expenditures must assume importance. Only such a stance can result in an accelerated flow of development expenditures leading to improved socio-economic growth. A consensus must develop on user charges. Whether it be power or transportation or water charges or municipal services, user charges must be levied to correspond with costs, even though they cannot follow a simple cost-plus formula. Efficiency norms must be imposed by a regulatory authority. However, within the framework of efficiency norms, every enterprise must at the minimum break even. The tariff or price structure can incorporate some element of cross-subsidisation. However, on balance, recovery of costs as determined by efficiency considerations must be the objective.

To go back to the core responsibilities of Finance Commissions, fiscal transfers require to be guided by certain definitive principles. Most analysts agree that a good transfer system should serve the objectives of equity and efficiency and should be characterized by predictability and stability. Equity can be conceptualized and understood in a number of ways both with respect to its vertical and horizontal dimensions. The share of gross revenue receipts of the Centre that should go to the States has to be related to the respective responsibilities at the two levels of government. The demands on the resources at both levels need to be assessed. This will call for a normative assessment. The calculation of available resources may face some additional difficulties in view of the impending changes in the commodity taxation at State level such as the introduction of VAT and other related modifications. The considerations that should go in determining the distribution among States have been examined in great length by the various Finance Commissions. Equity issues have dominated such discussions as they should be. The effort has been to identify variables which reflect the equity concerns. In designing a suitable scheme of fiscal transfers, three considerations seem relevant - needs, cost disability and fiscal efficiency. Needs refer to expenditures required to be made but not met by own resources. Cost disabilities refer to such characteristics of a State that necessitate more than average per capita cost in service provision due to factors that are largely beyond its control like large areas with low density of population, hilly terrains, poor infrastructure, proneness to floods and droughts. Fiscal efficiency encompasses parameters like maintaining revenue account balance, robust revenue effort, economies of expenditure linked to efficient provision of services and the quality of governance. Equity considerations must in effect aim for ensuring the provision of selected services at minimum acceptable standards across the country. It is seen that on average, the low income States spend only half of the average per person expenditure of high income States in social services. Such equalisation of services may demand some form of conditional grants requiring monitoring of the use of funds to achieve the desired objectives. At the same time, 'efficiency' in the use of resource should be ensured and promoted. States that perform more efficiently in the delivery of services or raise more revenues relative to their tax bases should not be penalized. The task of formulating a sound transfer system has to establish a fine balance between equity and efficiency, a system where fiscal disadvantage is taken care of but fiscal imprudence is effectively discouraged. In such a system, States that are fiscally disadvantaged but prudent stand to gain and States that have the resources but do not use them well stand to lose. The task is to devise a formula that redresses disadvantage but penalises imprudence. Needless to say that fiscal responsibility must be shared by both the Centre and the States. With the two channels of tax-devolution and grants, it should be possible for the Finance Commission to achieve the goals of equity and efficiency through a proper mix.

The Twelfth Finance Commission has just begun its work. This function this morning along with the State Finance Ministers' meeting in the afternoon and the meeting with the Chairmen and the Members of the previous Finance Commissions tomorrow are part of the consultation process. We will, in course of time, make up our minds on the many critical issues relating to fiscal transfers. A sound fiscal system is a necessary concomitant of sustained growth with the equity. Resource transfers have to be an integral part of such a system facilitating efficient use of resource, accelerated growth and balanced regional development.

May I extend to you all once again a warm and cordial welcome.