

FRAMEWORK AND APPROACH

Introduction

2.1 Our approach has been guided by the paramount need to restore fiscal equilibrium in the economy. Our recommendations have been informed by our Constitutional responsibilities, the terms of reference, the budgetary scenario of the Centre and the States, the emerging issues in federal finance, and the evolving macroeconomic policy environment.

2.2 The period covered by our recommendations will witness the completion of half a century of fiscal federalism. Federal relations, as envisaged in the Constitution, have evolved over the years through political, institutional and functional changes. In this changing scenario, the Finance Commission, as an institution, has had an important role to play as resource sharing, based on a Constitutional division of functions and finances, is a critical element in the federal system.

2.3 While the charter of the Commission flows from the Constitution itself, the terms of reference of each Commission have reflected some of the dominant concerns in the area of Centre-State relations and the emerging issues in national public finance. It is, therefore, not surprising that our terms of reference mirror the anxiety regarding the finances of the country and have been influenced by the systemic changes in the economic regime that have been initiated since 1991.

2.4 The whole gamut of policy changes is reflective of a change in the nature, content and extent of state intervention. The outcome of these changes will edge into view in the period which coincides with the period of our recommendations. Another dimension has been added by the 73rd and 74th amendments to the Constitution which have brought into being a third tier in the federal structure. It is these changes that provide the context for our recommendations and, in conjunction, with our concern for equity and efficiency, delineate the contours of our approach.

Centre and State Finances : An Analytical Overview

2.5 The macroeconomic vulnerability of the economy is linked in no small measure to the secular deterioration in its fiscal balance. The magnitude of aggregate deficits - revenue and fiscal - had reached levels in the late eighties that set the economy on a medium term path of stagflation and a recurring balance of payments problem.

2.6 From a revenue surplus the economy moved into a state of continuous deficit on revenue account in 1982-83. While in 1975-76 there was a revenue surplus of about 2.5 per cent of Gross Domestic Product (GDP), in 1990-91 revenue deficit reached 3.6 per cent and is estimated to be about 5 per cent of GDP in 1993-94. This rise has been even faster than that in the fiscal deficit which increased from 6 per cent in 1974-75 to about 12 per cent in 1990-91. It is estimated to be 11.5 per cent in 1993-94. A graphical presentation of the trends and pattern in the finances of the Centre and the States is at Appendix 1.

2.7 The change in the fiscal regime in 1982-83 - from revenue surplus to revenue deficit - has meant that what was earlier a non-debt creating source of financing has become a source of rising internal indebtedness. In other words, while

revenue receipts used to cover a part of the capital expenditure, now an increasing part of the capital receipts are used to finance revenue expenditure. The consequent build up of public debt and the interest burden, which is now the largest and fastest growing item of expenditure, further fuelled the growth of revenue expenditure. This led to a spiral of growing deficits, rising debt, escalating interest costs, and further expansion of deficit.

2.8 The statement that deficits have emerged because of differential rates of growth of revenue receipts and expenditures is tautological. It is, however, of prescriptive value to note that the total revenue receipts as a proportion of GDP increased from about 12 per cent in 1960-61 to 27.4 per cent in 1987-88. Thereafter it has levelled off. A major part of the increase is accounted for by a sustained improvement in tax revenues while the potential for exploiting the sources of non-tax revenues has remained largely untapped. During the same period the tax/gdp ratio of the economy more than doubled from 8.3 per cent to 17 per cent which is impressive at the prevailing levels of per capita income. Thus, the principal factor underlying the fiscal imbalance is the unbridled growth of government expenditure.

