REPORT
OF
THE ELEVENTH FINANCE COMMISSION

ON

THE ADDITIONAL TERM OF REFERENCE

(FOR 2000-2005)

AUGUST, 2000

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3. Views of the Ministry of Finance

3.1. The Ministry of Finance has stated that the added ToR contains two parts for the consideration of this Commission in order to advance fiscal reforms at the State level. One, the Commission should identify measures which are monitorable and are aimed at reduction of revenue deficits of the States. Two, the Central grant package should be linked to a reform agenda that confines itself to measures to reduce the revenue deficit through monitorable actions by the States. The Ministry has pointed out that the added ToR was not confined to 2000-01 alone but it also sought to establish a link between fiscal reforms and Central grants to cover assessed deficit of the States on non-plan revenue account. The Ministry has further stated that while the details of fiscal reforms programme would necessarily have to be decided by the States themselves, elements of the fiscal reforms programme should include raising of tax and non-tax revenue and user charges, rationalisation of work force and reduction of inessential non-plan expenditure. The overall objective of the fiscal reform programme should be to remove the structural imbalances in the finances of the States so that, within a given time-frame, the balance from current revenues becomes positive. The Ministry has suggested that the Finance Commission may indicate broad contours of fiscal reforms programme but the detailed programme should be designed by the States themselves. The reforms programme should be monitorable in the sense that the indicators can be measured in terms of numbers. The Ministry has suggested that the monitoring could be done by a joint committee consisting of the representatives of Central Government including Planning Commission and the concerned State Governments. It has further stated that the additional term of reference was only procedural in nature and would not envisage any additional financial implication. It has contended that any grant beyond what has been recommended in the main Report may open up avenues for further demand for grants by the States.

4. Views of the Planning Commission

4.1. The Planning Commission have pointed out that the fiscal position of all the States was under acute stress. The revenue deficit of all States has been growing alarmingly in recent years. They felt that unless suitable measures were taken immediately, the fiscal situation of the States would further deteriorate. They have suggested that the release of the grants should be linked to the progress in implementation of the monitorable fiscal reforms programme of the States. The Finance Commission may lay down the broad parameters; the State specific reform programme may be suitably designed to give effect to them. In the initial stages, monitoring of the programme may be limited to those States to whom revenue deficit grants have been recommended. Based on the experience, it should be extended to other States and some incentive-based transfer system could be formulated. According to the Planning Commission, the monitorable fiscal reforms programme should indicate specific measures required for improvement in the tax revenues, non-tax revenues especially the user charges, irrigation rates and reduction in expenditure, particularly in the areas of salaries and allowances and subsidies. The Planning Commission has also emphasised the need for effective governance so as to bring about better utilisation of the funds spent by the government.

5. Our Approach

5.1. We have carefully considered the comments and suggestions of the States, the Ministry of Finance and the Planning Commission on the different parts of the additional term of reference. Article 275 of the Constitution empowers the Parliament to identify the States in need of assistance and to determine the grants-in-aid for each State on a year to year basis by law. Till Parliament makes a provision as envisaged in the Constitution, the President has to exercise these powers by an order on the recommendation of the Finance Commission. We, therefore, do not see any constitutional limitation on linking the release of revenue deficit grants to specific performance as these measures are only meant to ensure sound finances envisaged under article 280(3)(d) of the Constitution.

5.2 The first task that confronts us in addressing the additional ToR is to formulate a monitorable fiscal reforms programme. In Chapter III of our Report, we have recommended a package of measures to be taken by the governments at both levels to reduce their fiscal deficit. If fully implemented, these measures should serve to eliminate the revenue deficit in the State budgets at the aggregate level and bring down the Centre's revenue deficit to not more than 1 per cent of Gross Domestic Product (GDP) by the year 2004-05. We have also specified a number of measures which would help to achieve this target by raising revenues, both tax and non-tax, and reducing non-plan revenue expenditure. In Chapter V of the main Report, dealing with assessment of States' resources, we have indicated specific measures to reduce their revenue deficits. The budgetary performance of the States and, in particular, their revenue deficits, however depend to a considerable extent on the emerging macroeconomic scenario, the Centre's conduct of macroeconomic policies, and the budgetary situation of the Union government. The growth of Central tax revenues has a direct bearing on the States' revenue receipts, and thereby on their revenue deficits. If the Centre's tax revenues do not show the expected buoyancy, States' revenue balances would also be affected though the impact may vary from State to State. It is difficult to lay down State specific targets of fiscal reforms focussing on revenue growth and expenditure compression for each of the next five years and enforce these, as the performance in this regard is affected by factors beyond their control such as the growth of output in the economy, rate of inflation and the budgetary position of the Centre. This is why the fiscal policy rules adopted in several countries in recent years allow a good deal of flexibility in operation and only lay down certain limits/ norms in broad terms.

Report of the Eleventh Finance Commission on the Additional Term of Reference

1. Introduction

1.1. The Presidential notification dated April 28, 2000 has mandated us to draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the States and recommend the manner in which the grants to States to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme. A copy of the notification is placed at Annexure I.

1.2 In the Presidential notification dated July 3, 1998, in which several terms of reference (ToR) were given to the XI Finance Commission, paragraph 4 had mandated the Commission with the following:

> "The Commission shall review the state of finances of the Union and the States and suggest ways and means by which the governments, collectively and severally, may bring about a restructuring of the public finances so as to restore budgetary balance and maintain macro-economic stability."

1.3. The Presidential notification dated April 28, 2000, has extended the aforementioned term of reference and added the following:

> "In particular, the Commission shall draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the State and recommend the manner in which the grants to the States to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme."

1.4. We had already addressed the first part of the paragraph 4 of the ToR in our main Report submitted to the President on July 7, 2000. While paragraph 4 of the ToR, as it originally stood, was wide enough to warrant not only a review of the finances of the two levels of governments but also spelling out measures for reforms, its extension under the Presidential Order of April 28, 2000 added a new dimension to our task. We are now required to formulate the fiscal reforms programme in a monitorable form and indicate how the grants-in-aid to States to cover the assessed deficit on their non-plan revenue account, can be linked to the progress in implementation of such a programme.

2. Views of the States

2.1. The Commission sought the views of the States as also of the Ministry of Finance and the Planning Commission on this additional term of reference. A conference of States' Finance Ministers was also convened on May 22, 2000 to discuss this subject. In particular, the focus of discussion was concentrated on the contents of the monitorable reforms programme, the agency for monitoring the programme, and the periodicity for monitoring.

2.2. The States have raised various issues like the constitutional validity of the additional term of reference, the need for prior consultation with the States in a federal spirit before addition of any new term, the need for monitoring of the performance of the Centre, nature of the monitoring agency, monitorable items, creation of an additional fund to induce fiscal discipline and the very need for the additional term of reference. Some States - Andhra Pradesh, Bihar, Kerala and Orissa - have stated that the Constitution does not envisage any conditionality for release of grants to the States in need of assistance under article 275. They were of the view that the grants recommended by the Finance Commission on the basis of the assessed needs of the States should be provided to them without any link to the progress in the implementation of fiscal reforms programme. Kerala, Madhya Pradesh, Nagaland and West Bengal felt that the additional term of reference was given to the Commission without any prior consultation with the States and as such, it went against the spirit of co-operative federalism. Rajasthan, Tamil Nadu and West Bengal argued that the Commission was required to suggest ways and means by which the governments, collectively and severally, may bring about restructuring of public finances so as to restore budgetary balance and maintain macro-economic stability. They felt that since this term was already implied in the original ToR, there was no need for the additional term. Maharashtra was of the view that if any conditionality were to be attached for releasing grants to the States on the basis of performance in implementing the reforms programme, the Centre should also be brought under similar conditionality. Andhra Pradesh, Tamil Nadu and West Bengal advocated that if at all a conditionality were to be applied, it should be enforced only from the third year, as the actual figures on relevant variables would be available after a lapse of one year or even more.

