Chapter 4

Restructuring Public Finances

4.1 This Commission has been asked under clause 5 of the TOR to "review the state of finances of the Union and the States and suggest a plan by which the Governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macroeconomic stability and debt reduction along with equitable growth". A similar term of reference, addressed for the first time to the Eleventh Finance Commission (EFC), had made reference to budgetary balance and macroeconomic stability. The plan for restructuring is now required to also address the objectives of debt reduction and equitable growth.

4.2 Some other parts of the TOR have a bearing on the plan for restructuring. Para 6(iv) makes reference to 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 6(v) emphasizes the need for raising the tax-GDP ratio for the centre and tax-GSDP ratios for the states. In the context of debt reduction, Para 9 stipulates that corrective measures in regard to states' debt may be suggested, consistent with macroeconomic stability and

debt sustainability. We have endeavoured to develop an integrated framework for restructuring public finances to address these interrelated objectives.

4.3 Referring to the issue of budgetary imbalance, the EFC had observed that revenue deficits have become 'malefic fixtures' in the central and state budgets and that a restructuring of public finances was called for to steer public finances away from the 'self-perpetuating spiral of debt and deficit'. The EFC went on to draw up a fiscal adjustment programme for the central and the state governments that was meant to eliminate revenue deficit of the states and reduce centre's revenue deficit to 1 per cent of GDP by 2004-05. The overall fiscal deficit target was set at 6.5 per cent of GDP with centre's target being 4.5 per cent, and that for the states, 2.5 per cent. The combined debt to GDP ratio was to be reduced to 55 per cent. The ratio of interest payment to revenue receipts for the centre was targeted to be brought down to 48 per cent within a period of five years and to 35 per cent in the long run. The target for the states in this case was set at 18 per cent.

4.4 The fiscal adjustment called for achieving these targets required raising the combined tax-GDP ratio to 17.7 per cent

with centre's tax-GDP ratio at 10.3 per cent. The aggregate revenue receipts to GDP ratio in the EFC's plan for restructuring were to be brought close to 20 per cent. On the expenditure side, with reference to the combined revenue expenditure, a reduction of 2.37 percentage points of GDP was planned with a corresponding increase in capital expenditures of a marginally higher magnitude. Evidently, there has been considerable slippage in achieving these targets by both levels of governments. Although the 2004-05 accounts data would become available only later, as per 2002-03 data, the combined revenue deficit of the centre and states was about 6.7 per cent and the debt-GDP ratio was about 76 per cent of GDP [1]. While failure in achieving the stipulated targets to some extent was due to deficiency in revenue effort and slackness in expenditure control, there was also a slowdown in economic growth during the first three years of the EFC reference period. The nominal growth rates in respect of GDP at current market prices in the four years during 2000-01 to 2003-04 were 7.9, 9.2, 8.2 and 12.3 per cent. The EFC had assumed a trend nominal growth rate of 13 per cent. If centre's fiscal deficit finally turns out, as estimated in the budget for 2004-05, to be 4.4 per cent of GDP, it would be fractionally lower than what was stipulated by the EFC.

4.5 There has been some notable improvement in the institutional environment that can support fiscal reforms. The central government has enacted a Fiscal Responsibility and Management Act (FRBMA) in 2003, which had, under its rules, set the target for eliminating revenue deficit by 2007-08, and reducing fiscal deficit to 3 per cent of GDP. The July 2004 budget has ensured that the target year is shifted to 2008-09.. The states of Karnataka, Kerala, Tamil Nadu, Punjab, and Uttar Pradesh have enacted fiscal responsibility legislations. Many states have drawn up their medium term reform programs with specific monitorable targets in the context of the Medium Term Fiscal Reform Facility instituted on the basis of EFC's recommendations. We note that these changes are likely to contribute to more effective and transparent fiscal management.

4.6 Restructuring public finances aimed at macroeconomic stabilization and achieving revenue account balance requires a broad analytical framework. The impact of the size and composition of government expenditure on growth, inflation, interest rate and the external account has to be considered in a framework that takes into account relevant inter relationships and feedbacks. The structure of public finances relates, apart from other features, to the size and composition of expenditure. Government expenditure as a proportion of GDP is smaller in India in comparison to many other countries. Getting the right size and the right composition of government expenditure with a view to facilitating achievement of highest attainable growth rates, and meeting governments' social obligations including poverty reduction and provision of health and education should be considered integral to any plan for restructuring public finances. This requires increasing public spending in social and economic infrastructure for accelerating growth while reducing the overall fiscal imbalance.

Views of the Central and State Governments

4.7 In their memoranda as also in their discussions with the Commission, most state governments have acknowledged the need for restructuring public finances. Some states have suggested that monitoring of the progress of restructuring should be done by an independent agency and not by the central government. Several specific suggestions were made by them. Some of the more commonly expressed suggestions are listed below.

(i) In regard to plan assistance, the states have suggested that the grant-loan ratio in the case of general category states be modified from the present 30: 70 to 50:50. In some suggestions, the ratio of 70:30 has also been suggested. In the case of the special category states, the suggestion in some cases is to raise the grant component to 100 per cent instead of the present 90:10 ratio;

(ii) In lending by the central to the state governments, a floating interest rate should be used, and the states should be allowed greater access to the market;

(iii) All centrally sponsored schemes should to be transferred to the states along with funds;

(iv) The distinction between plan and non-plan expenditure should be abolished as it leads to unbalanced prioritization of financial resources that ignores the need for maintenance expenditures;

(v) In the State Fiscal Reform Facility,

there should be no withholding of assessed gap grants;

(vi) There is a need to restructure state level public enterprises;

(vii) Following the constitutional amendments regarding rural and urban local bodies, there has been greater demand for resources by them, and states have come under tremendous financial pressure. Any restructuring should take a view covering all the three tiers of governments.

