
Chapter 2

Issues and Approach

2.1 Article 280 of the Constitution describes the duties of the finance commission, the core of which relates to sharing of central taxes under article 270 and determination of grants for the states as provided for under article 275. The Commission's approach is guided by the mandate of the constitutional provisions and the terms of reference (TOR) contained in the Presidential order constituting the commission. Being the twelfth in the periodic sequence of finance commissions, we have also had the benefit of the views of the earlier commissions on these and related issues [1]. The Commission has duly considered the views of the Union and state governments on the TOR as contained in their respective memoranda. We have taken note of areas where there is convergence, and areas where views differ.

2.2 The Commission has taken cognizance of the prevailing fiscal and macro-economic situation, particularly the need to sustain the growth momentum, while bringing about fiscal consolidation. The revenue deficit of the centre in 2002-03 at 4.4 per cent of GDP was higher by 1.1 percentage points as compared to its level of 3.3 per cent in 1990-91. In the case of the states, the revenue deficit in 2002-03 was 2.3 per cent of GDP, nearly 1.4 per-

centage points higher than its level of 0.9 per cent in 1990-91. During this period, while the fiscal deficit of the centre declined marginally, that of the states increased.

Design of Fiscal Transfers

2.3 The Commission's endeavour has been to recommend a scheme of transfers that could serve the objectives both of equity and efficiency, and result in fiscal transfers that are predictable and stable. These transfers, in the form of tax devolution and grants, are meant to correct both the vertical and horizontal imbalances. Correcting vertical imbalance relates to transfers from the central government to the state governments taken together, whereas the correction of horizontal imbalance is concerned with the allocation of transfers among the state governments. The vertical imbalance arises since resources have been assigned more to the central government and states have been entrusted with the larger responsibilities. The horizontal imbalance has its roots in the differential capacities and needs of the states as also the differences in the costs of providing services. In India, not only the number of states is large, they differ in various respects such as area, size of population, income, tax base, and mineral and forest resources. Resource gaps may

arise because states have inadequate capacities as also because the revenue effort is deficient in relative terms. While the former may need to be taken into account for correcting the horizontal imbalance, the latter should not qualify for such correction.

2.4 In the relevant literature, as also in practice in many federal countries, the concept of 'equalization' is considered to be a guiding principle for fiscal transfers as it promotes equity as well as efficiency in resource use. Equalization transfers aim at providing citizens of every state a comparable standard of services provided their revenue effort is also comparable. In other words, equalization transfers neutralize deficiency in fiscal capacity but not in revenue effort. Under such an approach, transfers should be determined on a normative basis instead of merely filling up gaps arising from the projections of revenues and expenditures based on historical trends. As noted by some of the earlier finance commissions also, there are adverse incentives associated with a 'gap-filling' approach where the case for larger transfers would depend merely on a larger gap in the past without reference to whether available revenue capacity was adequately exploited or whether there was an undue growth in expenditures. The normative approach can effectively neutralize such adverse incentives as states are assessed in terms of revenues that they ought to raise given their respective capacities. Similarly, expenditures are assessed on the basis of needs consistent with an average or minimum acceptable level of service and the relevant cost norms and not driven by the past history of expenditures.

2.5 Two of the well known systems of

federal fiscal transfers, viz., Canada and Australia also follow the equalization principle although the way it is defined and the methods by which it is applied are somewhat different in the two cases [2]. In Canada, the objective of equalization has been enshrined in the constitution itself. The Commission had occasion to visit these two countries and study their systems at length. In Australia, the equalization principle has been defined to say that 'States should receive funding ...such that if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard'. It is notable that it is only the capacity that is equalized and not necessarily the actual level or standard of service, which would depend on the priorities and allocations among different heads, which remain the prerogative of the states. The way this principle has been applied in Australia, particularly the reference to efficiency, involves detailed assessment of expenditures to take account of the cost disabilities. In Canada, as provided in the constitution, equalization payments are meant to 'ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of services at reasonably comparable levels of taxation'. In Canada, in determining equalization payments, no assessment is made of the expenditure side of the provincial budgets. However, these transfers are complemented by the equally important health and social service transfers, where expenditure requirements are taken into account generally on a per capita basis. The northern territories with large cost disabilities are separately treated under

Territorial Formula Financing. In delineating our approach further, we take up separately aspects of vertical and horizontal dimensions of transfers.

Vertical Dimension

2.6 Vertical transfers refer to the total transfers from the central government to the states. In India, resources are transferred from the central to the state governments through many forms and routes. Among these, the statutory transfers consist of sharing of central tax revenues and grants recommended by the finance commission. These are supplemented by grants from the Planning Commission and discretionary grants from the central ministries. Transfers under the recommendations of the finance commission account for about 65 per cent of the total transfers [see annexure 2.1]. Given the multiplicity of channels of transfers, it is important that the Finance Commission, in making its own recommendations, takes into account the overall volume of transfers. The Eleventh Finance Commission (EFC) recommended an overall share of 37.5 per cent of the centre's gross revenue receipts as transfers to states. In considering the matter further, we have taken into account both the long-term trends in the vertical transfers and their pattern in recent years.

2.7 Fiscal transfers to the states, through all channels, as percentage of the gross revenue receipts of the centre increased from an average of 31.4 per cent in the period of the Sixth Finance Commission to 38.1 per cent for the Seventh Finance Commission. As shown in annexure 2.1, it increased further to 40.3 per cent for the period covered by the Ninth Commission before coming down to 35.8 per cent during the

period of the Tenth Finance Commission. This ratio improved to 37.2 per cent during the first two years of the recommendation period of the Eleventh Finance Commission. As percentage of GDP at market prices, fiscal transfers show a decline, falling from the level of about 5 per cent for the period covered by the Eighth Commission to 4.9 and 4.1 per cent respectively for the reference periods of the Ninth and Tenth Finance Commissions. This fall was due mainly to a fall in the ratio of centre's gross tax revenues relative to GDP, which fell from the peak level of 10.6 in 1987-88 to less than 9 per cent at the end of the nineties. In the first two years of the EFC period of recommendation, transfers to the states have remained above 4 per cent of GDP.