2.3. On the subject of the parameters of reforms programme and the manner of monitoring, Goa, Kerala, Madhya Pradesh, Tamil Nadu and West Bengal in particular, were of the view that monitoring should not be done by the Central Government unilaterally, but by a joint committee consisting of State Chief Ministers and the Union Finance Minister. This committee should go into the different aspects of the monitorable measures, lay down State-specific reforms programme and review the progress in their implementation from time to time. Haryana and Punjab stated that the parameters for monitoring should be based on the actual revenue deficits only and detailed item-wise monitoring should be avoided. Himachal Pradesh was of the view that the Central revenue resources should be distributed between the Centre and the States on the basis of their respective fiscal performance. Gujarat fully supported the additional term of reference and suggested that the release of grants should be linked to the fiscal performance of the States.

6. Linkage of release of deficit grants-in-aid to monitorable measures

6.1. The Ministry of Finance has stated that the additional term of reference is of a procedural nature, and requires this Commission to draw only a monitorable fiscal reforms programme, linked to the release of grants to States on the basis of the assessed deficit in their non-plan revenue account. We have given careful thought to the wording of this term and in our view this interpretation is rather narrow and does not take into account the imperatives of reform not only for the States which have been assessed deficit on non-plan revenue account but also for those States which have revenue deficit in the revised budget of 1999-2000 and have not been recommended any grants because of the normative approach adopted by us. The additional term of reference, as stated earlier, is an amplification of the mandate contained in paragraph 4 of the original term of reference. In paragraph 4 of the original term, the Commission is required to review the state of the finances of the Union and the States and suggest ways and means by which the governments "collectively and severally, may bring about a restructuring of the public finances so as to restore budgetary balance and maintain macro-economic stability". It may be recalled that in paragraph 5(viii) of the original term of reference, the Commission was required to have regard in making its recommendations to "the scope for better fiscal management consistent with efficiency and economy in expenditure including the incentives that need to be provided for better realisation of tax and non-tax revenue." We have addressed to the requirements of this sub-para in our Report, already submitted, in some measure, by giving weightage to tax effort and fiscal discipline in our formula for distribution of the Central tax revenues among the States. We have suggested a scheme for debt relief based on the fiscal performance of the States on revenue account. We have also stated in paragraph 3.79 of our main Report as follows: **"We propose to further strengthen the incentive structures when we consider the additional term of reference mentioned in para 3.3 in a supplementary chapter".**

6.2. The additional ToR has thus been in furtherance of the overall objective of inculcating a sense of fiscal discipline and enjoins on the Commission to draw up monitorable fiscal reforms programme and recommend the manner in which the grants to the States to cover the assessed deficit in the non-plan revenue account may be linked to implementing the programme. The deficit to be reduced is both in relation to plan and the non-plan account. In addition, the Commission is to recommend the manner in which the release of grants to the States to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme. This programme has to be drawn up for all the years for which the Report of the Commission is relevant. Even in the case of the States having assessed deficit in the non-plan revenue account only for some years, the monitorable programme is to be drawn up to cover the years for which these States are entitled to grants-in-aid and also the years for which they are not entitled to such grants. Such a programme for the States to be credible and realistic must provide for incentives as well as disincentives, linked to progress in implementation of the programme. The Commission is, therefore, unable to accept the view that the additional term of reference is only procedural. in nature aiming at linking release of grants to States to cover the assessed deficit in their non-plan revenue account and that it does not envisage any additional revenue implication.

6.3. There are, however, some inherent limitations in our drawing a monitorable programme for every State. The budgetary performance of the States and, in particular, the revenue deficit depend to a considerable extent on the emerging macro-economic scenario, the Centre's conduct of macro-economic policy and the budgetary situation of the Union Government, as stated earlier. The monitoring of the fiscal reforms programme of a State with a view to reduce its revenue deficit will have to be in the context of the national economy and policies also. We do not have adequate information regarding plan revenue expenditure. Further, there is a nexus between the revenue deficit and capital expenditure. If capital investments do not bring in adequate revenue to service the debt, such investments result in an increase in revenue deficit. The revenue growth as well as the required compression of the revenue expenditure (non-plan) has been worked out on a normative basis and not on the actual position indicated in the budget of the different States. The grants-in-aid for some States to meet the revenue deficit on non-plan revenue account have been suggested on this basis. This factor has a relevance to the linkages to be suggested in the monitorable fiscal reforms programme with the release of the grant-in-aid to these States.

6.4. In working out the non-plan revenue deficit grant, the Commission adopted norms to estimate the revenue receipts and revenue expenditure. Considering this aspect, it may at first sight appear inappropriate to impose any conditionalities and to link the release of revenue deficit grants to a monitorable fiscal reform programme. However, the thrust of paragraph 4 of the ToR is on the restructuring of public finances for restoring budgetary balance so as to maintain macro-economic stability. A monitorable fiscal reforms programme has to be drawn up aimed at reduction of revenue deficit of the States. In this context, there is need for some linkage of the revenue deficit grant to the progress in implementation of the reforms programme and in case of better performance, there is a need to provide for incentives as well. In order to balance the twin objective, the Commission is of the view that 85 per cent of the revenue deficit grant recommended by the Commission and accepted by the Government of India may be released to the relevant States without linking it to performance under the monitorable fiscal reforms programme. Only 15 per cent of the revenue deficit grant to which a State is entitled may be withheld and linked with the progress in performance.

6.5. A monitorable fiscal reforms programme needs to be developed even for the States which have been assessed to generate surplus on non-plan revenue account or revenue account as a whole during each or any of the five years during 2000-05. This monitorable reforms programme has to be linked to a system of incentives; otherwise these States will not

have any interest in it. In our view, such a programme is also necessary to ensure that these States conform to an overall fiscal discipline indicated in our main Report. This would also ensure the restructuring of the public finances in these States on the lines suggested by us. Further, the prescribed norms and standards will require a time span for absorption and assimilation in the system before a meaningful result could be expected. These States also have the problem of large fiscal deficits, increasing liability on account of interest payments, etc. A system of incentive would help them to come out from the present precarious situation and put them on the path of a healthy fiscal recovery.

6.6. In the past, Finance Commissions have assessed the budgetary position of the States on the basis of norms laid down by them for revenue receipts and non-plan expenditure. It has been noticed that the States, without exception, have hardly paid any heed to this aspect of their Reports. The norms were seldom realised or adhered to; the result being a continuous deterioration in the fiscal situation of the States. The balance from current revenues for financing the plan expenditure has been coming down; in many cases, it is negative. The States have to resort to borrowings to finance even their non-plan revenue expenditure. A monitorable fiscal reforms programme based on our Report is essential to ensure that the growth in the revenue and compression in expenditure envisaged therein is given effect to by a programme of action.