(viii) Review of tax assignment should include the assignment of services to the states.

4.8 The central government, in its memorandum, referred to the report of the Task Force appointed in the context of the FRBMA, which has a bearing on issues related to restructuring of central finances. The Task Force has recommended a path of adjustment that emphasizes a revenue-led, front loaded fiscal consolidation, which augments capital expenditure relative to GDP. Similar views are also expressed in the fiscal policy strategy statement brought out along with the 2004-05 budget as required under the FRBMA. In formulating our programme for restructuring of public finances, we have taken note of the views, both of the central government and the state governments.

Growth and Macroeconomic Stability

4.9 Macroeconomic stability refers to the capacity of the economy to keep close to levels of output consistent with full employment while inflation is also contained within acceptable limits. In

practice, there may be structural rigidities that keep the economy below full employment on a long term basis. Issues of stabilization are, therefore, considered with reference to growth of 'potential' or trend levels of output. Measurement of potential output requires that cyclical variations are removed to identify the level of output along its long term path. In a period of recession, real output may fall below potential output. In a period of expansion, inflation may exceed its long term levels. Both departures constitute a threat to stability. The objective of stabilization is to keep the economy growing close to its long term growth path while also keeping the inflation rate within acceptable limits.

4.10   In a stable situation, the economy would have a built-in capacity to return to its long term path. In the context of fiscal policy, this capacity is provided by automatic stabilizers. Automatic stabilizers exist if the structure of public finances is such that the responsiveness of taxes is larger than that of expenditures following a change in nominal output. Thus, in an inflationary situation, taxes will withdraw more from the expenditure stream than what increased government expenditures would put in, and there will be a net contraction in aggregate expenditures, thereby dampening the cycle. In a recessionary situation, government expenditures contribute more to the expenditures than taxation withdraws, thereby reducing the impact of recession. If automatic responses are not adequate, discretionary fiscal interventions are called for to bring about stabilization. The Reserve Bank of India [2] in its Report on Currency and Finance for 2001-02, had estimated that the elasticity of receipts of the combined government sector is 1.07 whereas that for

combined non-interest expenditure is 1.06. Since the difference in the two response coefficients is small, automatic stabilizers in India may be weak. Effective discretionary action is therefore required for stabilization.

4.11   In considering the issue of growth with stabilization, there is a need to examine (a) whether potential output along its growth path remains persistently below full employment levels, and (b) whether actual output in any given year is above or below the growth path of potential output. In both cases, the structure of public finances and the management of fiscal policy have a role to play. When the long run growth path is below full employment levels, it is desirable to design public finances to remove the structural constraints such as supply bottlenecks and bring potential output closer to full employment levels. In this context, the structure of government expenditure, particularly the share of capital expenditure and its allocation becomes important. In regard to the second issue, in achieving stabilization, the management of aggregate government demand in response to the cyclical movements of potential output along its growth path becomes relevant.

4.12   The manner of financing government expenditures also affects stabilization and growth. Governments have to resort to borrowing, i.e. fiscal deficit to the extent their expenditures are not covered by the revenue and non-debt capital receipts. Excessive dependence on domestic market borrowing can push the interest rates, while excessive dependence on borrowing from the central bank can unduly accelerate the inflation rate. The use of external borrowing under certain circumstances can put pressure

on the exchange rate. Fiscal deficit also needs to be viewed as consisting of two components: a structural or long term component and a cyclical component reflecting deviation from the long run average. The cyclical or the temporary component of fiscal deficit may be used to stabilize fluctuations around the trend growth of output. Fiscal deficits in India are pre-dominantly structural in nature and the cyclical component is small in magnitude [3].

4.13   Our fiscal reform strategy centers on growth. Growth depends, among other factors, on the rate of investment which, in turn, depends on the saving rate. The saving rate depends, among other factors, on government's revenue deficit, which amounts to government's net dis-saving. In other words, the aggregate saving rate, consisting of the saving rate of the household sector, the private corporate sector, and the government sector, remains less than what is potentially achievable as long as government is contributing negatively, i.e., drawing upon the saving of the private sector to finance consumption expenditure. We review below the long term profile of growth, as well as that of the saving-investment rates, focusing on the experience of the nineties, with a view to highlighting the deleterious effects of government dis-savings on growth.

4.14   Chart 4.1 depicts the growth rates derived of trend levels of output along with actual annual growth of GDP at factor cost at constant 1993-94 prices from 1950-51 to 2002-03. The analysis is with reference to GDP at factor cost with a view to focusing on the performance in respect of growth of output. Indirect taxes net of subsidies are fiscal instruments that take GDP at factor cost to GDP at market prices. The trend growth has been estimated by using a statistical filter [4]. Chart 4.1 shows that a long term cyclical path has been followed by output where the trend growth fell from a little below 4.5 per cent to about 3.3 per cent in the early seventies, after which there was a rise bringing the trend growth to levels above 6 per cent in the mid-nineties. It is the fall in the trend growth rate to below 5 per cent since then that should be our primary current concern.