2.8 Our approach to formulating a view on the vertical imbalance is to look at the revenues accruing to the centre and the states after the transfers. Table 2.1 gives the share of the revenue receipts of the states in the combined revenue receipts of the centre and the states before and after transfers. It also gives the share of states in the combined revenue expenditure of centre and states after netting out inter-governmental flows. It shows that in terms of access to revenue resources before and after transfers, the position of the centre and states is reversed. In fact, the states get, after transfers, a share in the range of 62-64 per cent of the combined revenue receipts of the centre and states and this share has remained stable. Annexure 2.2 gives the year-wise position since the Seventh Finance Commission. States' share in combined revenue expenditures has also remained stable in the range of 56 to 58 per cent. Annexures 2.3 and 2.4 give details regarding relative shares of the centre and the states in combined

Table 2.1
Share of States in Combined Revenue Receipts and Expenditures

Average*	Revenue Receipts Before and After Transfers		Revenue Expenditures**
	Before	After	
VII FC	35.3	61.4	58.0
VIII FC	34.6	62.0	55.7
IX FC	37.5	64.7	56.9
X FC	38.6	63.0	56.8
2000-01	38.6	63.9	56.0
2001-02	39.3	63.9	58.0
XI FC (Avg. 2 years)	39.0	63.9	57.1

Source (Basic Data): Indian Public Finance Statistics

*Average for years under recommendation period

** net of inter-governmental transfers

revenue and total expenditures, respectively.

2.9 In our view, the overall size of transfers requires to be determined by considering the availability of central revenues after accounting for the relevant expenditure requirements. This in a way represents the supply side of funds in the context of inter-governmental transfers. The demand for funds arises from two considerations: the larger assignment of the responsibilities of the state governments considered together, and the need for ensuring minimum provision of services by the states with less than average fiscal capacities. The supply of transferable funds is influenced by the ability of the central government to raise taxes or prudently borrow or control expenditures. The demand for transfers has been expanding because the low fiscal capacity states are falling behind the average levels of service provisions. The average level of services is low even in the better off states considered against desirable standards. Our key concern is the resolution of these considerations in a manner that is consistent with the best principles of transfers. We take into account the fact that

the states receive transfers not only on the basis of recommendations of the finance commissions but also from other channels, which comprise plan grants as well as other grants. The implications of plan size for non-plan expenditures are discussed later in this chapter. Other discretionary grants may be considered relevant only in respect of unanticipated events since finance commission recommendations apply for a period of five years. However, these other grants should not assume a character of large or systematic transfers. In making our recommendations regarding sharing of taxes and grants, we recognize the need to take a holistic view of the transfers from different channels.

Horizontal Dimension

2.10 The horizontal aspect of transfers relates to their *inter se* distribution among states. If, in per capita terms, all states were similar in fiscal capacities and cost conditions, the equalization criterion would be met by equal per capita transfers. The differences in per capita fiscal capacities and differential costs of providing services justify departures from an equal per capita

transfer norm. Cost disabilities arise due to factors that are mainly beyond the control of the state like large areas relative to population, hilly terrains, excessive rainfall, and proneness to droughts.

2.11 In combining these considerations into a suitable scheme of transfers, there are both conceptual issues and practical problems. There are two major instruments of transfers: tax revenue sharing and grants. The latter can be unconditional and general purpose or conditional and purpose-specific. In the case of sharing tax revenues, two major considerations are (a) selecting appropriate allocative criteria and their related indicators and (b) determining their relative weights. The key determinant in this exercise is the relative revenue raising capacity of the states. Revenue capacity is often measured, as was done also by some of the previous finance commissions, by GSDP at factor cost even though it is recognized that GSDP is not a perfect correlate of income or fiscal capacity. The Central Statistical Organization (CSO) has furnished to us the comparable estimates of GSDP at factor cost at current prices. The question has been raised from time to time whether GSDP at market prices would serve as a better proxy for income or revenue capacity than GSDP at factor cost. In our view it does. Further, GSDP is an indicator of the domestic product and not of income or consumption. With a view to developing a more suitable macro indicator of fiscal capacity, we also had discussions with the CSO. However, a practical alternative is not readily available. We have, therefore, decided to continue to use the comparable estimates of GSDP as provided by the CSO.

2.12 The two principal modes of fiscal transfers, viz., tax devolution and grants

have certain distinguishing features. Tax devolution has a built-in flexibility as it can increase automatically if the central taxes are more buoyant. Conversely, there is a risk, if their buoyancy falls short of expectations. Grants are assured as these are fixed in nominal terms. It is also easier to target grants towards states or sectors. Targeting in the case of devolution is broad and indirect and is limited by the criteria used. Yet all states have expressed a preference for devolution because by definition it is unconditional and comes to the states as a matter of right. In the present scheme of transfers, tax devolution plays a dual role of correcting vertical as well as horizontal imbalance. Grants-in aid are mainly targeted towards achieving a degree of equalization. That is why many of the better-off states assessed to be in revenue surplus do not get article 275 grants. There has also been the question whether such grants can be given as conditional grants although these grants have generally been unconditional. We recognize that grants are the more effective transfer instrument for state-specific and purpose-specific targeting. As such, the transfer instruments available to the finance commission must include tax revenue sharing, assessed gap grants, and grants that may be earmarked for specific purposes like those meant for the local bodies or achieving certain minimum level of services.

2.13 The relative weights to the two forms of the unconditional transfers, viz., tax revenue sharing and assessed gap-grants depend on the extent of the vertical imbalance and the prevailing horizontal imbalance. The latter is linked to the changes in the imbalance in the fiscal capacities of the states. If large horizontal

imbalances exist, the horizontal task addressed by tax revenue sharing also becomes relevant.