2.9 The accelerating growth of revenue expenditure is a recent phenomenon. Till the mid-seventies revenue expenditure as a percentage of GDP remained constant at about 15 per cent. In fact, in the early seventies, aggregate government expenditure was actually declining in real terms. Thereafter, till 1987-88 it increased exponentially to reach 27 per cent of GDP - the real rate of growth being close to double digit during this period. After 1987-88 revenue expenditure as a percentage of GDP has remained stable at about 27 per cent. This appears to be in line with the behaviour of revenue expenditure over the last three decades during which it has increased in steps. The structure of expenditure has imparted downward rigidity and inflexibility to its level in recent years. Interest, and wages and salaries have emerged as the major components of expenditure as a direct result of the mode of financing of expenditure and the expansionary policies pursued by government. These two items are at any given point of time "committed expenditure" which can be curtailed only in the medium term. This has made expenditure more income elastic than revenue receipts thereby generating an in built tendency towards deficits. As a result the economy has moved away from resource based fiscal management to expenditure based budgeting.

2.10 From a diagnostic point of view, it is important to analyse the profile of deficits and their composition across levels of government. In the case of the Central Government, the revenue deficit increased from 0.2 per cent of GDP in 1981-82 to 3.5 per cent of GDP in 1990-91. It is estimated to be 4.3 per cent in 1994-95. The fiscal deficit for the corresponding period increased from 5.4 per cent to 8.4 per cent. Apart from the increase in magnitude, a disturbing aspect relates to the financing of fiscal deficit. Over the years, especially since 1991, the monetised deficit has been reduced significantly. Without a corresponding reduction in the fiscal deficit the proportion of other forms of borrowings has increased. The implication of this change is that the unit cost of financing government expenditure is increasing. This is of particular concern because revenue deficit as a proportion of

fiscal deficit is also rising and this underlines the need for reducing the revenue deficit and the fiscal deficit along with a reduction in monetised deficit.

2.11 The higher cost of financing government expenditure will make its impact felt on expenditure by increasing the burden of interest payments. This is so because borrowings are financing such revenue expenditure as cannot possibly yield financial returns and a fair amount of capital expenditure which yields inadequate returns. In other words, it is the burden of interest payments arising out of the none too prudent use of borrowings that lies at the root of the fiscal malaise. This is borne out by the fact that the primary fiscal balance (i.e. fiscal balance net of interest payments) of the Central Government has turned surplus after 1991-92.

2.12 At the aggregate level, the combined accounts of the State Governments exhibit a similar picture of increasing revenue deficits though the deficits emerge on a secular basis from 1987-88. While the share of States in total revenue deficit of the economy has increased, its share in fiscal deficit has remained constant perhaps on account of their inability, unlike the Centre, to finance the expenditure-revenue gap through borrowings.

2.13 It is important to recognise that there is a pattern in the transition from healthy revenue surpluses that the system used to generate to chronic deficits. This becomes evident by disaggregating the revenue account into plan and non-plan. The plan revenue account has been in marginal deficit till the early eighties. Thereafter it has increased in response to the plan size. On the other hand, the non-plan account has been in surplus till 1990-91.

2.14 Almost all States have gone through a three phase deterioration in the revenue account balance. In the first phase up to 1986-87, the non-plan account surplus was larger than the plan deficit and to that the extent it was yielding an overall revenue surplus. Between 1986-87 and 1991-92 the magnitude of plan revenue deficit increased sharply and it became larger than the non-plan surplus which itself had been declining. The third and final phase started in 1991-92 when the non-plan revenue account went into deficit. That all States have had almost identical turning points seems to suggest that there are systemic factors underlying this deterioration rather than State specific reasons.

2.15 The magnitude of the fiscal problem can be gauged by the level of deficits projected in the Central and State forecasts submitted to us. It is significant to note that the Centre did not project a crisis of resource availability to the Ninth Commission. There was a clear break with the past when the Finance Ministry submitted a forecast which showed a pre-devolution deficit on the revenue account. Again, for the first time not a single State has submitted a forecast showing a pre-devolution surplus on the non-plan revenue account. Thus the problem posed to us was far worse than that faced by earlier Commissions.