Chart 4.1

Growth Rates of Actual and Trend GDP at Constant Prices
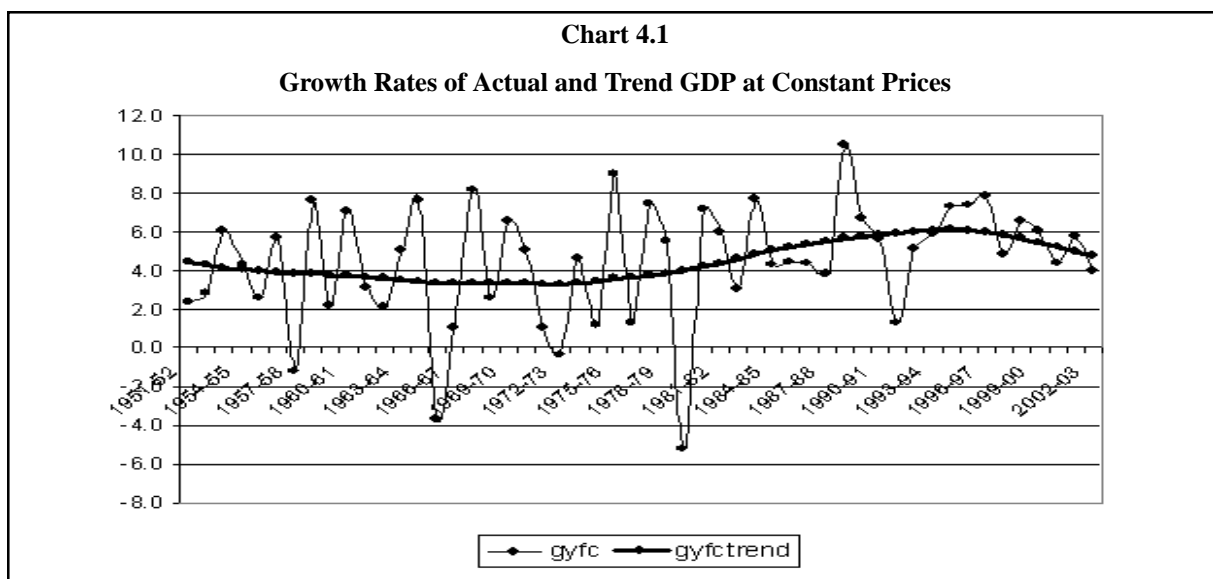
4.15 It may also be seen that the amplitude of variation from trend growth rate has come down in the late nineties. A corresponding analysis of actual and trend inflation rates indicates that the trend inflation rate during 1999-00 to 2002-03 has come down marginally below 5 per cent, although actual inflation rate was even lower remaining below 4 per cent. These clearly were signs of recession that had continued until 2002-03. Table 4.1 gives the actual, trend, and the residual components of growth and inflation from 1990-91 to 2002-03. Following the strong recovery of agriculture in 2003-04 and the upturn in industry in both 2003-04 and 2004-05, the overall growth rate during 2003-04 and 2004-05 is estimated to be above 8 per cent and 6 per cent, respectively.

To achieve a growth rate of above 7 per cent on a sustained basis, the investment rate has to increase to levels equal to or above those achieved in the mid-nineties. The saving rate also has to go up correspondingly.

4.16 Table 4.2 gives the saving rate of the household, private corporate, and the public sector. Table 4.3 provides the rate of gross domestic investment for private and public sectors. Looking at the public sector saving rate, it is clear that it became negative in 1998-99 and the magnitude of negative savings went on increasing until 2001-02. Within it, dis-saving of the government, consisting of administrative and departmental enterprises showed a sharp deterioration from 1.7 per cent of GDP in

Table 4.1

Growth and Inflation Rates: Trends and Actuals

(per cent)

Year	Actual growth in output*	Trend$ growth in output	Deviation from trend growth	Actual inflation rate**	Trend inflation rate	Deviation from trend inflation rate
1990-91	5.57	5.83	-0.26	10.50	9.65	0.85
1991-92	1.30	5.90	-4.60	13.81	9.46	4.35
1992-93	5.12	5.98	-0.86	8.72	9.15	-0.43
1993-94	5.90	6.06	-0.16	9.59	8.75	0.84
1994-95	7.25	6.10	1.15	9.43	8.27	1.16
1995-96	7.34	6.08	1.26	9.03	7.75	1.28
1996-97	7.84	6.00	1.84	7.44	7.21	0.23
1997-98	4.79	5.85	-1.06	6.67	6.68	0.01
1998-99	6.51	5.66	0.85	7.94	6.17	1.77
1999-00	6.06	5.45	0.61	3.94	5.70	-1.76
2000-01	4.37	5.21	-0.84	3.49	5.30	-1.81
2001-02	5.78	4.98	0.80	3.88	4.98	-1.10
2002-03	3.98	4.74	-0.76	3.46	4.72	-1.26

Source (Basic Data):National Accounts Statistics

* **Output refers to GDP at factor cost.**

** **Inflation refers to implicit price deflator of GDP at factor cost.**

\$ **Trend is calculated using Hodrick-Prescott filter covering 1950-51 to 2002-03 data.**