2.14 Some idea of the prevailing horizontal imbalance may be obtained by comparing the per capita GSDP of the states. For this purpose, a comparison of the three-year average of comparable GSDP over the period 1999-00 to 2001-02 indicates that there are ten states with average GSDP below the all-state average GSDP. These are Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Meghalaya, Orissa, Rajasthan, and Uttar Pradesh. Of these, Arunachal Pradesh and Meghalaya are close to the average. The remaining eight states are the ones with GSDP that is significantly lower than the average, requiring equalization transfers with a view to raising the standard of services upto the average. The newly created states as a result of the bifurcation of Uttar Pradesh, Madhya Pradesh, and Bihar are part of this group. With a view to examining whether the gap has widened, we have compared the growth of per capita GSDP taking the average over 1993-94 to 1995-96 and 1999-00 to 2001-02. It may be mentioned that comparable GSDP data are provided by the CSO only at current prices. Considering the all-state average, the per capita GSDP during this period increased by about 75 per cent. However, for the states at the lower end of the income scale, namely, Bihar, UP, Orissa, Assam, Madhya Pradesh and Rajasthan, the GSDP growth was less than this average. An indication of the increasing gap can also be obtained from the coefficient of variation in per capita incomes. In estimating this, it is relevant to exclude Goa, whose per capita income has increased considerably, but it is an outlier.

Comparing 1993-94 with 2001-02, the coefficient of variation has increased by about 2.5 percentage points.

2.15 In our approach, tax devolution has been used, as the earlier commissions have done, both for the vertical and horizontal aspects of transfers. It may be noted that the share of grants in total transfers recommended by the finance commissions has been less than 15 per cent on average over the recommendation period of the commission. Taking the average is relevant because in the case of recent finance commissions, grants in the initial years of the recommendation period have been larger than those in the latter years. The share of grants in total transfers recommended by the finance commissions, from the seventh to the tenth, has respectively been 8.1, 11.1, 13.8, and 10.3 per cent. In this context, in view of the need to ensure a larger role for equalization transfers, we are proposing to increase the share of grants in the total transfers.

Sharing of Central Taxes

2.16 Under article 270, the Commission is required to determine the aggregate and individual shares of the states in the shareable pool of central taxes. The main considerations before the Commission relate to (a) determining the aggregate share of states, (b) specifying criteria that may be used for deciding shares of the individual states, and (c) determining the weights attached to different allocation criteria. In considering the aggregate share of states in the shareable pool, we have examined how the shareable pool of central taxes has changed in the past in its scope and composition and how this may undergo further change in the light of some current

and proposed modifications, particularly those related to the taxation of services.

2.17 Prior to the 80th constitutional amendment, two main central taxes were shared with the states, *viz.*, income tax other than corporation tax and the Union excise duties. The sharing of the income tax was mandatory as, under article 270, it had to be shared with the states, while that of the Union excise duties was discretionary, as its sharing was subjected to the phrase “may be divided between the Union and the States” and could be shared if Parliament by law so provided. There were also two tax rental arrangements with the states, where the Union government collected the tax, as it were, on behalf of the states and then distributed the proceeds among the states on principles and shares recommended by the finance commission. These were additional excise duty in lieu of sales tax on textiles, tobacco and sugar, and grant in lieu of the tax on railway passenger fares.

2.18 Following the 80th amendment of the Constitution, all central taxes were brought into a shareable pool and it became mandatory to assign a share from each central tax to the states. The amended article 270 provided for the sharing of all central taxes except taxes under articles 268 and 269 and earmarked cesses, and surcharges under article 271. Only “net proceeds” are to be shared, and as such ‘cost of collection’ has to be deducted to obtain the net proceeds as prescribed under article 279. The proceeds are to be distributed among the states where the central taxes are “leviable” in “that year”. Article 269 has also been amended and it contains only central sales tax and consignment tax, which is not levied.

More recently, the Constitution has been amended, and services have been added under the Union List in the Seventh Schedule of the Constitution. Taxation of services has been brought under the purview of article 268 A [3].

2.19 The taxation of services has a bearing on the size of the vertical transfers as it has the potential to impart additional buoyancy to tax revenues [4]. With the 88th amendment to the Constitution, article 268A provides that “Taxes of services shall be levied by the Government of India and such tax can be collected and appropriated by government of India and the states...” It also further specifies that the principles of collection and appropriation will be determined by Parliament. So far, the central government has been levying the service tax on specific services under its residual powers relating to subjects that are not specified in any of the three lists, services being an example. The sharing of this revenue has been on the basis of the recommendations of the finance commission, as applicable to other central taxes. However, revenues from taxation of services that are taxed by the centre under article 268A rather than under article 270 would be excluded from the purview of the finance commission.

2.20 In the 80th amendment, the objective was to construct a pool of all central taxes for sharing so that a holistic view can be taken and both sides could share in the aggregate buoyancy of the central tax revenues. With service taxes having been excluded from the ambit of the recommendations of the finance commission, the idea of an overall shareable pool of central taxes appears to be in the process of

being reversed. While service taxes are likely to prove highly buoyant in the near future, these will not be subjected to sharing with the states under the Constitution, although other statutory arrangements can be made, which can include sharing as well as assignment. It may be noted that hitherto items under articles 268 and 269 were subjects that were generally of inter-state nature with limited revenue importance. These were wholly assigned to the states. In this context, it needs to be stressed that any legislation passed by Parliament with respect to appropriation of service tax proceeds must take care to ensure that the revenue accruing to the states through any proposed changes should not be less than the share that would accrue to them, had the entire service tax proceeds been part of the shareable pool.