Macroeconomic Stabilisation and Structural Reforms

2.16 The stabilisation and structural adjustment programme of the Centre was initiated in response to the situation of fiscal disequilibrium which reached crisis proportions in 1991. The components of the reform package are: deregulating industry, activist monetary management, gradual dismantling of the complex protective trade regime, a liberal policy towards foreign investment, strengthening the capital markets, restructuring the tax system, full convertibility on current account and an efficiency oriented hard budget approach towards the public sector. The overhauling and restructuring of the financial sector, which is the bridge between macro stabilisation and structural adjustment, is still under way.

2.17 The reforms aim at tackling a series of macroeconomic imbalances, both external and internal. The components of the reform, which are of particular relevance to government finances, are the policies relating to tax reform and reduction in fiscal deficit. Tax reform has revolved around simplification of procedures and reduction in rates of income and corporation tax, selective reduction in excise duties and a substantial reduction in customs duties. The premise is that the stimulus to growth provided by tax reforms and better compliance will more than offset the loss of revenues on account of lower rates.

2.18 The reduction in fiscal deficit was expected to come about both through improved revenue receipts and reduced revenue expenditure. However, in the face of temporary shortfalls in revenue and the inflexibility displayed by revenue expenditure in the short run, the fiscal deficit has been reduced primarily by compressing capital expenditure. Thus, contrary to expectation, the fall-out has been an increasing revenue deficit and reduced capital expenditure.

2.19 In the case of States, the rising revenue deficit has also cut into maintenance expenditure in the revenue budget. In order to accommodate the rising interest payments and the growth of wages and salaries, which have come to be regarded as committed expenditure, maintenance expenditure has been treated as a residual item. This has had a visible impact on infrastructure. The deteriorating conditions of roads, poorly maintained hospitals, neglected school and administrative buildings have together become a formidable supply side constraint on growth. Most assets like power stations, irrigation systems, and highways are operating at levels well below their capacity on account of poor maintenance and continual neglect.

2.20 Clearly, any attempt to curtail the growth of expenditure must be accompanied by measures to protect essential expenditure on maintenance of existing infrastructure and creation of new capacities. This requires a change in the emphasis and priorities of government expenditure. Development of physical and human infrastructure is also essential if the market oriented process of development, with its emphasis on competition and private investment, is not to bypass many States and sectors. If such development does not take place, regional inequalities are bound to accentuate. Quite paradoxically, expenditure priorities of States have in a number of ways tended to reinforce rather than reduce inter-regional disparities.

2.21 The long term implication of this will be that the resource raising capacity of States will be differentially affected. While to some extent this can be addressed through a greater degree of progressivity in transfers to States, the primary responsibility for strengthening the resource base is that of the States. The States will have to make continuous efforts to improve their revenue base, strengthen their capacity to provide better services and curtail expenditures.

2.22 As for receipts, States should initiate restructuring of the tax system through rationalisation of the complex multi-layered sales tax system. The multiplicity of rates is counterproductive and can be rationalised by reducing dispersion in the rates. Inter-State variations in the rate and structure of taxes can be harmonised and move in the direction of uniformity. It would lead to an increase in the tax revenues of States as they will no longer be forced to indulge in unhealthy reduction of rates. If this is done, it would be an important step towards removing impediments to developing a common economic space which would give a substantial fillip to the rate of growth.

2.23 The potential of non-tax revenues as a buoyant source of revenue is virtually untapped by the States. Much greater attention must be focussed on non-tax receipts for resource mobilisation. There are two specific areas that merit attention viz. rates of return on investment and user charges. The total investment in public enterprises runs into thousands of crores of rupees but the rate of return is next to nothing. In many areas particularly power supply, transport services, irrigation, and higher education only a small portion of the expenditure incurred is recovered. It is important to reverse these trends not only for budgetary considerations but also for the overall growth of the economy.

Approach

2.24 Given the evolving scenario, and the goals set out by our terms of reference - of not only balancing the revenue account but generating surplus for capital investment - the task before us was far from enviable. We could reach this objective for the States by recommending the requisite increase in transfers from the Centre but leave it with an unmanageable deficit. Alternatively, we could have left the States with an uncovered deficit. We have chosen not to do either because in doing so we would be just shifting the deficits while our aim was to arrive at a sustainable and healthy fiscal balance.