1996-97 to 6.2 per cent in 2001-02. The aggregate saving rate had peaked in 1995-96 at 25.2 per cent. In 1998-99, it reached its lowest level in recent years at 21.5 per cent. Correspondingly, the investment rate had peaked in 1995-96 and reached its lowest level in recent years at 22.6 per cent in 1998-99. The three years in the mid-nineties provide some evidence for the kind of saving and investment rates required for a 7 plus growth. The three years covering 1994-95 to 1996-97 had an average investment rate of about 26 per cent and domestic saving rate of about 24.7 per cent. In contrast during 2000-01 to 2002-03, the investment rate on average was 23.6 per cent and the average saving rate was 23.8 per cent. There has been a persistent fall in public investment in the nineties. The rate of gross domestic capital formation in the public sector fell from an average of 10.1

per cent of GDP during 1985-1990 to 5.7 in 2002-03. Since private investment was increasing up to the mid-nineties, it made up for the fall in the public sector investment. However, after 1995-96, the private corporate sector investment also fell.

4.17   There are four main features that can be highlighted in comparing the growth-saving-investment profile of the mid-nineties with that of the first three years of the new decade.

    i. In the mid-nineties, the average growth of GDP at factor cost was 7.5 per cent per annum, which fell to an average of 4.7 per cent during 2000-03;

   ii. The public sector saving rate fell during this period from an average level of 1.8 per cent to -2.3 percent of GDP, amounting to a fall of 4.1

Table 4.2

Gross Domestic Saving at Current Prices as per cent of GDP

(per cent)

Year	House-hold	Private corporate Sector	Private Sector (2+3)	Public Sector	Total (4+5)
1	2	3	4	5	6
Average (1985-86 to 1989-90)	16.03	1.96	17.99	2.39	20.38
1990-91	19.33	2.67	22.00	1.10	23.10
1991-92	16.96	3.11	20.07	1.97	22.04
1992-93	17.51	2.67	20.18	1.59	21.77
1993-94	18.42	3.48	21.90	0.63	22.53
1994-95	19.68	3.48	23.16	1.66	24.82
1995-96	18.19	4.93	23.12	2.03	25.15
1996-97	17.05	4.47	21.52	1.67	23.19
1997-98	17.63	4.17	21.80	1.33	23.13
1998-99	18.77	3.74	22.51	-0.99	21.52
1999-00	20.88	4.35	25.23	-1.04	24.19
2000-01	21.93	4.12	26.05	-2.31	23.74
2001-02	22.74	3.46	26.20	-2.75	23.45
2002-03	22.65	3.41	26.06	-1.85	24.21

Source (Basic data): National Income Accounts, CSO

percentage points;

iii. The public sector investment fell by 1.9 percentage points from an average level of 7.8 percent of GDP to 5.9 per cent and the overall investment rate fell by 2.2 percentage points from an average level of 25.8 per cent to 23.6 per cent. The corporate investment fell from a high of 9.8 per cent of GDP in 1995-96 to 4.8 per cent in 2002-03;

iv. The excess of gross domestic investment over gross domestic saving between the two periods, showing the extent of reliance on current account deficit, fell from 1.4 percentage points to -0.2 percentage points.

4.18   For increasing and sustaining the growth rate at 7 per cent, an aggregate investment rate of 28 percent is required on the assumption that the incremental capital-output ratio (ICOR) is 4. The Tenth Plan had envisaged an average investment rate of 28.4 per cent to attain a growth of 8 per cent by assuming a lower ICOR. Such levels of total investment would require increasing levels of both public and private investment relative to GDP. The restructuring plan suggested by us, as detailed later in this chapter, provides for a tangible increase in government investment and savings relative to GDP.

Issues of Equitable Growth

4.19   In considering the issue of equitable

Table 4.3

Gross Capital Formation at Current Market Prices as per cent to GDP

(per cent)

Year	Public sector	Private corporate	Household	Private sector (3+4)	Total (2+5)	Errors& omissions	Adjusted total (6+7)
1	2	3	4	5	6	7	8
Average (1985-86 to 1989-90)	10.11	4.33	8.83	13.16	23.27	-0.56	22.71
1990-91	9.34	4.13	10.60	14.73	24.07	2.23	26.30
1991-92	8.82	5.66	7.45	13.11	21.93	0.62	22.55
1992-93	8.55	6.46	8.78	15.24	23.79	-0.17	23.62
1993-94	8.24	5.61	7.40	13.01	21.25	1.84	23.09
1994-95	8.71	6.91	7.76	14.67	23.38	2.62	26.00
1995-96	7.66	9.58	9.29	18.87	26.53	0.37	26.90
1996-97	7.03	8.05	6.69	14.74	21.77	2.71	24.48
1997-98	6.61	7.97	7.99	15.96	22.57	2.02	24.59
1998-99	6.58	6.39	8.41	14.80	21.38	1.20	22.58
1999-00	6.94	6.46	10.26	16.72	23.66	1.67	25.33
2000-01	6.29	5.06	11.27	16.33	22.62	1.73	24.35
2001-02	5.83	4.88	11.60	16.48	22.31	0.83	23.14
2002-03	5.68	4.80	12.34	17.14	22.82	0.45	23.27

Source (Basic data): National Income Accounts, CSO

growth, we look at three of its manifestations. Inter-state disparities in levels and growth of per capita GSDP indicate disparities in fiscal capacity. Disparities in per capita government expenditures, particularly those in priority sectors like education, health, and water supply and sanitation indicate how lower fiscal capacities translate into differences in governments' fiscal intervention in the provision of services. By examining the inter-state pattern in the human development index, we look at the disparities in some of the relevant outcomes that may be influenced by fiscal intervention among other factors.