2.21 One dimension of transfers relates to their predictability. The finance commission makes recommendations only about the share of states in the central taxes. This implies that the actual amounts are known only when the central taxes are actually realized in the concerned years. The finance commission does provide estimates of the likely amounts of what a state may get as its share in the shareable central taxes. This is then taken into account when grants are determined in absolute amounts. As already noted, predictability is a significant attribute of a robust scheme of transfers. Since devolution of taxes is recommended in terms of shares of central taxes, and the absolute amounts may fall short of these estimates, a suggestion has been made from time to time, and has also been included in many of the states' memoranda submitted to the Commission, that a minimum guaranteed amount under tax devolution should be

prescribed. Under the provisions of article 270 only a share for the states in the central taxes is determined. This provides for automatic sharing of the central tax buoyancies. States, however, have a genuine problem if growth in central taxes falls short of expectations. This calls for a certain caution in the projection of central revenues, bearing in mind that such estimates of revenue feed into the determination of grants.

2.22 In deciding the different criteria for transfers under tax devolution, our approach has been to keep in mind three sets of considerations, viz., needs, cost disabilities, and fiscal efficiency. Needs refer to expenditures that are required to be made but have not been made due to deficiency in fiscal capacity. In considering the expenditure requirements, merit goods like health and education need to be considered as of prime importance. Cost disabilities refer to the circumstances that lead to higher than average per capita costs for delivering the same level of services at an average level of efficiency. In this case, exogenous causes that are beyond the control of the concerned states like excess rainfall, hilly terrain, and large and remote areas with low density of population may be considered important. Some cost disabilities arise when the size of the state is too small and some minimum expenditure has to be incurred for providing the relevant administrative infrastructure. In a normative approach, fiscal efficiency is implicit because requirements are assessed taking into account only the average revenue effort. However, some explicit incentives have been considered relevant relating to tax effort or other fiscal performance measures so as to raise the average performance itself. These considerations were incorporated in

the allocation criteria used by the previous commissions also. While adopting the same criteria, there may be a need for modifying the scheme of weights. These weights will also be affected by the relative importance of the two modes of transfer, namely, tax devolution and grants.

2.23 In the criteria-based distribution of the central taxes, the more recent finance commissions have given considerable importance to the horizontal task of redistribution by giving relatively larger weight to the distance factor, which reflects the difference of the per capita GSDP of a state from the highest per capita GSDP, taken as the average of the three highest per capita GSDPs. The weight attached to this factor reflects the fiscal capacity equalization element of transfers under tax sharing. The better-off states have represented to us that their share has steadily fallen in the overall allocation. We have taken note of this concern. In particular, the share of the better-off states can go down either because the weight to the distance factor has been increased significantly or the inequality among per capita GSDPs, i.e. the fiscal capacities, has increased. Over the period covered by the last four commissions, we find that it is the second factor, which is primarily responsible for this. Since there is some vertical gap even for the richer states, a continuous fall in their tax shares does not appear to be desirable. To some extent, this could be addressed by increasing the aggregate share of the states. However, there are clear limits to the extent to which this could be done. Alternatively, the weights among different criteria could be realigned. To the extent to which this is done, the share of the low fiscal capacity states would be reduced. This would need

to be balanced therefore by increasing the equalization content of the grants. Our approach follows this route to a large extent. With an improvement in the buoyancy of the central taxes, this problem will be eased. It may be mentioned that the balancing of resources against responsibilities is qualitatively different now when governments at all levels are nursing large and rising revenue deficits than when the centre and some of the better off states had a surplus. There was a time when some of the states even had a pre-devolution surplus. The task has become progressively more demanding with successive finance commissions. It is in this context that there is a need to emphasize the fiscal efficiency criterion.

Approach to Determining Grants

2.24 In relation to grants, there are two duties cast upon the Finance Commission jointly by articles 280(3) (b) and 275. Article 280(3) (b) requires the Commission to make recommendations as to the “principles” which should govern such grants-in-aid. Following from article 275(1), specific “sums” are to be recommended to be paid to the states which are assessed to be in “need of assistance”. Thus, while article 270 speaks of percentage share, article 275 refers to specific ‘sums’ and that these grants should be given to states which are in need of assistance.

2.25 Need cannot be taken to mean that any shortfall in revenue relative to expenditure can be met by a corresponding increase in grants. That would only result in the lowering of tax rates in the states in the expectation of expanding the share of the state in the ‘common pool’ of resources.

Need has therefore to be assessed in relation to norms applied to both revenue effort and the desirable levels of service provision. In this context, the services that should be covered should be limited to the services that can be interpreted as public goods like general administration and law and order and merit goods like education and health services provided by the state governments. Many private goods provided by the state governments do not merit consideration in this context. In considering the expenditure requirements, account can also be taken of particular circumstances of a state that may result in higher per capita costs. This brings us to the issue of suitable principles of assessment.

Principles of Assessment

2.26 This Commission is required to make recommendations regarding sharing of central taxes and grants for a period covering five years from 2005-06 to 2009-10. This, in turn, requires making projections of resources and needs for the centre and for each individual state. Since many of the fiscal variables are related to growth in GDP or GSDP, projections of these variables as also other variables like the interest rate are required. It may be mentioned that such a forecasting mechanism is quite unique to transfers recommended by the finance commission in India. It necessarily follows that the basic data progressively become more dated as we come closer to the later years of the forecast period. Sometimes, critical events like the award of a Pay Commission or the onset of a recession can seriously upset the assumptions on which the recommendations of a finance commission may be made. In other federations, alternative mechanisms

have been evolved to cope with the problem of information lag. For example, in Canada, the transfers for any one year remain 'open' for four years and as new data come in, entitlements are reworked on principles that have already been determined. In Australia, there is a five yearly cycle of 'Review' whereby the Commonwealth Grants Commission formulates the methodology of determining the 'relativities', but the calculation is done on an annual basis using latest available data, which are called 'Updates'.

2.27 In the methodology developed by the previous finance commissions, it is the assessment of central finances that indicates availability of funds, and the assessment of state finances that provides the claim on those funds. Para 6(i) and (ii) of the TOR make reference, respectively, to the resources of the central government and the demands on those resources. Resources of the central government have to be assessed on the basis of "levels of taxation and non-tax revenues likely to be reached at the end of 2003-04". The 2003-04 tax and non-tax revenues can therefore serve as the base for assessment of resources for the period from 2005-06 to 2009-10. Para 6(ii) makes reference to the demands on central resources by the central government. Particular reference has been made to expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditures and liabilities. In making the assessment of central resources and corresponding needs, we have taken into account centre's memorandum and the forecasts.

