Conference

on

"Issues Before theTwelfth Finance Commission"

Inaugural Address

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Issues before the Twelfth Finance Commission

On behalf of the Twelfth Finance Commission, may I extend to all of you a hearty welcome. I must thank the National Institute of Public Finance and Policy and more particularly, Professor Govinda Rao and Professor Tapas Sen for organizing this Conference. It is gratifying to see the response to the Seminar.

2. In federal fiscal systems, on grounds both of equity and efficiency, resources are generally assigned more to the central government whereas states together with the local governments have the larger responsibilities. The resultant vertical imbalance requires transfer of resources from the Centre to the States. States also have different capacities and needs, and this lends a horizontal dimension to the issue of resource sharing. Neither vertical nor horizontal imbalance is expected to be static. Some of the core provisions regarding sharing of resources are built into our Constitution itself. But changes in the economic and fiscal situation warrant a review of the existing arrangements. The Indian constitution has provided for both continuity and change. The Finance Commission is entrusted with the task of periodically examining these issues according to the constitutional provisions and the terms of reference.

3. With the setting up of the Twelfth Finance Commission we are once again drawn into the core issues of determining tax devolution and grants. The terms of reference contained in the Presidential Order constituting the Commission also reflect concern about the rapidly deteriorating fiscal scenario. Like the Eleventh Finance Commission, this Commission has also been asked to review the state of the finances of the Union and the States and suggest a plan for restructuring public finances with a view to restoring budgetary balance, maintaining macroeconomic stability, and bringing about debt reduction along with equitable growth. In comparison to the terms of reference for the EFC, the reference to debt reduction and equitable growth is new and emphasizes concern with the growing disparities among states even as debt has crossed sustainable thresholds.

4. It is not as if the issues are entirely new, but the problems are more serious. The balancing of resources against responsibilities is

qualitatively different now when governments at all levels are nursing large and rising revenue deficits than when the Centre and some of the better off States had a surplus. There were days when some of the states even had a pre-devolution surplus. The task has become progressively more demanding with successive Finance Commissions. In 1988-89, the base year for the Ninth Finance Commission, the combined revenue deficit of the Centre and States was 2.9 percent of GDP at current market prices. The combined revenue deficits of the Centre and States for the corresponding base years for the Tenth and Eleventh Finance Commissions were respectively 3.6 percent of GDP in 1994-95 and 6.3 percent in 1999-00. In 2001-02, the combined revenue deficit exceeded 7 percent of GDP. With current trends indicating continued deterioration, the situation is likely to further worsen by 2004-05, the year immediately preceding the reference period of the Twelfth Finance Commission.

Fiscal Trends

5. It is useful to look at the overall fiscal trends over a longer period. Considering the 15-year period from 1986-87 to 2000-01, and comparing three-year averages at both ends, that is for 1986-89 and 1998-2001, the following major changes in the combined finances of the central and state governments may be noted:

(i) The tax-GDP ratio fell from a level of about 16 per cent relative to GDP by 1.9 percentage points during this period. The average tax-GDP ratio continues to be just a little above 14 per cent in 2002-03 RE. The decline in the tax-GDP ratio was due to a fall in revenues from the indirect taxes relative to GDP of 2.8 percentage points, which could only partially be compensated by the rise of 0.9 percentage points in the ratio of direct taxes to GDP.

(ii) Since non-tax revenue relative to GDP also fell by a margin of 0.3 percentage points to reach an average level of 2.4 per cent of GDP during 1998-2001, the overall ratio of revenue receipts to GDP fell by 2.2 percentage points.

(iii) In contrast, the combined revenue expenditure of the central and state governments relative to GDP increased by 1.43 percentage points to reach an average level of 22.9 per cent of GDP during 1998-2001. Interest payments and pensions relative to GDP increased since the late eighties to this period respectively by 2.9 and 0.95 percentage points.

(iv) The resulting imbalance led to an increase in the ratio of revenue deficit to GDP by a margin of 3.6 percentage points. The average level of the combined revenue deficit to GDP in 1998-2001 was 6.4 per cent. It has since increased to cross 7 per cent of GDP in 2001-02.

(v) Fiscal deficit, which was already at a high level of 8.8 percent of GDP in the late eighties, increased by a margin of 0.4 percentage points. The quality of fiscal deficit as measured by the ratio of revenue to fiscal deficit deteriorated from 33.0 per cent to 69.0 per cent during the period under reference. In 2001-02, the combined fiscal deficit was in excess of 10 per cent of GDP.