4.20   Table 4.4 shows trend growth rates of GSDP at 1993-94 prices. In general, the higher income states have grown at higher rates. There are some significant changes between average growth rates in the eighties

and the nineties. In the case of Punjab and Haryana, growth has come down although Punjab has the highest per capita GSDP considering the average over 1999-00 to 2001-02. Among the poorer states, cases where the growth rates fell in the nineties as compared to the eighties are Assam, Bihar, Orissa, Uttar Pradesh, and Rajasthan.

4.21   Table 4.5 presents summary indicators of disparity in comparable per capita GSDP over 1993-94 to 2001-02. The ratio of minimum GSDP per capita (that of Bihar) and maximum GSDP per capita (which, after excluding Goa, has pertained to either Maharashtra or Punjab in different years) decreased from 30.5 in 1993-94 to 26.1 in 1995-96, after which the ratio improved until 1998-99. It again declined reaching a level of 26.5 per cent in 2001-02. In the weighted coefficient of variation also there is some reduction

Table 4.4

Trend Growth Rates of GSDP at Constant Prices (1993-94): State Series#

	1980-81 to 1989-90	1990-91 to 2001-02		1980-81 to 1989-90	1990-91 to 2001-02
Andhra Pradesh	5.35	5.60	Madhya Pradesh.*	4.02	4.81
Arunachal Pradesh	8.14	4.68	Maharashtra	5.64	6.27
Assam	3.50	2.53	Manipur	5.12	5.35
Bihar*	4.60	3.79	Meghalaya	4.94	5.81
Goa	4.79	8.40	Orissa	5.01	4.21
Gujarat	5.05	7.20	Punjab	5.44	4.66
Haryana	6.21	4.72	Rajasthan	6.01	5.85
Himachal Pradesh	4.70	6.09	Tamil Nadu	5.18	6.26
J & K**	2.80	4.89	Tripura	5.29	8.94
Karnataka	5.36	7.17	Uttar Pradesh*	4.80	3.84
Kerala	3.16	5.51	West Bengal	4.70	6.93

Source(Basic data): CSO

 *   **These states were divided in 2000. Data relate to the combined states.**

 ** **Upto 2000-01**

 # **Pertains to State GSDP series**

witnessed after 1995-96; and it rose again after 1999-2000. The Gini coefficient, given in Table 4.5, reflects income inequality assuming that all persons within a state are located at the mean income for that state. It therefore captures inter-state inequality and not intra-state inequality [5]. The Gini coefficient shows progressive increase in income disparity till 1999-00, except in 1996-97. Thereafter, it has shown a decline. It may, however, be noted that the value of the Gini coefficient lies between 0.1917 and 0.2173.

Table 4.5

Disparity in Per Capita GSDP

	Ratio of minimum to maximum Per capita GSDP* (per cent)	Coefficient of variation (per cent)	Gini coefficient #
	Weighted**		
1993-94	30.527	34.549	0.19170
1994-95	29.697	35.031	0.19262
1995-96	26.107	37.892	0.20719
1996-97	27.586	36.781	0.20708
1997-98	28.282	35.933	0.20853
1998-99	30.018	35.898	0.21062
1999-00	28.899	37.417	0.21732
2000-01	28.233	37.638	0.21034
2001-02	26.534	37.877	0.21016

Source (Basic Data): CSO

  * **excluding Goa;**

 ** **weighted by population**

  # **Relates to 14 states, i.e. Assam and the general category states excluding Goa; Gini coefficient is calculated with respect to state GSDP series at constant 1993-94 prices. For 2000-01 and 2001-02, the divided states are clubbed together to maintain comparability.**

4.22 The inter-state pattern of per capita government expenditures, particularly in social and economic services shows the prevailing disparities in respect of publically provided services. Table 4.6 shows per capita average state government expenditures over the period 1998-99 to 2000-01 in general, social, and economic services. In the general services, interest payment, pensions, and lotteries are excluded. The larger states are considered here focusing on the general category states except Goa but including Assam. Within the social sector expenditures, per capita expenditures on education, health, and water supply and sanitation are also shown. States are arranged in ascending order of per capita GSDP. The general pattern is that states with low per capita GSDPs also have low per capita expenditures. However, there are several exceptions. The ratio of minimum to maximum expenditure and that of minimum to mean expenditure indicates that in the case of general category states, the minimum expenditure is only 30 per cent of maximum expenditure, excluding Goa, and it is 60 per cent of average expenditure. In the case of social services the minimum per capita expenditure is 36 per cent of the maximum and 47 per cent of the mean. The corresponding relations for economic services are 16 per cent and 34 per cent. In the case of education, the minimum to mean ratio is 57 per cent. The corresponding figures are 41 per cent and 34 per cent for health and water supply and sanitation. These figures cover both non-plan and plan revenue expenditures.

4.23 The Planning Commission prepares estimates of state wise index of human development (HDI). This is available for

Table 4.6

Per capita expenditure on General, Social & Economic Services

(Rs.)