2.28 In the case of states, a corresponding sub-clause, *viz.*, para 6(iii) of the TOR

provides that the assessment of resources for the period 2005-06 to 2009-10 will need to be made on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2003-04. This is symmetrical to the corresponding consideration for the centre, and gives rise to a similar set of issues. In regard to the needs of the states, particular reference to any specific needs has not been made in the TOR except to the non-salary component of maintenance and upkeep of capital assets and non-wage related maintenance expenditure on plan schemes. Clause 6(iv) specifies the more general consideration in regard to 'the objective of not only balancing the receipts and expenditure on revenue account of *all the States and the Centre*, but also generating surplus for capital investment and reducing fiscal deficit'.

2.29 Although the TOR do not specifically mention that needs of the states should be assessed except in an indirect way, our approach has been to make the assessment in sufficient detail and with the same degree of comprehensiveness as was done by the previous commissions. Our approach to assessments takes into account the need for a normative basis, which encompasses both the revenue and expenditure heads. These assessments also bear a relationship with the overall restructuring plan. In order to meet the requirements of adjustments in the restructuring plan, certain prescriptive parameters have been outlined. These assessments necessarily take into account the additional sub-clause, which makes reference to the taxation efforts of the central government and each state government as against 'targets' and 'potential' in order to improve the tax-GDP

and the tax-GSDP ratios respectively for the central and the state governments. The para asking the Commission to suggest a plan for "restructuring of public finances" would also require various measures to augment tax and non-tax revenues beyond levels reached in 2003-04, considered in relation to GDP or GSDP of the individual states.

2.30 Sometimes the issue is raised as to the role of assessment exercises in determining total transfers taking both tax devolution and grants into account. This issue is linked to determination of the appropriate weights to tax devolution and grants in a scheme of transfers. If the relative weight of tax sharing is kept too low, many states would emerge in assessed deficit and would be entitled for grants. There may be some states, which may emerge in pre-devolution surplus and would therefore obtain a share only in the relatively low amounts of tax devolution. Tax devolution should be calibrated to ensure that at least the requirement of minimum vertical transfers is met. The finance commissions in the past have evolved a scheme where a little more than half of the states generally emerge in assessed revenue deficits. Considering entitlements in the *first year* of their respective award periods, 16 out of 25 states emerged in assessed deficit in the case of the Tenth Finance Commission and 15 states emerged in assessed deficit in the case of the Eleventh Finance Commission. All the ten general category states were in assessed deficit. There is also the consideration that the share of tax devolution is very nearly downward rigid. Virtually all states have asked for an upward revision in the share and even the central government's latest memorandum to the Commission effect-ively endorses that idea.

2.31 Grants recommended by the finance commission are largely general and unconditional in nature. But in the case of selected services where minimum standards of service may be considered desirable, it is possible to consider conditional grants. For conditional grants the relevant purposes and associated conditions also need to be specified along with an effective monitoring mechanism. The First Finance Commission had considered the 'principles' of determining grants at length and had opined that both unconditional and specific purpose grants can and should be considered by the finance commission under article 275 read with article 280(3)(b). They had observed [page 91 of their Report]: "We consider that the problem has to be viewed in the larger perspective of securing an equitable allocation of resources among the units. We are, therefore, of the view that the scope of article 275 or article 280(3) (b) should not be limited solely to grants-in-aid which are completely unconditional; grants directed to broad but well defined purposes could reasonably be considered as falling within their scope". The Second Commission had observed that grants-in-aid should be a residuary form of assistance given in the form of general and unconditional grants. However, it also agreed that grants for broad purposes may be given and, in respect of these, states should be under obligation to spend the whole amount in furtherance of the broad purposes indicated. Most of the subsequent commissions had generally agreed to the principles listed by the First Commission but have by and large followed the procedure adopted by the Second Commission. In our view, there is need to ensure that in respect of two areas, viz., education and health

including family welfare, states that are below average in terms of per capita expenditures should be brought closer to the average. However, even in these areas, we have not followed a gap-filling approach. The assessed gap covers only the difference that arises due to deficiency in fiscal capacity. It does not take into account the gap, which might be due to deficiency in tax effort or due to a state according a less than average priority in resource allocation to the concerned sector. The precise methodology has been dealt with in chapters 6 and 10.

Interface with Plan Assistance

2.32 The plan assistance is given to the states as consisting of grants and loans. The grant-loan ratio for the states in general is 30:70 whereas for the special category states, this ratio is 90:10. In normal central assistance, 30 per cent is earmarked for the special category states. The expenditure on state plans is met by the balance from current revenues (BCR) from the state budgets, plan assistance in the form of grants and loans by the central government, and borrowing from other sources including the market and those based on small savings. The BCRs for most states have progressively fallen and become negative. In consequence, the financing of the plan, apart from a small contribution of the plan grants from the centre, depends entirely on borrowing by the states. A large plan effectively also means larger borrowing. It becomes therefore necessary that the plan size of every state is linked to the sustainable level of debt.

2.33 There are three links in this process that have a bearing on the tasks assigned to the finance commission. First, as borrowing

accumulates as part of the planning process, it gives rise to interest payment liabilities, which are part of the non-plan revenue expenditure.

2.34 Second, the plan process leads either to creation of posts or assets. Once the plan is over, the posts are meant to be carried into the non-plan side of the budget. Assets created in the previous plans also require maintenance expenditure. Both of these increase non-plan expenditure in the form of committed liabilities. The distinction between plan and non-plan expenditures has progressively become blurred as states often continue old plan schemes as part of the new plan so as to show a higher size of the plan. As noted by the previous commissions, notably the tenth and eleventh commissions, the plan, non-plan dichotomy of expenditures results in several inefficiencies. It is far more important to ensure that assets already created are maintained and yield services as originally envisaged than to go on undertaking commitments for creating new assets. The continued transfer of plan posts on to the non-plan side has also resulted in surplus staff in many sectors, whose salaries must be paid. Surplus staff on the non-plan side is not usually absorbed in the new plan schemes. Considering a larger plan size as more development oriented and ignoring maintenance is not desirable and provides at best an optical illusion of development.