(vi) Capital expenditure relative to GDP fell to the extent of 3.5 percentage points during this period, reaching an average level of 3.2 per cent of GDP.

6. The deterioration in the revenue account balance of the Centre, States and their combined accounts had started towards the end of the seventies. It was in 1979-80 that the central finances fell into revenue deficit after recording a surplus since 1950-51 in all but two years. The combined account of the Centre and States went into revenue deficit in 1982-83, and that of all states in 1986-87. As noted by the Tenth Finance Commission, almost all the states went through a three-phase deterioration in the revenue account balance. In the first phase up to 1986-87, non plan account surplus was larger than the plan deficit and to that extent it yielded an overall revenue balance. During 1986-87 to 1991-92, the magnitude of plan revenue deficit increased sharply and it became larger than the non plan surplus. Since then, both the plan revenue account and the non plan revenue account have remained in deficit and the deficit has generally been growing in magnitude. Only some of the special

category states continued to have a surplus on the plan revenue account. However, this was due solely to the special dispensation for plan assistance where they got ninety percent as grant credited to their revenue accounts.

7. Among the reasons generally given for this all round fiscal deterioration, some of the important ones are: revision of salaries and pensions in the wake of the recommendations of the Fifth Central Pay Commission, erosion in the buoyancy of central indirect taxes, and the high nominal interest rates towards the end of the nineties. After the peak growth rate achieved in the mid-nineties, there was also a general slow down in growth towards the end of the nineties, which has continued till 2002-03. In the first three years of the new decade, the growth rates have been estimated at 4.0, 5.6 and 4.4 percent respectively, which are much less than the range of 7 to 7.5 percent envisaged by the Eleventh Finance Commission. In fact, in spite of the falling nominal interest rates, it has been noted that for these three years the growth rate has fallen short of the average interest rate on the outstanding liabilities unlike in the previous four decades, when the interest rate was lower than the growth rate. This has meant that the growth in the central debt relative to GDP has been due not only to the primary deficit but also to the sign reversal in the growth-interest rate differential. The situation is worse for the states as in their case the effective interest rate is even higher. In the context of macroeconomic stability at a desired level of growth, determination of sustainable levels of fiscal deficit and debt becomes important.

Sustainability Issues

8. There has been an interesting debate as to the right level of fiscal deficit and the debt that is sustainable in the Indian context. The Tenth Plan has envisaged the average size of fiscal deficit as 6.8% of GDP during the plan period. The Eleventh Finance Commission had suggested fiscal deficit of 6.5% of GDP as the desirable target to be achieved by 2004-05. The fiscal deficit in 2002-03 is estimated to be more than 10 percent of GDP. The adverse impact of a large fiscal deficit on the economy should not be underestimated. Despite some initial beneficial effects of deficit, many studies have highlighted the

adverse effects that result from rising debt, increasing interest payments, fall in the growth rate of developmental expenditure and the consequent impact on growth rate.

9. Available analytical models suggest different answers as to the appropriate size of debt and deficit, and an assessment has to made on the basis of the prevailing empirical situation. In the Keynesian paradigm, government expenditures even if financed by borrowing can have beneficial real effects if there are unemployed resources. The traditional Keynesian framework does not distinguish between alternative uses of fiscal deficit as between consumption and investment expenditure nor does it distinguish between alternative modes of financing, through monetization or internal or external borrowing. The Keynesian framework recognizes the emergence of pure inflation only after the state of full employment is reached. In many developing countries, due to supply side rigidities, the limit is often reached well before full employment, beyond which increments to fiscal deficits do not necessarily add to growth. The Keynesian prescription admittedly works well in the short run and particularly in a situation where unutilized capacities exist. However, persistent fiscal deficits become an impediment to growth, when they begin to impact adversely on saving and investment. Under Ricardian Equivalence, fiscal deficits do not really matter except for smoothening the path of adjustment to expenditure or revenue shocks. However, empirically there has not been much support for this theory.