7. Monitorable Measures

7.1. In Chapter III of our main Report, we have indicated the content of a fiscal reforms programme for the reduction of the revenue deficit of the Centre to one per cent of Gross Domestic Product (GDP) by 2004-05. In the case of States, the revenue deficit of all the States at the aggregate level has been projected to come down to zero level by the same year. The contents of this programme have many specifics requiring action by the Central Government. These do have a direct impact on the financial position of the States, apart from what arises from the management of the economy at the macro level. These measures, therefore, need action by the Government of India. After a decision is taken in respect of these recommendations, these can form the basis for drawing up State-specific monitorable fiscal reforms programme in respect of all States.

7.2. The design of a reform programme should be such that it can be monitored in an objective manner. The Ministry of Finance emphasised the need for laying down the measures in a quantifiable form. There would be several components in this programme; some of these would be State specific. In order to make it quantifiable and measurable, we indicate a scale of 100 points, 50 points assigned to revenue receipts and the other 50 points to the expenditure. We feel that both these aspects need to be addressed in the preparation of a detailed programme.

7.3. We have indicated in our Report the required growth of tax revenue for each State. Growth of tax revenue in relation to their past realisation is a monitorable measure. Actual realisation of tax revenue in 1999-2000 may be taken as the base year figure, and a State may be required to improve upon it in accordance with the norm of the growth rate indicated in the Report. It is up to a State to choose specific taxes and rates to achieve the desired level of improvement. A weight of 30 out of 100 is assigned to this measure.

7.4. Non-tax revenue of the States broadly comprises interest receipts, royalty on minerals, revenue from forestry and wildlife, irrigation receipts and the user charges levied on a host of services provided by the States. While some of these are dependent on the policy and action of the Centre, there are other areas, indicated in our Report, where it is possible to increase the revenue by suitable and periodic revision of rates. We have already indicated the required rates of improvement in irrigation tariffs, interest receipts, dividends and user charges in the Report. Improvement in user charges can be limited to those services which are directly provided by the State. Where services are provided by the local bodies, the State should ensure that the user charges are revised in accordance with the suggestions made in the main Report. A weight of 20 per cent is assigned to the non-tax revenue. The *inter se* weight among the various components of non-tax revenue can be decided for each State, based on the relative importance attached to each of these factors in the finances of the State.

7.5. One of the important items of expenditure is the salary bill. The budgets of the States do not contain at one place the number of employees and the salary expenditure provided by the Government directly, department-wise. We recommend that each State should provide this information in a tabular form as given by the Central Government in its budget. The expenditure on salary bill of a State should be limited to a growth of 5 per cent or to inflation (Consumer Price Index) whichever is higher. Since this is an important component of the expenditure, a weight of 30 per cent is assigned to this factor.

7.6. It is assumed in our main Report that the growth of interest may be limited to 10 per cent per year. We suggest that this may be retained as a monitorable measure and a weight of 10 per cent be assigned to it. This assumes the growth of capital stock at around 9 per cent given the existing rate of interest. However, the level of borrowing for a State is determined by the Centre each year. If the capital stock is expected to go up at a higher rate than assumed, due to an investment programme taken by a State, suitable adjustments may be made. In any case, borrowing for consumption purposes or for meeting day-to-day routine expenditure should be discouraged.

7.7. Subsidies are an important item in the budgets of some State Governments. In our assessment, we have assumed these subsidies at a zero level. However, in actual practice States may take a time span for coming to this situation. The

monitorable programme should aim at bringing down the explicit subsidies - subsidies provided for a purpose or for an organisation - to a zero level over a period of ten years on a pro-rata basis. This would, however, not include the subsidies given under a programme sponsored or approved by the Central Government. The basis for pro-rata reduction should be the actual subsidies given in the year 1999-2000. A weight of 10 per cent may be given to this factor.

7.8. The monitorable programme gives equal weight to the raising of revenue and control of expenditure. A summary of weights given to the various items is given in Table I.

Table I

Summary of the measures and their weights

Measures	Weights
Revenue Receipts	
1. Growth of tax revenue	30.0
2. Non-tax revenue	20.0
Revenue Expenditure (non-plan)	
1. Salaries and allowances	30.0
2. Interest	10.0
3. Reduction of subsidies	10.0
Total	**100.0**

7.9. The areas indicated for monitoring are only suggestive; so are the weights. These can be suitably modified while drawing the State specific programme. However, the broad contents of the reform indicated in our main Report, as also here, should be kept in view as the ultimate objective is to bring the revenue deficit of the States to zero, in the aggregate, by 2004-05.

7.10. It may be possible that a State may not be able to achieve the desired level in one or more criteria, but may achieve in others. While working out the overall achievement, this factor should be taken into account and excess achievement in some areas may be balanced against the shortfall in others. However, if a State reduces the revenue deficit (non-plan revenue deficit in the case of release of grants-in-aid) as stipulated in the agreed reforms programme, but is unable to adhere to the specifics of what has been suggested by the Commission, it should be entitled to get the benefit of full release of non-plan revenue deficit grants and incentive grants. Conversely, if a State adheres to the agreed reforms programme but has not been able to reduce the revenue deficits due to the factors beyond its control, e.g., higher rate of inflation, lower rate of growth of GDP, lower tax devolution etc., it should get the benefit of grants.

7.11. The revenue receipts and the expenditure of the States also depend on the impact of economic policy pursued by the Central Government. To the extent that these are affected by the rate of growth of GDP, rate of inflation, and other macro- economic decisions, suitable adjustments may be made at the time of formulation of the monitorable fiscal reform programme as well as when an assessment of implementation is done.

8. Incentive Fund and its Release

8.1. In the light of what has been stated in the foregoing paragraphs, we recommend the setting up of an Incentive Fund comprising two parts, A and B. The first part of the Fund would comprise 15 per cent, which is the withheld part, of the grants recommended to cover the deficit of the States on non-plan revenue account. Depending on the performance of a State in the implementation of the monitorable programme, the withheld amount would be released to it on a proportionate basis. The second part of the Fund would be created by contribution from the Central Government, equivalent to 15 per cent of the revenue deficit grants recommended by us. In para 4.21 of our main Report, we have suggested that the Central fiscal transfer to the States should be around 37.5 per cent of the gross revenue receipts of the Central Government. This contribution from the Central Government to the Incentive Fund should be accommodated within this level. We have had several alternatives in view on the size of this Fund. It is clear that the size should be sufficiently attractive for the State to undertake and adhere to an agreed reform programme. We felt that fiscal reforms are the need of the current economic situation, and no State would, on its own, like the financial position to deteriorate. At the same time, a medium size fund should be so designed as to provide adequate incentive to the States, and also put them in a scale of assessment of performance. We also felt that the burden on the Centre's finances on this account should be modest and it should enable the Centre to accommodate it with ease.