2.35 The third aspect of the interface between plan expenditure and the overall scheme of transfers is even more important. By definition, plan expenditure is 'incremental development expenditure'. It is expected that as a result of the plan

intervention, inequalities among states in incomes and services that are publically provided would decrease. If these continue to increase, the horizontal considerations compel finance commission transfers to become more progressive. In this context, it is useful to compare the pattern of inter-state distribution of per capita finance commission (FC) and non-FC transfers consisting of plan grants, external assistance, and other discretionary grants. Relating comparable per capita GSDP with per capita FC transfers for 2001-02, a strong negative relationship is observed. The coefficient of correlation is (-) 0.87 for the general category states excluding Goa. In the case of per capita non-FC transfers for this group of states, the correlation with per capita GSDP turns out to be positive (0.16). This shows lack of progressivity in their distribution. The non-FC transfers become even more regressive when account is taken of the implicit transfers, such as those arising from procurement of food grains by the Food Corporation of India (FCI) largely from some of the better-off states [5]. In the case of special category states, the correlation is positive both for FC and non-FC transfers.

Restructuring of Public Finances

2.36 Like the EFC, this Commission has also been asked to review the state of the finances of the Union and the states and suggest a plan for restructuring public finances with a view to restoring budgetary balance and maintaining macroeconomic stability. Para 5 of the TOR asks for a 'review' of the state of finances of the Union and state governments and a 'plan' for a 'restructuring' of the public finances. In comparison to the terms of reference for the

EFC, the reference to debt reduction and equitable growth is new and emphasizes concern with the growing disparities among states as also accumulation of unsustainable debt. The TOR also mentions certain other factors that should be considered along with para 5. Para 6(iv) talks of the "... objective of not only balancing the receipts and expenditure on revenue account of all the States and the Centre, but also generating surpluses for capital investment and reducing fiscal deficit". Para 9 also stipulates that corrective measures in regard to states' debt may be suggested, consistent with macroeconomic stability and debt sustainability. Clearly, any restructuring plan has to aim at eliminating revenue deficit and bring down fiscal deficit to levels consistent with macroeconomic stability. The reference to capital investment and fiscal deficit in clause 6(iv) also implies that the financing of entire government expenditure, revenue and capital, has to be considered in an integrated framework.

2.37 In understanding the need for restructuring public finances, considering the combined accounts of the centre and states, we take note of five key fiscal trends that cause serious concern. These are: decline in the tax-GDP ratio, large pre-emptive claims of interest payments relative to revenue receipts, high revenue-deficit to GDP ratio, large and unsustainable fiscal deficit to GDP ratio, and falling levels of capital expenditure relative to GDP. Taking the 15-year period from 1987-88 to 2001-02, and comparing three-year averages at both ends, that is for 1987-90 and 1999-2002, we note that

- (i) The tax-GDP ratio fell from a level of about 16 per cent relative to GDP

by 1.6 percentage points to reach an average level of 14.4 per cent of GDP.

- (ii) Interest payments relative to revenue receipts rose by nearly 13 percentage points during this period to reach an average level of 34 per cent of the combined revenue receipts.
- (iii) The ratio of revenue deficit to GDP increased by a margin of 3.5 percentage points to reach a level of 6.5 per cent of GDP.
- (iv) Fiscal deficit, which was already at a high level of 8.8 per cent of GDP in the late eighties, increased by a margin of 0.7 percentage points. In 2002-03, the combined fiscal deficit was in excess of 10 per cent of GDP.
- (v) Capital expenditure relative to GDP fell to the extent of 2.8 percentage points during this period, reaching an average level of 3.3 per cent of GDP.

2.38 The deterioration in the revenue account balance of the centre, states and their combined accounts had started towards the end of the seventies. It was in 1979-80 that the central finances fell into revenue deficit after recording a surplus since 1950-51 in all but two years. The combined account of the centre and states went into revenue deficit in 1982-83, and that of all states in 1986-87. As noted by the Tenth Finance Commission, almost all the states went through three-phase deterioration in the revenue account balance. In the first phase up to 1986-87, non-plan revenue account surplus was larger than the plan deficit and to that extent it yielded an overall revenue balance. During 1986-87 to 1991-

92, the magnitude of plan revenue deficit increased sharply and it became larger than the non plan surplus. Since then, both the plan revenue account and the non plan revenue account have remained in deficit and the deficit has generally been growing in magnitude. Only some of the special category states showed surplus on the plan revenue account. However, this was due solely to the special dispensation for plan assistance where they got ninety per cent as grant credited to their revenue accounts.

2.39 In 1988-89, the base year for the Ninth Finance Commission, the combined revenue deficit of the centre and states was 2.9 per cent of GDP at current market prices. The combined revenue deficits of the centre and states for the corresponding base years for the tenth and eleventh finance commissions were respectively 3.6 per cent of GDP in 1994-95 and 6.3 per cent in 1999-00. In 2002-03, the combined revenue deficit was 6.7 per cent of GDP. The main reasons generally given for this all round fiscal deterioration include the revision of salaries and pensions in the wake of the recommendations of the Fifth Central Pay Commission, erosion in the buoyancy of central indirect taxes, and the high nominal interest rates towards the end of the nineties. Transfers cannot be taken as a means of reducing the revenue deficit for one tier of the government by increasing it for the other. There is a need for improving the position of revenue balance both at the centre and the states.