10. In the neo-classical perspective, fiscal deficits adversely affect the growth rate, if the implicit reduction in government saving is not fully offset by an increase in the private savings. A net fall in the savings rate puts pressure on interest rate and crowds out private investment. In this context, two factors may be relevant in determining the appropriate level of fiscal deficit, viz. private savings ratio, and the ratio of government revenues to GDP. When either of the two is higher, a higher fiscal deficit may be permitted without producing adverse effects of crowding out or putting pressure on the interest payments as a proportion of revenue. Further, it is private savings in the form of financial assets that are relevant. While gross savings by the household sector in India is reasonably high with the average of 19% of GDP in recent years, the transferable savings are a little over half of that. The household sector savings in financial

assets in the 1990’s has been around 10% of GDP on average. The combined fiscal deficit of Centre and States has been approaching this figure. In the Indian situation, presently, the nominal interest rates may not appear to be under pressure in the wake of the flow of external funds and the sluggishness in private commercial demand. However, the ease with which the Central Government has been able to raise funds from the market should not cloud the fact that several State Governments are facing serious problems with respect to borrowing and repaying past loans. In fact we need to study separately for each State the appropriate level of fiscal deficit and sustainable debt. Fiscal deficits of the Central and State Governments need to be brought down in a calibrated way by augmenting revenues and pruning expenditures.

11. For fiscal sustainability, it is required that a rise in fiscal deficit is matched by a rise in the capacity to service the increased debt. It has been argued that from this angle, borrowing for generation of assets may be justified. Apart from the fact that a little less than 70 per cent of borrowing is presently not being spent on capital assets at least of the physical kind, even where there is capital expenditure, the return on assets is negligible. Even the more indirect return through higher growth to match the growing interest liabilities has not been forthcoming. In fact, the high level of fiscal deficit combined with the rising debt-GDP ratio has led to a fall in the aggregate government demand net of transfer payments.

Design of Fiscal Transfers

12. Fiscal transfers require to be guided by certain definitive principles. A good transfer system should serve the objectives of equity and efficiency and should be characterized by predictability and stability. Equity can be conceptualized with respect to its vertical as well as horizontal dimensions. Efficiency should be conceptualized in the context of a welfare function that may be augmented by government expenditures at different levels. The concept of equalization is considered to be consistent both with equity and efficiency. It aims at ensuring that citizens of every state are entitled to a common standard of services provided the revenue effort is the same. In India there is wide disparity in the level of services across

states. It is seen, for example, that on average, the low income states spend only half of per capita expenditure of high income states in social services. Given the average per capita expenditure adjusted for cost disabilities, equalization would make up the gap arising due to deficiency in capacity, but not in revenue effort. In a good fiscal transfer system, fiscal disadvantage needs to be taken care of while effectively discouraging fiscal imprudence. The task is to devise a formula that redresses disadvantage but penalizes imprudence. The issue before the Commission is to transfer these general principles into concrete terms given the empirical realities.

Vertical Dimension

13. Fiscal transfers from the Centre to the States take place through the Finance Commission as well as the Planning Commission apart from discretionary transfers through the Central Ministries. The EFC considered that it would be useful to take an overall view as to the extent of total transfers relative to center's gross revenue receipts. The EFC recommended an overall share of 37.5 percent of the Centre's gross revenue receipts as the extent of total transfer. One issue that requires to be considered is whether there are circumstances that would warrant a change in this recommended overall ratio prescribing the extent of total vertical transfers.

14. Some long-term trends in the context of the issue of determining the extent of vertical transfers are notable.

(i) The share of the revenue expenditure of the states in the combined revenue expenditure of the Centre and the States, after netting out all intergovernmental flows including transfers, ever since the First Finance Commission period, shows a remarkable stability at around 57 percent. Averages calculated with reference to the recommendation periods of the earlier Finance Commissions show variations in the range of 56 percent to 60 percent.

(ii) In comparison, the share of states in the accrual of revenues, i.e. their share in combined revenue receipts after transfers, has been above sixty percent since the Seventh Finance commission.

(iii) The share of Centre's debt net of lending to the states in the combined debt of the Centre and the States, which was, on average, a little less than 60 per cent for the reference periods of the Sixth and Seventh Finance Commissions increased to the range of 68-69 percent for the periods covered by the Ninth and Tenth Finance Commissions.