8.2. The total amount of the fund comprising both parts is recommended at Rs.10,607.72 crore for a five year period to be apportioned at the rate of Rs.2121.54 crore per year. As the grants-in-aid are in a descending order from the first year to the last year, the year-wise contribution from the Central government to this fund will be increasing very marginally and imperceptibly from year to year to retain the level of Rs.2121.54 crore per year. The year-wise composition of the proposed incentive fund is given in Table II below:

Table II

Composition of the Proposed Incentive Fund

(Rs. in Crore)

Year	Part A (Tied up Grant-in-aid)	Part B (Incentive component - contribution of the Centre)	Total Fund
2000-01	1523.06	598.48	2121.54
2001-02	1080.43	1041.11	2121.54
2002-03	994.64	1126.91	2121.55
2003-04	861.74	1259.81	2121.55
2004-05	843.99	1277.55	2121.54
Total	**5303.86**	**5303.86**	**10607.72**

8.3. The incentive component would be provided to all the States. The initial eligibility of the States has been worked out on the basis of the population as per the 1971 Census (Table III). The amount will be available to a State in proportion to the level of performance in the implementation of the monitorable fiscal reforms programme for each year.

Table III

Distribution of the Incentive Fund during the Forecast period (Part B)

(Rs. in Crore)

States	Population (1971)		2000-01	2001-02	2002-03	2003-04	2004-05	2000-05
	(in lakhs)	% to Total						
Andhra Pradesh	435.03	**8.01**	47.94	83.40	90.27	100.92	102.34	424.87
Arunachal Pradesh	4.68	**0.09**	0.52	0.90	0.97	1.09	1.10	4.58
Assam	146.25	**2.69**	16.12	28.04	30.35	33.93	34.40	142.84
Bihar	563.53	**10.38**	62.10	108.03	116.93	130.72	132.57	550.35
Goa	7.95	**0.15**	0.88	1.52	1.65	1.84	1.87	7.76
Gujarat	266.97	**4.92**	29.42	51.18	55.40	61.93	62.80	260.73
Haryana	100.37	**1.85**	11.06	19.24	20.83	23.28	23.61	98.02
Himachal Pradesh	34.60	**0.64**	3.81	6.63	7.18	8.03	8.14	33.79
Jammu & Kashmir	46.17	**0.85**	5.09	8.85	9.58	10.71	10.86	45.09
Karnataka	292.99	**5.39**	32.29	56.17	60.80	67.97	68.92	286.15
Kerala	213.47	**3.93**	23.52	40.92	44.30	49.52	50.22	208.48
Madhya Pradesh	416.54	**7.67**	45.90	79.85	86.43	96.63	97.99	406.80
Maharashtra	504.12	**9.28**	55.55	96.64	104.61	116.94	118.59	492.33
Manipur	10.73	**0.20**	1.18	2.06	2.23	2.49	2.52	10.48
Meghalaya	10.12	**0.19**	1.12	1.94	2.10	2.35	2.38	9.89
Mizoram	3.32	**0.06**	0.37	0.64	0.69	0.77	0.78	3.25
Nagaland	5.16	**0.10**	0.57	0.99	1.07	1.20	1.21	5.04
Orissa	219.45	**4.04**	24.18	42.07	45.54	50.91	51.62	214.32
Punjab	135.51	**2.50**	14.93	25.98	28.12	31.43	31.88	132.34
Rajasthan	257.66	**4.74**	28.39	49.39	53.47	59.77	60.61	251.63
Sikkim	2.10	**0.04**	0.23	0.40	0.44	0.49	0.49	2.05
Tamil Nadu	411.99	**7.59**	45.40	78.98	85.49	95.57	96.92	402.36
Tripura	15.56	**0.29**	1.71	2.98	3.23	3.61	3.66	15.19
Uttar Pradesh	883.41	**16.27**	97.35	169.35	183.31	204.93	207.82	862.76
West Bengal	443.12	**8.16**	48.83	84.95	91.95	102.79	104.24	432.76
Total	**5430.80**	**100.00**	**598.48**	**1041.11**	**1126.91**	**1259.81**	**1277.55**	**5303.86**

8.4. If any State is unable to get the full amount as indicated in Table III in any year, such amount will not lapse but will continue to be available in subsequent years to the same State. During the first four years, no amount of this fund earmarked for assistance/incentive to a State, would be transferred to another State. However, if any State is not able to draw the amount indicated on the basis of the performance of the first four years, the amount undisbursed to a State would form part of the common pool and would be distributed to the performing States in the fifth year on a pro-rata basis in addition to the amounts to which they are initially entitled as per Table III. The same would apply to the undrawn amount of Part A. Every State irrespective of the assessed deficit or not would be entitled to get the assistance on a pro-rata basis related to performance from the additions to the Fund. This additional entitlement can go up to 100 per cent of their initial eligibility indicated for the State concerned in Table III. The fund may be kept separately, preferably in a public account.

8.5. The withheld amount of grants releasable in the fifth year i.e. 2004-05 will be released to the concerned assessed State on the basis of a review of their performance. In case any amount remains unreleased, it would be added to Part B of the Fund and would be available to the States in the same manner as indicated in paragraph 8.4. The balance amount in the Fund at the end of the Sixth year i.e. 2005-06 will lapse to the Central Government.

8.6. This Commission has recommended grants for specific purposes like upgradation, special problems and local bodies. There are certain specific conditionalities for releasing these grants. The progress in the implementation of the identified schemes may be reviewed by the monitoring agency suggested by us in the following section. If the Agency is satisfied that a State has not taken effective steps to implement these in the first four years, and is not in a position to utilise the amount either in full or in part, the same may be added to Part B of the incentive fund in the fifth year.

8.7. In addition to the incentives for better performance referred to above, Central Government may also consider the fiscal reforms programme linked assistance by way of extended ways and means advance and additional open market borrowings. The scope and dimension of such facilities should be drawn up by the Central Government bearing in mind the Centre's fiscal position and the macro-economic implications of this facility. This facility should also be extended to all States linked to monitorable fiscal reforms programme drawn up for the State.

9. Monitoring Agency

9.1. For the purpose of drawing up State-specific monitorable fiscal reforms programmes in the context of the broad parameters suggested by the Commission and as accepted by Government of India, the following administrative arrangements are suggested:

(a) A group designated as the 'Monitoring Agency' may be constituted by the Government of India which may include, amongst others, representatives of Planning Commission, the Finance Ministry of the Government of India and the representatives of the State Government for which the programme is to be worked out.

(b) We have suggested in our main Report that a permanent secretariat of the Finance Commission headed by an Additional Secretary may be set up for the period when there is no Finance Commission. The Additional Secretary of this Division may act as Secretary of this agency and this Secretariat may act as the office for the Agency.

(c) This Agency may draw up State specific monitorable reform programmes for all States whether getting any grants-in-aid on the basis of assessed non-plan revenue deficit or not.

(d) This monitorable fiscal reforms programme should cover both, the withheld part of the grants-in-aid in the case of States which are getting such grants-in-aid and provision for incentives to all such States which perform better. The programme relating to States not getting grants-in-aid in some or all years should relate to the grant of incentives linked to progress in performance. The programme relating to States getting grants-in-aid should also cover, besides release of withheld amount of grants, incentives in case of better performance. Such States would then get the full quantum of the revenue gap grants plus the incentive grants linked to performance.

(e) This Agency may authorise release or withholding of grants-in-aid on the basis of their assessment of implementation of the reform programme. The same Agency would assess the performance of the States not getting any revenue deficit grants and authorise the extent of release accordingly. The releases authorised by the Committee both in respect of withheld grants-in-aid as well as incentives will be on a provisional basis, subject to review and a final decision as explained in sub-para (g) below.