2.25 This concern would be fully tackled by taking a holistic view of government finances and looking for an integrated solution. It should be obvious that no policy prescription for the fiscal malaise can be given if a large component of the budget, viz. plan outlay, is left out of reckoning. Even if we leave out that part of the plan outlay which is financed by borrowings and is used for creating new capital assets which would eventually earn a return, there is a revenue plan which ought to be covered by revenue receipts. The clubbing of the revenue and capital components in one category termed as plan outlay has generated a tendency to use borrowings to finance revenue expenditure. It is imperative to match the revenue resources separately with the revenue component of the plan. Failure to appreciate this basic requirement of fiscal discipline is one of the main causes of the endemic fiscal disequilibrium.

2.26 In an effort to project larger plan outlays, inadequate provision is made for crucial expenditures like the maintenance of existing assets which are, in current practice, regarded as non-plan expenditure and hence of lower priority. New schemes take priority over maintenance resulting in sub-optimal use of resources. We think that such a bias arises at least in part from the artificial classification of expenditures between plan and non-plan and the attitude of regarding all non-plan expenditure as of low priority. It needs to be appreciated that a large part of non-plan expenditure is of a developmental nature and should enjoy the same priority, if not higher, as new plan schemes.

2.27 We are of the view that there is a clear rationale for the Finance Commission to deal with the revenue account as a whole, and not merely the non-plan revenue expenditure. Our terms of reference require us to keep in view the objective of reducing fiscal deficit and generating surplus for capital investment which cannot be done adequately unless we reassess the projection of plan expenditure also. But our terms of reference also explicitly require us to assess non-plan revenue expenditure. Our period of recommendations not being co-terminus with the Eighth plan has further complicated the issue. The practical difficulties of making acceptable projections of plan outlay - even for the remaining two years of the plan - were brought to our notice by the representatives of the Planning Commission. Most States have also chosen not to hazard any estimates. In view of these

constraints we have confined our reassessment to the non-plan revenue account.

2.28 We have, however, not lost sight of the need to reduce the fiscal deficit. Our approach to this issue has been based on the understanding that a reduction in fiscal deficit has to come about through improvements in the revenue account balance emanating from the non-plan revenue account. Accordingly, our attempt through the reassessment of Centre and State forecasts, has been to generate sustainable non-plan revenue surpluses. The premise is that a recurring revenue surplus is the basic prerequisite for achieving desirable macro fiscal balance.

2.29 In estimating the base and reassessing the non-plan revenue account of the Centre and States we have maintained, to the extent permitted by functional specificities and compositional differences, a uniform pattern of reassessment. The principles and methodology of the reassessment of Central and States forecasts is dealt with in detail in the subsequent chapters. Briefly, the reassessment of tax revenues is based on a study of the buoyancy of major taxes of the Centre and States with respect to the GDP and individual state domestic product. Non-tax revenues and some items of expenditure have been reassessed on a normative basis. Expenditure reassessment in general is based on price elasticity of expenditure besides allowing for a uniform 1.5 per cent rise in real terms independent of the rate of growth of nominal or real GDP. We have provided for higher real growth for priority sectors like elementary education, health, and family welfare. In contrast, we expect that even implicit subsidies in sectors like power, transport, and irrigation would be reduced greatly. Subsidies on food and fertilisers should be given on a uniform scale and pattern from a single source. We are of the view that the quantum of subsidies should progressively account for a smaller proportion of GDP.

2.30 In estimating revenues and expenditure a major determinant is the nominal GDP growth rate and its decomposition into real growth and inflation. In its forecast, the Ministry of Finance had assumed nominal GDP to grow at 11 per cent per annum comprising a rate of inflation of about 5 per cent and real growth of 6 per cent. While we accept the underlying premise of the medium term growth rate being around 11 per cent, we find it unrealistic that the rate of inflation will decline suddenly from about 10 per cent in the 1994-95 to 5 per cent next year. In an attempt to approximate reality we have assumed that the rate of inflation would decline gradually and reach a level of 5 per cent by the year 2000 A.D. At the same time the real rate of growth will increase in a secular manner. On this graduated basis we have assumed the nominal rate of growth to be 12.5, 12, 12, 11.5 and 11 per cent in successive years of the period 1995-2000.