States	1998-99 to 2000-01			1998-99 to 2000-01		
	GEN	**SOC**	**ECO**	**EDN**	**HTH**	**WSS**
Bihar	189.1	474.0	204.9	311.1	50.9	19.1
Orissa	224.2	931.2	406.5	463.1	94.7	56.2
Uttar Pradesh	267.5	555.8	324.9	340.4	63.4	20.0
Assam	334.4	929.9	369.3	615.2	92.2	59.2
Madhya Pradesh	235.6	781.3	469.0	344.5	86.2	63.4
Rajasthan	265.4	1020.7	405.0	545.3	128.3	111.5
West Bengal	262.4	958.2	392.6	512.3	136.8	42.5
Andhra Pradesh	255.8	1004.1	634.3	411.7	118.2	57.7
Kerala	318.2	1254.8	716.5	713.3	172.3	52.3
Karnataka	279.2	1083.9	755.8	558.3	135.7	60.3
Tamil Nadu	336.4	1240.9	685.3	651.5	154.4	38.3
Gujarat	274.6	1331.3	1285.7	664.4	154.3	39.0
Haryana	320.9	1145.4	902.4	587.6	122.1	102.1
Maharashtra	624.4	1276.1	647.7	730.9	131.7	79.7
Punjab	533.6	1220.5	733.9	716.3	221.1	55.0
coeff of variation	36.88	25.24	45.95	26.30	34.93	45.11
Min/Max	0.30	0.36	0.16	0.43	0.23	0.17
Min/Mean	0.60	0.47	0.34	0.57	0.41	0.34

Source: State Finance Accounts

Key: GEN = General services excluding interest payments and pensions.

SOC: Social services; ECO: Economic services; EDN=Education; HTH=Health; WSS= Water supply and sanitation. States are arranged in Order of per capita GSDP; Bihar,U.P., and M.P.are taken as undivided states

1981 and 1991. The UNDP office in Delhi prepared, for the benefit of the Commission, the HDI for 2001[6]. According to these estimates the lowest ranked state is Bihar, followed by Uttar Pradesh, Orissa, and Madhya Pradesh. There is a clear positive relationship, as expected, between per capita GSDP and the HDI. At the same time, states, which have provided more in terms of per capita budgetary expenditures on health and education, have ranks that are higher than their relative position in the ranking of per capita GSDP. This is so also for the special category states. Based on the relative ranking of an index of infrastructure [7], the states have also been grouped into five categories, as shown in Table 4.7. While the HDI reflects access to social services, the infrastructure index reflects access to physical infrastructure. Together, these capture two different dimensions of disparities. It is notable that while the special category states do better in the HDI, their position in terms of access to infrastructure is a major handicap. For the low income states like Bihar and Rajasthan, both HDI and the infrastructure index show a handicap.

Table 4.7

States Grouped According to Selected Indicators

Human Development Index	Infrastructure Index
High	**High**
Goa, Kerala, Maharashtra, Mizoram	Goa, Maharashtra, Punjab
High Middle	**High Middle**
Gujarat, Manipur, Nagaland, Punjab, Sikkim, Tamil Nadu	Gujarat, Haryana, Kerala, Tamil Nadu
Middle	**Middle**
Andhra Pradesh, Arunachal Pradesh, Haryana, Himachal Pradesh, Meghalaya, Karnataka, Tripura, West Bengal, Uttaranchal	Andhra Pradesh, Karnataka
Lower Middle	**Lower Middle**
Assam, Chhattisgarh, J &K, Jharkhand, Rajasthan	Himachal Pradesh, Madhya Pradesh, Orissa, U.P., Uttaranchal, West Bengal
Low	**Low**
Bihar, Madhya Pradesh, Orissa, Uttar Pradesh	Arunachal Pradesh, Manipur, Meghalaya, Jharkhand, Mizoram, Nagaland, Assam, Chhattisgarh, Sikkim, Tripura, J&K, Bihar, Rajasthan

Source: **UNDP for HDI and IDFC for Index of Infrastructure**

4.24 Levels of income and its growth depend on many factors that include states' own efforts and policies, the inter-state distribution of private capital, domestic and foreign, and the inter-state pattern of the benefit of central investment and current expenditures. In some respects, the increasing globalization and market orientation may result in increasing the relative flow of funds towards the more developed states partly because of the pro-active policy stance and partly because of the availability of infrastructure facilities. Much of the required correction has to come from the distribution and allocation of plan funds. On our part, besides building into the devolution formula appropriate criteria in the scheme of transfers, we have also recommended grants, based to some degree on the application of the equalization principle to expenditures on education and health. The benefit would accrue mainly to the states, which have relatively lower ranks in the HDI.

Trends in Combined Government Finances

a. Fiscal Imbalance

4.25 We have examined the main trends in the combined government finances over the 15-year period from 1987-88 to 2001-02. The reference to the period in the late eighties highlights changes from peak levels of tax-GDP ratio as also peak past levels of fiscal deficit. Fiscal imbalances as indicated by revenue, fiscal, and primary deficits, which were at high levels at the end of the eighties, showed improvement in the mid-nineties, but deteriorated since then. As indicated by annexure 4.1 and chart 4.2, revenue and fiscal deficits as percentage of GDP were higher in 1999-2002 on average as compared to their levels in the late eighties. Revenue deficit shows the most persistent deterioration, increasing by more than double, from the average of 3 per cent of GDP in 1987-1990 to 6.7 per cent in 1999-2002. It had declined to 3.2 per cent in 1995-96, after which it steadily climbed up.