(f) Under the Constitution, a Finance Commission has to be constituted "at the expiration of every fifth year or at such earlier time as the President considers necessary" from the date on which the earlier Finance

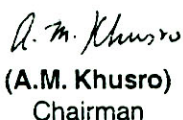
Commission was appointed. The present Finance Commission was notified on July 3, 1998. We have suggested in our main Report that the next Finance Commission should be set up in time so that it may be able to submit its report at least three months before the commencement of the period from which its report would become applicable. Taking this into consideration, it is expected that the next Finance Commission would be in position some time in the year 2002. We recommend that the next Finance Commission be entrusted the task to review the monitorable fiscal reforms programme of each State and the releases of grants-in-aid/incentives made thereunder be made a specific term under article 280(3)(d) of the Constitution.

(g) The Agency suggested above may submit the monitorable fiscal reforms programme drawn up by it and the details of provisional releases of withheld part of grants-in-aid and incentive amount to various States along with a report to the Finance Commission. The Finance Commission may examine the whole matter and take a final view regarding the releases of withheld grants-in-aid and incentives and make suitable recommendations. The Finance Commission may also examine the progress in utilization of other grants under article 275 recommended by this Commission and make recommendations, if any, in respect of these. The recommendations by the next Finance Commission in respect of this term may be made even before the final report is submitted by the Commission on its other terms of reference. This arrangement would have the advantage that the utilisation of grants-in-aid recommended by a constitutional body is monitored by the next constitutional Commission. This arrangement would also be in keeping with the constitutional provision relating to devolution. Final decision in respect of the release of these withheld part of the grants-in-aid and incentives may be taken as per recommendations of the next Finance Commission.

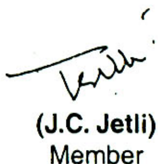
10. Concluding observations

10.1. We feel that the creation of an Incentive Fund by drawing a small contribution from the Central Government would not impose any strain on its finances. However, the well performing States will have an access to incentive funding from two sources, namely, (i) the Incentive Fund given in Table III in this report and (ii) the undrawn balance from the grants recommended by us in the main Report. Moreover, we have suggested the provision of assistance through extended ways and means advance and additional open market borrowings linked to performance. The degree of incentives and satisfaction for the performing States would be substantial. Thus, apart from being a healthy innovation in public finance, the Incentive Fund will have an effect of bringing all the States within the ambit of assessment of their performance on the basis of agreed parameters by a body under the Constitution. We hope that this will inculcate a sense of fiscal discipline among the States and usher in an era of cooperative federalism in the fiscal arena.

10.2. Dr. A. Bagchi, a member of the Commission does not agree with the propositions and recommendations made in this Report. He has given a note of dissent which is attached with this Report.



(A.M. Khusro)
Chairman



(J.C. Jetli)
Member

(N.C. Jain)
Member

(A. Bagchi)
Member

(T.N. Srivastava)
Member-Secretary

New Delhi
August 30, 2000

Note of Dissent by Dr. Amaresh Bagchi, Member

1. With utmost respect, I regret, I am unable to agree with my esteemed colleagues on the approach to the additional Term of Reference (AToR) enunciated in their report addressing the said AToR (hereinafter referred to as the majority report) and the recommendations based thereon. In essence, the operative content of the recommendations consists of:

(i) A proposal to withhold a portion of revenue deficit grants (para 6.4);

(ii) Identification of five indicators for monitoring the progress of reforms (para 7.8);

(iii) Proposal to set up an "incentive fund" for giving grants over and above those already recommended in the main report (paras 8.1 & 8.2);

(iv) A proposal to constitute a monitoring agency consisting of group(s), to be "appointed by the Government of India, which may include, amongst others, representatives of Planning Commission, Finance Ministry of Government of India and representatives of the State government for which the programme is to be worked out" [para 9.1 (a)];

(v) Proposals indicating additional responsibilities for the next Finance Commission [para 9.1 (f) and (g)].

2. After a careful consideration of the proposals and the arguments advanced to support them, I find myself unable to go along with any of them. The reasons for my disagreement are indicated below:

(i) Withholding of Revenue-Deficit Grants

3. The proposal to withhold a part of the revenue deficit grants recommended by us in the main report and making its release, conditional on progress in the implementation of a reform programme is, according to me, unjustifiable and runs contrary to the spirit of Article 275 of the Constitution which authorises the Finance Commission to recommend such grants-in-aid.

4. This is because the determination of revenue-deficit grants in our main report is characterised by two basic features: one, given the revenue and expenditure profiles of the Central and State governments, it involves massive compression of the revenue deficits projected by the States for the five years 2000-05; and two, it involves application of norms on the base year figure (that is for 1999-00), as well as on the growth of revenues and expenditure over the said five years. Reference may be made to the upward adjustments made in the tax revenue of the States and downward adjustments in their interest expenditure for the base year (Annexure Tables V.1 and V.2 of the main report). Again, in estimating salary expenditure for the subsequent five years, growth in salary bill beyond 5 per cent is not provided for, and growth in interest payment beyond 10 per cent is also not taken into account. An idea of the compression involved is provided by the fact that for the year 2000-01, the pre-devolution non-Plan revenue deficit of the States taken together, as per their forecasts, amounted to Rs.131,295 crore (Table 5.1, main report). Against this figure, if we set off the total amount of recommended tax-devolution which comes to nearly Rs.54060 crore in 2000-01, the residual non-Plan revenue deficit of States works out to Rs.77235 crore. As against this, the revenue deficit grants recommended by us for 2000-01 came to Rs.10154 crore. In the face of such compression, how can there be any justification to withhold even a single paise of the grants arising out of the needs assessed by the Commission? In my view, given the compression of their deficits, withholding any part of the statutory transfer would itself serve to debilitate and destabilise the finances of States that are in revenue deficit on non-plan account, and thereby upset the reform process instead of strengthening it.

5. That apart, a fundamental principle is involved in proposing conditionality to be attached to the release of grants-in-aid to meet revenue deficits. For, in essence, these grants, like tax devolution, come within the category of "general purpose grants" required to meet the vertical and horizontal imbalances in the system. It will create a most unhealthy precedent to impose conditionalities on the release of any part of these grants.

6. Another reason why the deficit grants should not be withheld even partially as a mechanism for introducing fiscal discipline is that not all States are entitled to grants-in-aid for all the five years (2000-05). The States for which the non-Plan revenue account turns into a revenue surplus after devolution as per our assessment are not going to get any revenue deficit grant, although they also may default in meeting the norms on the basis of which their revenues and expenditures have been estimated. If any rule of fiscal prudence is to be imposed, it should apply to all States equally and should not discriminate against States who happen to be receiving revenue deficit grants while others escape any such conditionality because their assessed non-Plan deficits turn into a surplus with tax devolution even though they may fail to meet the assessed targets of revenue and expenditure in this manner.

7. Furthermore, the scheme suggested by my learned colleagues envisages that if, after the first four years, a revenue-deficit State is unable to get the full amount of grant which has been recommended for it, the withheld portions will be given to other States. I do not think that there can be any circumstance under which a grant under Article 275,

recommended by the Commission in its main report, and already accepted as per the ATR, can be given to a State, which as per assessment, is not in deficit. The Commission in its main report had recommended different sums for different States after due assessment. No part of these are, in my view, transferable between States. It is relevant to note that several States have contended that the Constitution does not envisage any conditionality for release of grants-in-aid of States in need of assistance under Article 275 (para 2.2 of majority report). I am in agreement with this view.