(iv) Fiscal transfers to the states, through all channels, as percentage of the gross revenue receipts of the Centre increased from an average of 31.4 per cent in the period of the Sixth Finance Commission to 38.0 per cent for the Seventh. It increased further to 39.3 per cent for the period covered by the Ninth Commission before coming down to 35.2 per cent during the period of the Tenth Finance Commission. As percentage of GDP at market prices, fiscal transfers show a decline, falling from the level of about 5 percent for period covered by the Eighth Commission to 4.8 and 4.1 per cent respectively for the reference periods of the Ninth and Tenth Finance Commissions.

15. Often, there has been a demand that the centrally sponsored schemes should be transferred to the states along with funds. It may be mentioned that this does not imply an increase in the overall ratio, as CSS transfers are part of the total transfers. However, there can be other compelling reasons for transferring at least some of the centrally sponsored schemes to the States along with the funds.

16. Some forthcoming changes in tax assignments also have a bearing on the issue of vertical sharing. Under article 268A, specified services will be assigned to the states that will collect and retain the tax-revenue even though the basic law may be made by the central government. In addition, the set of services that are taxed by the Centre will be shared with the states as specified under article 268A

rather than under Article 270 thus excluding the purview of the Finance Commission. Other important changes relate to the introduction of the state level VAT and the phased withdrawal of the central sales tax. It is important to make an assessment of the revenue implications of these changes.

17. As already noted, predictability is a significant attribute of a robust scheme of transfers. Since devolution of taxes is recommended in terms of shares of central taxes, and the absolute amounts often fall short of those estimated by the Finance Commission, a suggestion has been made that a minimum amount under tax devolution should be prescribed. Under the provisions of article 270 only a share for the states in the central taxes is determined. This provides for automatic sharing of the central tax buoyancies. However, states have a genuine problem if growth in central taxes falls short of expectations.

Horizontal Dimension

18. 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. 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 based on the principle of equalization 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. 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.

19. In combining these considerations into a suitable scheme of transfers, there are both conceptual issues and practical problems. A major concern relates to the weights to be attached to the various factors. Besides, there are problems of choosing appropriate indicators and their measurement. For example, revenue capacity is

measured by GSDP even though it is recognized that GSDP is not a perfect correlate of income. Comparability of GSDP estimates prepared by the states is also a contentious issue. Although the Central Statistical Organization (CSO) provides comparable estimates of GSDP at factor cost at current prices, it remains a compilation of the state estimates after certain adjustments. There has also been the question as to whether GSDP at market prices would serve as a better proxy for income or revenue capacity than GSDP at factor cost. Discussions reveal that the allocation of central indirect taxes net of subsidies according to states still remains an intractable problem. Even the measurement of revenue deficit is not unambiguous any more. Some have argued that a proportion of grants given to the local bodies should be counted as capital expenditure. Others have argued that expenditure on health and education should be treated as investment in human capital.

20. The measurement of cost disabilities is also not a straightforward exercise. Some of the cost disabilities are clearly related to exogenous circumstances like the nature of the terrain, the extent of rainfall, and proneness to drought and floods. Other factors like the distance from centers of economic activities, the incidence of diseases, the extent of illiteracy, and the composition of population may also be important. Conceptually, cost norms are required to be developed in respect of these different dimensions for application in determining the norm-based expenditure requirements.

21. As already mentioned, the notion of efficiency is implicit in an equalization approach since transfers are related to some standard revenue effort. But some times efficiency indicators are used more directly in the devolution formulae. The two previous commissions who have explicitly introduced some efficiency factors have focused on tax effort and improvement in revenue account balance. There is also the issue of backward looking vis-à-vis forward looking indicators of efficiency. Only in the case of Medium Term Reform Facility, incentives are linked to performance. However, there are several inherent difficulties in including forward looking indicators in the distribution formula.

22. An important issue in the context of transfers under the Finance Commission pertains to the relative role of tax devolution and grants.

Tax devolution has a built-in flexibility as it can increase automatically if the central taxes are more buoyant. Conversely, there is risk if their buoyancy falls short of expectations. Grants are ensured as these are fixed in nominal terms. It is easier to target grants towards states or sectors. The flexibility in the case of devolution is limited by the criteria used. Yet states have often expressed a preference for devolution because by definition it is unconditional and comes to the states as a matter of right. Within the subset of grants, grants could be made conditional or purpose specific, although Article 275 grants have generally been unconditional. However, if a move is made towards equalization of services through grants, conditional grants are inescapable.