Sustainability of Fiscal deficits

2.40 In fact, if the central government could borrow without limits, it could also

transfer resources without limit. On the other hand, if the state governments could borrow without limits, they can do with minimal transfers. The need for ensuring sustainability of fiscal deficits, however, puts a limit on the borrowing, i.e. fiscal deficit that can be prudently undertaken by the two tiers of governments, considered separately as also together. Sustainable levels of fiscal deficits can be derived with reference to three key parameters: growth rate, ratio of revenue receipts to GDP/GSDP, and the interest rate. The existing level of the debt-GDP ratio also is quite material in the context of sustainability. Prudent levels of fiscal deficit may be determined in relation to growth and interest rates but growth may depend on fiscal deficit and interest rate. Much of this interdependence arises due to the fact that fiscal deficits affect the saving and investment rates of the economy, which in turn affect the growth and interest rates.

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

revenue deficits relative to GDP are equivalent to government dis-savings, which lead to a fall in the overall saving rate unless there is a corresponding rise in the private saving rate. Compared to the levels of domestic saving rate in the mid-nineties, which ranged about 25 per cent in the mid-nineties, there was a clear fall in the rate in recent years where it has been around 22 per cent of GDP.

2.42 Determining the right size of fiscal deficit and the debt in relation to GDP is important for prudent fiscal management. The Tenth Plan has envisaged the average size of fiscal deficit as 6.8 per cent of GDP during the plan period. The Eleventh Finance Commission had suggested fiscal deficit of 6.5 per cent of GDP as the desirable target to be achieved by 2004-05. The macro economic assumptions of the EFC included a growth rate of nominal GDP of 13 per cent with real growth in the range of 7 to 7.5 per cent and an effective rate of interest in nominal terms of 9.8 per cent for the centre and 11 per cent for the states. Since the period in which the EFC formulated its recommendations, one important change relates to a fall in the nominal interest rates. The central government has specified in the rules under its Fiscal Responsibility and Budget Management Act, 2003 (FRBMA), a fiscal deficit target of 3 per cent, which is to be achieved by 2008-09. A view needs to be taken for the aggregate fiscal deficit of the states so that a consolidated fiscal deficit target can be indicated. We have considered this issue in the next chapter.

2.43 The EFC had also set targets for reduction of the level of debt in relation to GDP. The combined debt-GDP ratio of the centre and states was to be brought down

by 10 percentage points so as to reach the level of 55 per cent in 2004-05. There has been considerable slippage in achieving this target. According to Reserve Bank of India's annual report for 2003-04, the combined debt-GDP ratio was 75.7 per cent at the end of 2002-03 with centre's debt-GDP ratio at 63.1 per cent and that for the states at 27.8 per cent of GDP. In these estimates, external debt is taken at historical exchange rates. As discussed in chapter 4, if external debt is evaluated at current exchange rates, an upward adjustment of about 5.6 per cent in the debt-GDP ratio of 2002-03 would be required. The sharp increase in the level of debt relative to GDP has been the consequence of a rise in primary deficits as well as the fact that during the three year-period 2000-2003, the growth rate turned out to be lower than the interest rate. We feel that reduction in the level of primary deficit to GDP would provide the key to controlling the growth of the debt-GDP ratio. This would need to be encouraged by explicit as well as implicit incentives.

Incentives: Explicit and Implicit

2.44 The adoption of a fiscal correction and restructuring plan by the states can be facilitated and induced to some extent by built-in incentives and rewards provided for within the scheme of transfers. We have endeavored to strengthen the incentive and reward mechanism by various elements in the design of transfers. A reward is by definition backward looking in the sense that it links the benefit to past performance. It helps in inducing the desired change to the extent that there is expectation that the reward mechanism will be continued in future. In contrast, an incentive is forward

looking in the sense that the benefit is linked to future performance. We recognize that there are several inherent difficulties in including forward looking indicators in the distribution formula. The reward mechanism through indicators of tax effort and fiscal efficiency would continue in our scheme and strengthened. For a forward looking scheme, there are two proposals that can be made in the context of the TOR. These relate to the medium term reform facility and debt relief. These are discussed in subsequent chapters.

Fiscal Consolidation and Institutional Reforms

2.45 Recent experience in fiscal consolidation [6] suggests that institutional reforms, well defined rules, and transparency facilitate fiscal reforms. Institutional reforms should aim at achieving and maintaining fiscal consolidation while leaving enough scope for coping with business cycles through automatic stabilizers as well as discretionary action. Three main ingredients of such reforms relate to formal deficit and debt rules, specification of expenditure rules, and fiscal transparency. The Maastricht Treaty rule of 3 per cent of GDP as the fiscal deficit target and 60 per cent as the desired debt-GDP ratio are well known. In United Kingdom a 'golden rule' of limiting borrowing only to finance capital expenditure has been followed since 1997 as a sustainable investment rule. In other countries like USA, Finland, Netherlands, and Sweden procedural requirements have been used to support expenditure limits. Fiscal transparency has been emphasized in countries like New Zealand, Australia, and the United Kingdom. Fiscal transparency

implies being open to public regarding the structure and functions of government. Transparency requires that any policy changes must be introduced with a clear statement of relevance and objectives. Strategies of fiscal consolidation require a longer term focus and the need to promote growth. In this context, the central government's initiative in enacting the FRBMA is a welcome step. Some state governments have also brought about fiscal responsibility legislations. In our view, other states would do well to emulate this example.

Issues of Debt Relief

2.46 Several state governments have asked for debt relief. Some of the previous commissions, notably the tenth and the eleventh, had observed that recommendations regarding debt relief by successive commissions create anticipations about such measures, which has a built-in adverse incentive. Debt relief often underwrites lack of fiscal discipline of the past. It could be unfair and could give significantly adverse signals if the benefit of relief is largest for the state, which was the most profligate in the past. In the literature relating to fiscal federalism, considerable attention has been given to the deleterious effects of a soft budget constraint, which refers to the relative ease with which states can borrow. This also has implications for the assessment of interest payments. If any amount of interest payments liability can be considered as legitimate claim for determining transfers, all normative assessments of current expenditures would be rendered redundant. All that a state would need to do is to borrow more in the current period and generate

larger claims for the future. It is imperative that interest payments be assessed normatively and a hard budget constraint be imposed. We have considered the issue of debt relief in the light of these considerations.