(ii) Identification of indicators to measure progress in Fiscal Reform

8. Drawing on the suggestions put forward by the EFC in Chapter III of its main report, the majority report suggests that these should form the basis for drawing up State-specific monitorable fiscal reforms programme. The majority report then goes on to propose weights in respect of five items, two under revenue receipts and three under revenue expenditure for measuring progress in reforms (vide paragraph 7.8). I envisage several formidable difficulties in monitoring progress in implementation of a reform programme in terms of these indicators. Some of these, I am constrained to point out are as follows:

a. *Growth of tax revenue*

It has been recommended that growth-rate of tax revenue be measured starting with 1999-2000 as the base year. It hardly needs pointing out that annual growth of revenues depends not only on the reform measures that a State may initiate but also on a number of factors beyond its control such as growth of GDP and GSDP, change in prices, caused by internal and external factors (like exchange rate changes) and other extraneous circumstances. A look at the annual growth rates of tax revenues of States in the past would show that they fluctuate sharply from year to year. Given this background, failure to reach the stipulated target cannot be taken to indicate lack of progress in implementing the reform programme, nor excess achievement would indicate, necessarily, progress. The influence of the extraneous factors needs to be quantified and allowed for before assessing the growth in tax revenue which can be attributed to a given State's tax effort and rewarded accordingly. Measurement of tax effort, on an objective and comparable basis across States is a complex exercise and the suggestion of my esteemed colleagues asking the monitoring agency to make "suitable adjustments" every year is simply impracticable. After all, the exercise will not be for merely academic purposes; the State's entitlement to grants will hinge on the results and so brushing aside the problems as one of "measurement" would be unacceptable.

b. *Salary Bill*

Departures in the growth of salary bill from a figure of 5 per cent or the rate of inflation (Consumer Price Index), whichever is higher, will be given high or low marks. Thus, if a revenue deficit State exceeds the benchmark of 5 per cent, it will not be able to get back its 'withheld' portion. In my view this will be patently unjustified because, in the assessment exercise, no State has been allowed a growth in salary bill, over and above 5 per cent, in the first place. Since the penalty has already been built into the assessment exercise, there is no case for penalising any State a second time by withholding the grant recommended for it.

c. *Interest Payment*

The infirmity inhering in assigning scores based on growth of interest payment is possibly even more serious. Here again, any growth rate of more than 10 per cent is not allowed in the assessment exercise. It will be grossly unfair to impose a second penalty, if the growth of interest payment happens to go beyond 10 per cent on the plea that the State's progress in the reform programme is poor. Secondly, interest rates are not under the control of any State government. Further, States who want to invest in infrastructure may borrow additionally to finance their investment. The Commission itself has suggested significant increase in capital expenditure. All that is required is that the additional debt-servicing burden should be financed with additional revenues raised by the States. Interest payments higher than 10 per cent can very well indicate progress of reforms and not lack of it.

d. The majority report recognises the problems and provides a wide latitude to the monitoring agency in applying the monitoring measures and working out the scores. It appears to me that instances where the official committee(s) will have to make "suitable adjustments" will be too large in number to invest any sanctity in the assessments and are bound to result in subjectivity and non-comparability across States. "Suitable adjustments" will have to be made whenever the nominal GDP growth varies from our assessed rate of 13 per cent. The moment it does, as almost certainly it will, all the GSDP growth rate benchmarks will also change. In each instance a "suitable adjustment" will have to be done. In some instances, variation in international prices like those relating to tea and other plantation crops critically affect revenue growth of some States. Again, "suitable adjustments" will have to be made. The official committee will also have to assign relative weights to each component of non-tax revenue also. It will have to put all States on equal footing regarding subsidies whereas it is well known that accounting of subsidies in State budgets is marked by diverse practices. In my view the tasks that have been assigned to the official committees will render the whole exercise arbitrary, full of *ad hoc* adjustments and insupportable and cannot provide the basis for any intergovernmental transfers.

(iii) The Incentive Fund

9. Regarding the proposal for creating an incentive fund, I do not think that we are in a position to recommend any such fund or set apart any amount for this purpose. The so called surplus remaining out of the indicative ceiling of 37.5 per cent of Centre's revenue left after taking out tax devolution and grants-in-aid, is really meant for meeting the plan revenue grants and other non-plan revenue grants that may be made by the Centre for emergency and other urgent purposes. We did not make any recommendation regarding plan revenue grants for lack of information. The surplus estimated in the assessment of Centre's revenues over the five years, 2000-05 (vide Chapter IV of the main report) is based on an *ad hoc* estimation of plan revenue grants. It is also not possible to project what could be the requirement for non-plan revenue grants other than recommended by us in the coming years. Demands for such grants may arise for various reasons, e.g., the need to compensate the States for loss of revenue if and when the Central Sales tax rates are brought down to facilitate the introduction of a destination based VAT. If we now suggest that a fund be created out of this "surplus" it will mean an inroad into the plan grants and the Centre's capacity to meet unforeseen demands.

10. In any case the AToR did not ask for any incentive scheme additional to what the Commission may have provided while considering its original ToR. My esteemed colleagues have made a reference to para 5 (viii) of the original ToR as one of the reasons providing that occasion. They observe "........ we have addressed to the requirements of this sub-para in our main report, already submitted, in some measure...." (para 6.1 of the majority report). The incentive scheme now being proposed would enable them to address the requirement of this sub-para in fuller measure. The requirement of the sub-para 5 (viii) has implications for all the recommendations of the Commission, including those under para 3. In particular, any change in the manner in which para 5 (viii) was attended to in the main report will have implications for the entire exercise of assessment of needs and resources. More specifically, the sums indicated in Table III of the majority report will need to be taken as potential resources of the concerned States and accordingly grants-in-aid will have to be reworked. The Commission has completed the task of assessing the needs and resources both of the States and the Centre, vide its main report. There is no reason now for providing additional grants in respect of unforeseen needs.

11. I have also not been able to understand how the size of the proposed incentive fund is determined. My esteemed colleagues have endeavoured to establish a link between the portions of revenue deficit grants to be withheld from States that fail to measure up fully to the measures of progress in reforms and the size of the incentive fund. However, the logic of this link is not clear. I do not think that there can be any such link in principle. Revenue deficit grants have been determined for States assessed to be in non-Plan revenue deficit. The amount recommended as grants-in-aid is equal to the assessed deficit. What is the rationale for providing to non-deficit States additional grants in proportion to an arbitrary fraction of the revenue deficit grants of the deficit States? As far as I can see, neither there is, nor there can be any link between grants meant for deficit States and any transfer contemplated for non-deficit States by way of incentive or otherwise. The proposed proportionality appears to me to be wholly irrational and contrived.

12. Furthermore, the incentive scheme recommended by my esteemed colleagues, would apparently entitle a State to a share equal to its share in 1971 population at the most, if it scores 100 in terms of the multiple indicators of progress of reforms. In my view, any reasonable scheme of incentives if it is to have the intended effect should be able to provide to a State which performs well, a share in the pool, which is distinctly higher than its share in the 1971 population. For example, under the 'tax effort' criterion Kerala gets a share of nearly 5.27 per cent while its share in 1971 population is 3.93 per cent and Tamil Nadu gets a share 10.03 per cent while its share in 1971 population is 7.59 per cent. Similarly, under the 'fiscal discipline' index in the devolution formula, performing States get a share higher than their respective shares in 1971 population. If maximum obtainable shares are limited to a maximum of 1971 population shares and that too upon scoring hundred per cent in the proposed tests, the incentive can hardly enthuse any State.