23. In order to address problems of adverse incentives, a normative approach for determining revenues as well as expenditures of the state governments is relevant. Following a historical approach in determining revenues and expenditures leads to what is described as gap filling. Such an approach has built-in adverse incentives inducing the states to under-perform in terms of revenues relative to capacity. They also do not have sufficient incentive to economize in the use of resources. The normative approach can effectively neutralize such adverse incentives. In such an approach, states will be assessed in terms of revenues that they ought to raise given their capacity. Similarly, the expenditures will be in line with their requirements on the basis of cost norms and not driven by the past history of expenditures. Designing a fully normative approach is conceptually straight forward, but applying it in practice has to overcome numerous constraints. Some of the previous Commissions have partially applied a normative approach for determining revenues and expenditures. A fully normative approach requires an assessment of revenues and expenditure for the base year as well as determining the relevant growth norms during the reference period.

Restructuring Issues

24. The Eleventh Finance Commission (EFC) in its outline for restructuring the public finances of Centre and States has suggested a revenue deficit target of 1% in 2004-05 for the Centre, with the States achieving balance in their budget, and the overall fiscal deficit

target was set at 6.5%. The current trends indicate that the economy is far from achieving this target. The overall debt-GDP ratio was supposed to be brought down to 55 percent from a level of 65 percent in 1999-00, i.e. a fall of 10 percentage points. As per the latest data, the combined debt-GDP ratio at the end of 2002-03 is estimated at 76 per cent. Thus, instead of falling, the debt-GDP ratio has risen substantially.

25. Restructuring public finances aimed at macroeconomic stabilization and achieving revenue account balance requires a broad analytical framework. The impact of the size and composition of government expenditure on growth, inflation, interest rate and the external account has to be considered in an inter-dependent framework that takes into account feedbacks of first and subsequent round effects. This will require that in terms of methodology, one should go beyond consistency frameworks. Restructuring has to spell out adjustments both on the revenue and expenditure sides. Some hard decisions are required to arrest the persistent rise in the debt-GDP ratio.

26. Fiscal policies will have to be restructured to facilitate acceleration in growth with macroeconomic stability. Public spending in areas such as roads, water supply, power, primary education and primary health will need to be stepped up to provide the appropriate physical and social infrastructure necessary for accelerating growth. The problem would have been a simple one, had there been some fiscal space for augmenting such expenditure. This unfortunately is not the case. The challenge lies in finding ways of augmenting such expenditures while reducing the overall fiscal imbalances at the same time. Failure to step up expenditure on the necessary items will dampen the growth momentum of the economy. Failure on the fiscal consolidation front, on the other hand, can come in the way of faster growth.

27. The Fiscal Responsibility Act of the Central Government envisages that central revenue deficit will be eliminated by 2007-08. A target for fiscal deficit relating to GDP has not been specified in the Act itself but it may be indicated in the rules to be framed in relation to the Act. Some of the State governments have also shown initiatives in this direction through Fiscal Responsibility and Management

legislations. Some notable initiatives are from Karnataka, Maharashtra and Punjab. One may hope that this trend will catch on and other states would also impose explicit self-discipline on themselves through such legislations.

28. Several state governments have asked for debt relief. Some of the previous Commissions have observed that recommendations regarding debt relief by successive Commissions create anticipations about such measures, which has a built-in adverse incentive. At the same time, the extreme difficulty in which the state finances are placed today calls for fresh consideration of this issue. It is clear that any debt relief will have to be linked to a desired path of deficits in the future. The Planning Commission must also ensure that the size of a State Plan is consistent with a sustainable level of debt, as the State Plans are almost fully financed by borrowing in one form or another.

29. I have referred in some detail to some of the key issues before the present Finance Commission. There are several issues like the role of the Commission in relation to local bodies and re-examination of the Medium Term Reform Facility which I have not touched upon. It will be the endeavour of the Twelfth Finance Commission to evolve a scheme of fiscal transfers which will give due weightage to the available resources of the Centre and the States and the demands on these resources by both the Centre and the States. The correction of vertical and horizontal imbalances has to be done within a framework of fiscal prudence. A good transfer system must establish an appropriate balance between equity and efficiency, a system in which, as I mentioned earlier, fiscal disadvantage is taken care of but fiscal imprudence is effectively discouraged. Needless to say, that the fiscal responsibility must be shared by both the Centre and the States. We look forward to your counsel and advice in discharging our task.

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