4.26   In the case of fiscal deficits, there is a deterioration of 0.7 percentage points. At the end of the eighties, the average level of fiscal deficit was 8.8 per cent of GDP, which increased to 9.5 percent in 1999-2002. However, there was an improvement in the mid-nineties. In 1996-97, fiscal deficit had fallen to 6.3 per cent of GDP. The primary deficit was 4.9 per cent of GDP on average at the end of the eighties. It fell to 1.1 per cent in 1996-97, after which it deteriorated but the average over 1999-2002 was still lower than that in 1987-1990. Thus, the primary deficit as percentage of GDP was lower by 1.2 percentage points as compared to its average level in 1987-1990. The ratio of revenue to fiscal deficits indicates the 'quality' of fiscal deficit by highlighting the proportion of government borrowing that does not lead to creation of assets, which can give returns in the future to service the borrowing. This ratio has increased from

about 34 per cent at the end of the eighties to 68 per cent on average during 1999-2002. This underlies a major weakness in the profile of government finances, indicating that a progressively larger share of borrowing is being spent on consumption. The main reasons given for the fiscal deterioration after the mid-nineties 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 late nineties combined with a fall in the inflation rate in subsequent years. The fall in the nominal interest rates towards the end of the nineties has however had some beneficial effects on expenditures.

b. Trends in Combined Revenues and Expenditures

4.27   Table 4.8 shows the structural

Chart 4.2

Revenue, Fiscal, and Primary Deficits as per cent of GDP
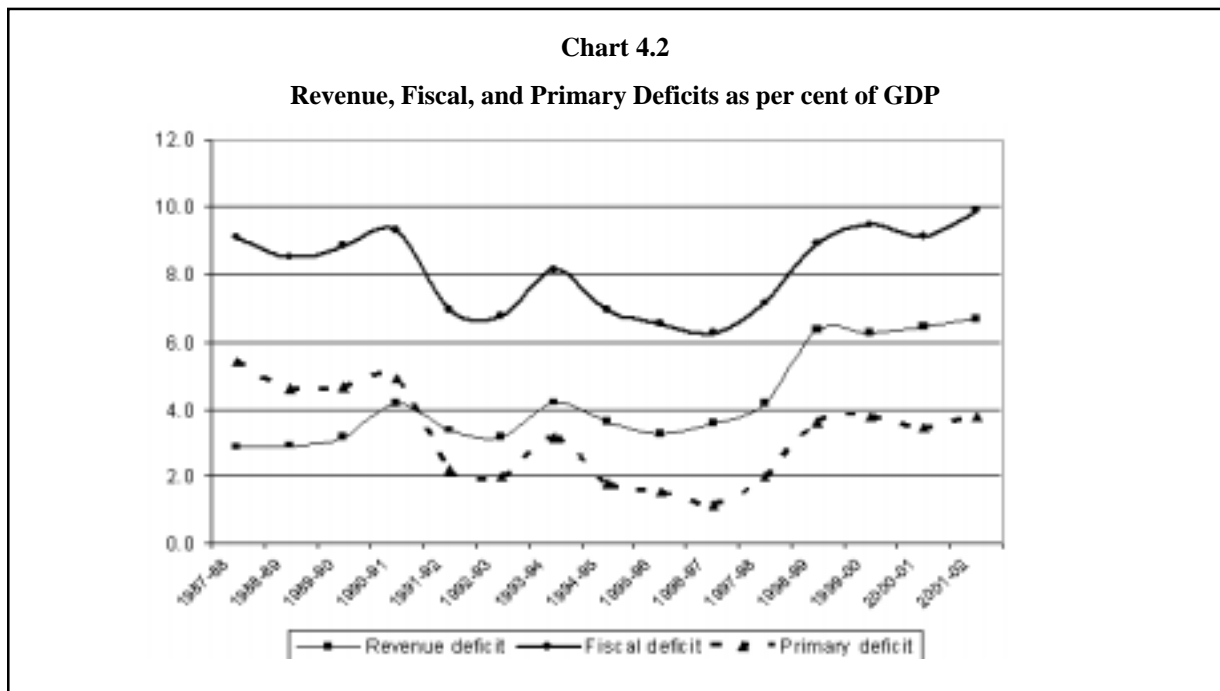
changes in some of the major heads of the combined revenues and expenditures of the central and state governments after netting out all intergovernmental flows. The aggregate tax-GDP ratio fell from a level of 16 per cent of GDP towards the end of the eighties to about 14.4 per cent, i.e. a fall of 1.6 percentage points. The fall in the ratio of total revenue receipts was of the same order indicating that there was no perceptible change in the contribution of non-tax revenues relative to GDP. In the case of revenue expenditure, the average revenue expenditure increased from 21.7 per cent of GDP to 23.6 percentage points showing a rise of 1.8 percentage points. This was mainly accounted for by the increase in interest payments relative to GDP, which increased from 3.9 to 5.8 per cent. Capital expenditure fell by 2.8 percentage points, from 6.1 to 3.3 per cent of GDP on average during 1999-2002.