2.47 In the context of the question of debt relief, account needs to be taken of the fact that the nominal interest rates have fallen. There are also grounds to believe that the margins that the central government may have charged on its own lending to the states may have been unduly high in the past. It is clear that any debt relief will have to be linked to a desired path of fiscal adjustment including targets for revenue and fiscal deficits. The Planning Commission may also need to ensure that the size of a state plan is consistent with a sustainable level of debt, as the state plans are almost fully financed by borrowing in one form or another.

Decentralization and Transfers to Local Bodies

2.48 Decentralization in governance is considered efficiency augmenting as local representatives are presumed to better understand the preferences, needs, and willingness to finance the provision of the related local goods provided adequate sources were assigned to them. The 73rd and 74th amendments to the Constitution relating respectively to the rural and urban local bodies provided an effective basis for introducing local self governance in the country. Under the Constitution, the duties cast on the state governments included periodic holding of local elections, bring out enabling legislations, specifying the functions transferred to the states along with the sources of revenue, and constituting the state finance commissions at the required

intervals.

2.49 The Commission had occasion to listen to the representatives of the local bodies in different states. The emergent picture falls far short of what was envisaged in the two constitutional amendments. States have often been not prompt enough to constitute the state finance commissions with the required regularity. In many instances, after the recommendations are received, decisions have been kept pending. Even grants recommended and earmarked for the local bodies by the earlier finance commission, having been received into the consolidated fund of the state, have not been passed on to the local bodies in certain cases.

2.50 Our approach is to strengthen the basic idea of promoting a fiscal domain for the local bodies as being the key to effective local self-governance. The provision of local goods requires that the link between local service and the responsibility of financing it by the potential beneficiaries is appreciated. Since the local public goods have limited externalities, financing by external sources has considerable problems of adverse incentives that could lead to increasing dependence on transfers from above. The idea can work only if the local bodies are assigned adequate sources of revenue by the states. Various studies do indicate that local bodies have not been enthusiastic about raising revenues. The principle of equalization, extended to the local bodies would mean that while lack of fiscal capacity, at the state level as well as the local level can be made up, lack of revenue effort should not be made up.

Summary and Long Term Perspective

2.51 The system of fiscal transfers in India has run a course of more than fifty years. Apart from the finance commission and the Planning Commission, other institutions like the Inter-State Council and the National Development Council have played a role in providing a framework for centre-state financial relations. In a longer term context, there is a need to emphasize stability in federal relations in general and in the system of transfers in particular. Growing disparities in fiscal capacities and levels of services upset this stability as widening disparities require larger and more progressive transfers. The task of achieving greater equality does not depend on finance commission transfers alone. Transfers by the Planning Commission and those by other central ministries need to play a complementary role that would help reduce these disparities. States also need to give greater attention to policies aimed at accelerating growth and reducing intra-state regional inequalities. It is only when inter-state and intra-state disparities are reduced, that the federal fiscal system would become stable. A coordinated effort is required to reduce inequalities, which would also make the system more stable.

2.52 Some of the basic features of our approach and the resultant modifications in the scheme of transfers considered by us may be summarized as below

- (i) Our scheme of transfers provides for larger transfers to correct for the fall in the volume of transfers relative to GDP and to ensure minimum vertical transfers while correcting a larger horizontal imbalance. For this reason, we have suggested that the indicative benchmark for the overall

transfers may be raised to 38 per cent of the gross revenue receipts of the central government.

- (ii) Our approach to transfers comprising tax devolution and grants is guided by the equalization criterion, determined on the basis of a normative approach. In the case of tax devolution, there is the additional task of ensuring reasonable vertical transfers.
- (iii) Increasing imbalance in fiscal capacities of the states adds to the horizontal task of equalization that needs to be performed by fiscal transfers. However, care must be taken that while deficiency in fiscal capacity is redressed; deficiency in revenue effort is effectively discouraged.
- (iv) Three main considerations guiding tax devolution are: needs, cost disabilities, and fiscal efficiency.
- (v) With a view to ensuring minimum level of services in the case of education and health, we consider conditional grants derived on the basis of a normative approach as relevant. A similar consideration applies to maintenance expenditures.
- (vi) There is need to encourage fiscal consolidation both for the centre and the states, which can be facilitated by fiscal frameworks that have institutional basis including rules for deficit and debt and provisions ensuring greater fiscal transparency.
- (vii) While a hard budget constraint for

the states is desirable, any debt relief that may be considered would need to be linked to monitorable

achievements in regard to fiscal consolidation.



Endnotes

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- [1] The Commission brought out a volume summarizing the terms of reference of the previous finance commissions and their observations on “Issues and Approach” in a commemorative volume on the occasion of celebrating 50 years of fiscal federalism in India.
- [2] A review of the transfer systems in Canada and Australia and relevant comparisons with the Indian system are drawn in C. Rangarajan, and D.K. Srivastava, “Fiscal Transfers in Canada: Drawing Comparison and Lessons”, *Economic and Political Weekly*, Vol. 39, No.19, May, 2004, and “Fiscal Transfers in Australia: Review and Relevance to India”, *Economic and Political Weekly*, Vol. 39, No.33, August, 2004.
- [3] This constitutional amendment would

become effective from the date of notification.

- [4] The recently completed report of the Task Force appointed by the Union Ministry of Finance, in the context of achieving the FRBMA targets, estimates that the service tax may have a buoyancy of more than 5 in the period 2005-06 to 2009-10 in their reform scenario.
- [5] The recently published World Bank Report (Macmillan, 2004) on State Fiscal Reforms in India provides a discussion of implicit transfers to states and their implications for the overall progressivity of transfers.
- [6] World Economic Outlook, IMF, 2001 contains a review of some recent experiences in fiscal consolidation.