13. I am unable to accept the premise on which the entire incentive scheme exercise is predicated. My esteemed colleagues observe (para 6.5 of majority report): "This monitorable reform programme has to be linked to a system of incentives; otherwise these States will not have any interest in it. In our view, such a programme is also necessary to ensure that these States conform to an overall fiscal discipline indicated in our main report." These observations are open to objection on several grounds. First, there is an asymmetry between the States and the Centre in as much as the States only are supposed to conform to overall fiscal discipline while there is no corresponding requirement for the Centre also to conform to similar fiscal discipline. States turn to the Central government for a short or medium term assistance often because there is unanticipated decline in Central tax revenues, and thereby in tax devolution - a case clearly evidenced with respect to TFC assessments of Central tax revenues. Sometimes the Centre's unilateral action also affects their budgets adversely e.g., the implementation of the Fifth Pay Commission's recommendations. Secondly, the assumption that without an incentive scheme of the kind that my esteemed colleagues have put forward, States would have "no interest" in a appropriate reform programme designed to put the finances of the States on a sound footing, is an assumption difficult to accept or justify. I think that an incentive scheme can be only a subsidiary consideration; and the States are, and should be, interested in reform programmes if they are convinced of their merit and the anticipated results of that programme.

(iv) Monitoring Agency

14. As for monitoring, I am opposed to the idea of a monitoring agency to be set up in the form of an official committee consisting of representatives of the Planning Commission, Finance Ministry of the Government of India and representatives of the States concerned. A fiscal reform programme unavoidably enters into the arena of the fiscal policy of the States and this has the potential of interfering with the priorities of the States in the matter of their revenue and expenditure policies. What should be the size of government or which subsidies should be considered meritorious and which not are matters that should be left to the States to decide. While I do not deny the need for co-ordination of fiscal management between the Centre and the States in the interests of macro-balance of the economy, the objective of such fiscal management should be to move towards a balance in the budgets of the States through co-operation and acceptance of the need for fiscal discipline on the part of the States themselves. Hence, although it may be useful to have the States to come out with their specific reform programmes, the approval of such a programme should not be left to an official committee which is essentially bilateral. Fiscal policy is the vehicle through which governments implement their policies and programmes. To require the States to get their fiscal policies reformed according to a plan approved by a monitoring agency heavily dominated by the Centre detracts from their autonomy in a fundamental way. For all these reasons, in my opinion, it is necessary to set up the monitoring agency as a multi-lateral forum like the Inter-State Council or an empowered Committee of Chief Ministers consisting of the Finance Ministers of the States and the Union Finance Minister (such as the one set up to steer the introduction of a harmonised system of Valued Added Tax at the State level). Only such a Committee can command the authority needed to push the reform programme forward and ensure its implementation through mutual surveillance. The suggestion for having a multilateral body as the monitoring agency has been put forward by several States as well (vide para 2.3 of the majority report).

(v) On the Role of the Next Finance Commission

15. In another recommendation, it has been suggested by my esteemed colleagues that "a term to review the monitorable fiscal reform programme of the State and the release of grants-in-aid/incentives made thereunder" may be included under article 280(3)(d) of the Constitution for the next Finance Commission. The majority report stipulates that the monitoring agency, presumably, the twenty-eight groups, "*may submit the monitorable fiscal programmes drawn up by it and the details of provisional releases of withheld part of grants-in-aid and incentive amount to various States along with a report to the Finance Commission*". The next Finance Commission would then be required to "*examine the whole matter and take a final view regarding the releases of withheld grants-in-aid and incentives and make suitable recommendations*" [para 9.1(g) of the majority report]. Elsewhere, my esteemed colleagues have observed: "the areas indicated for monitoring are only suggestive; so are the weights" (para 7.9). It goes on to add: "while working out the overall achievement, this factor should be taken into account and excess achievement in some areas may be balanced against the shortfall in others" (para 7.10). And time and again "suitable adjustments" have to be made (e.g. paras 7.6 and 7.11). It will unduly burden the next Finance Commission if it is required to take a "final view" on these "suggestive" areas, weights, balancing of shortfalls against excess achievements and the suitability of the "suitable adjustments" which by then would presumably have been carried out by the official groups. That would inevitably deflect the Finance Commission from attending to its basic tasks.

16. Also, in my view the additional responsibilities for the next Finance Commission, suggested in the majority report would open up a Pandora's box with representations from States indicating mitigating circumstances and factors not taken into account by the monitoring groups and why they deserve higher scores. Going by the experience that I have had, a Finance Commission has to work under considerable pressure of time, and if it begins to take a "final view" of past matters and examine reports of twenty eight monitoring groups, their task would hopelessly multiply leaving much less time for it to attend to its main tasks. In my view, the next Finance Commission should be spared of such responsibilities.

(vi) Miscellaneous

18. The majority report has further recommended that in addition to the incentives for better performance, "Central government may also consider the fiscal reforms programme linked assistance by way of extended ways and means advance and additional open market borrowings.........This facility should also be extended to all States linked to monitorable fiscal reform programme drawn up for the State" (para 8.7). This recommendation virtually endorses the mechanism evolved last year (1999-2000) to bail out States in fiscal distress with medium term loans on the condition that the assisted State signs a Memorandum of Understanding (MoU) with the Centre for carrying out a fiscal reform programme. Although this arrangement was evolved in pursuance of a decision taken at the National Development Council, the operation of the scheme was left to an official committee. In my view, while it is necessary to have some arrangement to help the States in distress, a system of bailout against MoUs signed under a bilateral agreement entered into by the States individually or under secrecy is undesirable. Even though it may be argued that the terms of the MoU are not dictated by the Centre but are drawn up by the States concerned, it cannot take away from the fact that it requires a stamp of approval of the Centre. The line between "suggestion" and "imposition" becomes thin when the two sides are unequal. Hence, co-ordination between the Centre and the States in fiscal management should be operated on an equal footing and under the supervision of a multilateral agency like the Inter-State Council or a Committee of Chief Ministers and the Union Finance Minister as suggested in para 14 above. It is this Committee which should lay down the broad contours of fiscal reform programme. Accommodation for tiding over fiscal stress should be granted against conditions laid down under guidelines formulated

by the multilateral agency. This is particularly important in a federal system with diverse political parties ruling at the Centre and the States, and with some States wielding greater weight at the Centre than others.