2.31 The balance on the non-plan revenue account that we have sought to achieve is contingent on the profile of receipts and expenditure as reassessed by us. On this basis we have formulated our recommendations on vertical resource sharing and horizontal distribution. Our basic approach to vertical resource sharing has been influenced by the view that it would be in the interest of better Centre-State relations if all central taxes are pooled and a proportion devolved to the States. There is considerable merit in moving to such a system as it would make the vertical sharing simple and transparent. It also gives greater freedom to the Centre in choosing tax policy measures in an integrated manner. If a proportion of all taxes goes to the States, any apprehensions of bias in the choice of tax measures will be allayed. Therefore, we have proposed an alternative scheme of devolution.

2.32 We are conscious that moving over to such a system of pooling will require amendment of the Constitution. Our terms of

reference do not require us to consider such a change. As such, we have made our recommendations in accordance with the existing provisions of the Constitution. The share of income tax and excise duty to be devolved has been recommended in a way that will facilitate a move towards the pooling of all central taxes and devolving a proportion to the States. We have reduced the gap between the percentage of income tax and excise duty shared with the States. This has been accompanied by uniform criteria for distribution of both the shareable taxes.

2.33 Our concern for equity and efficiency has been built into our criteria for horizontal distribution. We believe that the two are not mutually exclusive and we have in our devolution formula tried to blend equity with efficiency. Towards this end, tax effort - which represents fiscal efficiency on the revenue side - has been explicitly rewarded in our scheme. We have incorporated two new elements, area and infrastructure, keeping in view the spatial dimension of providing public services and the enhanced importance of infrastructure development across States.

2.34 A healthier fiscal attitude can be generated if the grants are not based only on the emerging picture of surpluses or deficits but also on the urgent needs and special problems of the States as identified on the basis of discussions and field visits in the States. In our scheme of transfers, we have used grants as an instrument for upgrading services and providing earmarked resources for some important purposes.

2.35 Following the 73rd and 74th amendments of the Constitution, enabling legislation has been enacted by all States and State Finance Commissions have been constituted by them. While our terms of reference do not require us to consider the financial needs of the third tier of the federal structure, we feel that the development of these institutions would be impaired if they are not put into funds at their inception. We are aware that a major part of their needs would come by transfers of functions and funds from the States, including plan funds, and central and centrally

sponsored schemes. However, we still consider it important that initial funding of priority areas of basic services like drinking water, health facilities, and elementary education to our rural population and civic amenities to the huge population living in the slums in our megapolises, metropolises and other urban centres should be made. Accordingly, we have provided grants to all States for this purpose.

2.36 Our approach to the problem of the accumulating debt burden has been informed by the need for economy in expenditure and efficiency in raising resources. The solution to the problem of debt lies in restoring the revenue account balance and generating surpluses for investment. We are firmly of the view that debt relief offers only temporary reprieve and a long term solution to the problem lies in corrective measures discussed later. In line with our diagnosis we have tried to introduce an incentive based system of debt relief which is related to an improvement on the revenue account balance. We have, utilising the opportunities offered by the new economic environment, recommended a scheme of debt retirement from the proceeds of disinvestment of equity in the public sector enterprises. We have introduced an incentive scheme in this respect also.

2.37 Our projections of revenue and expenditure for the period 1995-96 to 1999-2000 set out the direction in which policies to restore fiscal balance have to move and provide a picture of what should happen in the five-year period if these are undertaken. Our projections, while showing an improvement over the present picture, are still far from the goal of having revenue surpluses for each State. It is not too much to expect that the measures we recommend would be implemented fully by the Centre and the States. If in actual practice the picture turns out to be worse than what is being projected, even our conservative assessment of what can realistically be done would have been proved wrong. It is a perpetual battle between hope and experience.