Concluding Observations

19. While opposing the recommendations of the majority, I am not suggesting that nothing should be done to see that the system of federal transfers does not undermine accountability and fiscal discipline. I am aware of the proclivity of unstable governments with short time horizons to expand unproductive expenditures in political expediency even when resources for essential expenditures are lacking. The country has been witness to the sorry spectacle of State governments with jumbo sized cabinets far exceeding the limits suggested by the Sarkaria Commission and going in for schemes that do little to advance the welfare of the people as a whole. But that does not apply to the States alone. Instances of Central Ministries doling out privileges to employees in utter disregard of the consequences for the public finances of the country are not unknown. This argues for fiscal discipline all round and not in the States alone, and such discipline calls for co-ordination in fiscal management between the Centre and the States but as equal partners in which the Centre also pledges not to take any action unilaterally that adversely impacts the State budgets in a big way and is obligated to compensate them in such eventualities. Such conditionality can be effective only if conducted by a high level Committee. This Committee can identify the monitorable measures which, in my view, should focus primarily on fiscal and revenue balances of the governments and if thought fit, also go into such matters as compliance with requirements of accounts keeping and reporting in which several States are found to be in default over long periods. Such a committee can also consider recommending changes in the Gadgil formula to strengthen the incentives for better fiscal performance such as by using an index of improvement in fiscal management, as has been used by us in the scheme of debt relief in Chapter XI of our main report.

20. Competition among the States is one factor that can and is going to serve as a disciplining influence on the States. But competition cannot be fair unless all States are placed on a footing of reasonably equal fiscal capacity. Hence the need for equalisation transfers for "stabilising competitive outcomes" as Albert Breton, the renowned scholar in the field of federalism, characterises them[1]. It should be a matter of concern that the assessed per capita non-Plan revenue surpluses of the States after all the devolution and grants for the years 2000-05 are marked by acute disparities, as much as over Rs.6,000 for some States and less than Rs.300 for some. Competition among such unequals can hardly be fair. There is thus a case for more equalisation grants for development, the quantum of which the Planning Commission is in a better position to determine. Conditionalities for proper use are more appropriately attached to such grants.

21. A golden rule in getting governments to observe fiscal prudence is a hard budget constraint, that is, a clear understanding that there should be no expectations of any revenue transfer over and above what is provided by the Finance Commission and the Planning Commission. It also needs to be recognised that enforcement of fiscal discipline in a democratic polity has to come about through the political process – ultimately the verdict of the electorate. However, there can be no gainsaying that fiscal rules can also help but in evolving such rules care should be taken to see that the federal fabric is not weakened.

22. It is salutary to note in this context that, as Breton points out, "Conditional grants can be equivalent to a centralisation of constitutional powers"[2]. It may be argued that our Constitution gives supreme authority to the Parliament in laying down any conditionality to grants-in-aid under Article 275. Support may be sought from the Supreme Court's observations in Rajasthan Vs Union of India that while in a sense the Indian Union is federal, the extent of federalism is watered down "by the needs of progress and development of the Country"[3]. But as the late H.M. Seervai points out in his celebrated work, *Constitutional Law of India*, this view is not supported by an examination of the provisions of our Constitution when compared with corresponding provisions in acknowledgedly federal constitutions. The Supreme Court judgement dates back to the days when coercive federalism was at its height in India. A durable federal system, in my view, must be founded not on coercion but on a judicious blend of co-operative and competitive federalism. And federalism alone, in its true spirit, can hold a diverse nation like ours together. Nothing should be done that can cause any damage to the delicate federal fabric.

23. The AToR raises issues that bear vitally on Centre-State relations and the considerations mentioned above should be kept scrupulously in view while addressing it. I am afraid, the principles sought to be inculcated in the majority report, apart from their infirmity and unfairness in several respects, will be injurious to the federal system. Hence my dissent.

(A. Bagchi)
Member
August 30, 2000

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[1] *Competitive Governments* by Albert Breton, p. 258 (Cambridge University Press, Paperback, 1998).

[2] Albert Breton, op. cit.

[3] State of Rajasthan v. Union of India (1971) SCR1.

The Majority view on Note of Dissent given by Dr. A. Bagchi, Member

Our esteemed colleague, Dr. A. Bagchi, a Member of this Commission, has given a Note of Dissent on the majority view on this additional term of reference. The sum and substance of his note is that this Commission is not competent to make the grants given under article 275 of the Constitution as conditional on implementation of a monitorable fiscal reforms programme devised by us. He has also raised issues on the contents of the monitorable fiscal reform programme, the creation of Incentive Fund, the system of incentives and dis-incentives, the creation of a monitoring agency and the role envisaged for the next Finance Commission in reviewing the monitoring and implementation of the grants given under article 275 of the Constitution. Each of these issues has already been dealt in our Report adequately.

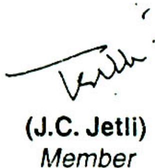
2. We have given due consideration to the issues raised and find that we are unable to agree to the views expressed in this note. We have already dealt with the issue whether any condition can be imposed on any grants given under article 275 in para 5.1. of the report. We reiterate that article 275 does permit the conditionalities to be imposed and does not make any distinction between general purpose grants and special purpose grants.

3. Paragraph 4 of the term of reference and the addendum to that paragraph given in the Presidential notification of April 28, 2000, as we understand, arise out of article 280(3)(d) of the Constitution. In the 'interest of sound finance' as envisaged in this article, the Commission is quite competent to develop a fiscal monitorable programme, to develop a system of incentives and dis-incentives and to devise a scheme for release from this fund to performing States. We have made a beginning in that direction. The monitoring programme has necessarily to be devised on a year-to-year basis and, therefore, there is a need for a committee consisting of the representatives of the Government of India and the concerned State Governments to do this. Since this programme has to be devised for each State, each year, irrespective of whether they generate surplus or deficit on non-plan or overall revenue account, it would be difficult for an Inter-State Council or a Ministerial Group to do this on a regular basis. Hence, the suggestion in the note of dissent is impractical. Similarly, on the contents of monitorable programme, we have already made recommendations on the structural changes in our main Report and the programme, therefore, has necessarily to follow from what has been recommended in Chapter III of our Report. State specific programmes have therefore to be devised which may take into account the variation in the fiscal situation in a State and would be more conducive to their implementation.

4. These recommendations are made in pursuance to Presidential Order by a Finance Commission constituted under Article 280 of the Constitution. It is in the fitness of things that the implementation of these recommendations is also reviewed by a constitutional body - the next Finance Commission - which can take a view taking into account the changing economic scenario.

5. The esteemed Member has not given any alternative suggestion for addressing this additional term of reference. The thrust of the note of dissent is that this Commission is not competent to address it. We do not agree with this view.

(A.M. Khusro)
Chairman



(J.C. Jetli)
Member

(N.C. Jain)
Member

Member-Secretary

New Delhi
August 30, 2000

Annexure I

The Gazette of India

EXTRAORDINARY

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MINISTRY OF FINANCE

(Department of Economic Affairs)

ORDER

New Delhi, the 28th April, 2000

S.O. 425 (E).- The following Order made by the President is published for general information:

In pursuance of the provisions of article 280 of the Constitution read with sections 6 and 8 of the Finance Commission (Miscellaneous Provisions) Act, 1951 (33 of 1951), the President hereby directs that in the Order dated the 3rd July, 1998 published in the Notification of the Government of India in the Ministry of Finance (Department of Economic Affairs) No. S.O. 557(E), dated the 3rd July, 1998, in paragraph 4, the following shall be added at the end, namely:-

"In particular, the Commission shall draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the State and recommend the manner in which the grants to States to cover the assessed deficit in their Non-plan Revenue account may be linked to progress in implementing the programme."

Sd/-

(K.R.NARAYANAN)
PRESIDENT OF INDIA

28th April, 2000

[No. 10(12)- B(S)/99]
D.SWARUP, Jt. Secy. (Budget)