4.28   The size and composition of tax revenues are of major importance in the

Table 4.8

Structural Changes in Combined Finances of Central and State Governments

(Per cent to GDP at Market Prices)

	Tax revenues	Interest payments	Capital expenditure	Revenue Receipts	Revenue expenditure	Interest payments to revenue receipts (per cent)
Average (1987-88 to 1989-90)[I]	16.0	3.9	6.1	18.7	21.7	21.0
Average (1999-00 to 2001-02)[II]	14.4	5.8	3.3	17.1	23.6	34.0
(II-I)	**-1.6**	**1.9**	**-2.8**	**-1.6**	**1.8**	**13.0**

Source (Basic data): Indian Public Finance Statistics

structure of government finances. An examination of the evolution of the tax-GDP ratio since 1950-51 indicates that starting from a level of 6.3 per cent of GDP in 1950-51, the tax-GDP ratio steadily increased to 16.1 per cent in 1987-88. Much of this increase was due to growth in indirect taxes. In 1950-51, indirect taxes amounted to 4 per cent of GDP whereas the direct taxes accounted for 2.4 per cent of GDP. Since then indirect taxes increased to a peak level of 14 per cent in 1987-88 whereas direct taxes remained less than 3 per cent until 1994-95. As a result of tax reforms, the indirect taxes relative to GDP started coming down whereas that of direct taxes started increasing. But the magnitude of increase in the direct taxes was less than the fall in indirect taxes. In consequence, the overall tax-GDP ratio fell from its peak in 1987-88 to 14.4 per cent in 2001-02. Table 4.9 shows decade-wise buoyancies of direct and indirect taxes for the central and state governments. The buoyancy of central direct tax revenues, except for the seventies, was less than 1 until the eighties. It was with the direct tax reforms in the nineties, which included widening of the tax base and reduction in tax rates, that the buoyancy picked up to reach a level of 1.3 for the period 1990-91 to 2001-02. The central indirect taxes followed a reverse course.

Maintaining a buoyancy of more than 1 until the end of the eighties, their buoyancy with respect to GDP fell significantly below 1 in the nineties. This followed from the reduction in the tax rates of both Union excise duties, and even more sharply in the case of the customs duties. Given the higher weight of central indirect taxes, the overall tax-GDP ratio fell. The buoyancy of state

indirect taxes also fell in the nineties although it remained higher than that of the central indirect taxes. The decade-wise buoyancies of state indirect taxes show a noticeable decline in the eighties and nineties although these have remained higher than 1.

c. Growth in Debt: Centre and States

Table 4.9

Decade-wise Buoyancies of Central and State Tax Revenues

	1950-51 to 1959-60	1960-61 to 1969-70	1970-71 to 1979-80	1980-81 to 1989-90	1991-92 to 2001-02	1950-51 to 2001-02
Central Taxes: Gross Revenues						
Direct	0.94	0.96	1.18	0.94	1.30	1.09
Indirect	1.65	1.24	1.30	1.20	0.72	1.16
Total	**1.38**	**1.15**	**1.27**	**1.14**	**0.89**	**1.14**
States Own Tax Revenues						
Direct	-8.43	3.61	-6.32	-8.20	-4.34	-2.46
Indirect	1.41	1.37	1.37	1.11	1.02	1.23
Total	**1.39**	**1.17**	**1.35**	**1.11**	**1.02**	**1.17**
Total Tax Revenues						
Direct	1.05	0.79	1.16	0.96	1.26	1.03
Indirect	1.55	1.29	1.33	1.16	0.86	1.19
Total	**1.38**	**1.16**	**1.30**	**1.13**	**0.93**	**1.15**

Source (Basic data): Indian Public Finance Statistics and National Income Accounts

Direct taxes in the case of states contribute a negligible share in total tax revenues. Negative buoyancy implies a fall in absolute terms.

4.29 The combined debt-GDP ratio of the central and state governments at the end of 2002-03 was about 76 per cent of GDP, subject to some qualifications. First, the government budget documents give the centre's external debt as evaluated at the historical exchange rates, i.e. exchange rates in the years in which the debt was incurred. Since the exchange rate has depreciated over the years, it makes a difference if external debt is evaluated at the current exchange rates. This difference was as large as nearly

11 per cent in 1991-92. However, over the years, this difference has steadily come down. In 2002-03, if external debt is evaluated at the current exchange rates, about 5.6 per cent would need to be added to the debt-GDP ratio. This would take the combined debt-GDP ratio in 2002-03 to 81.6 per cent. The second qualification is that in accounting for the liabilities of the state governments, certain liabilities of reserve funds and deposits are not included. In 2002-03, about 3.4 percentage points of GDP

needs to be added on this account, taking the overall debt-GDP ratio to 85 per cent. These figures do not include contingent liabilities, which amount to more than 11 per cent of GDP.

4.30 Even if we focus on the more conventional budgetary figure of debt without these qualifications, it is striking how the growth in debt-GDP ratio has accelerated since 1996-97 when it was 56.3 per cent, which was only marginally above the EFC's stipulated target. During the period of 1995-96 to 2002-03, the combined debt-GDP ratio rose from 56.3 per cent to 76 per cent in 2002-03, i.e. an increase of a little less than 20 percentage points in a span of 6 years. This is an unprecedented increase in the growth of the debt-GDP ratio in such a short span of time. One way of looking at the source of increase in the debt-GDP ratio during this period is to decompose the increase in terms of the contribution of cumulated primary deficits and that of the differential between growth and interest rates [8]. For three consecutive years, viz., 2000-01, 2001-02, and 2002-03, the nominal growth rate fell below the effective interest rate. In these years, instead of absorbing the impact of primary deficits, the growth-interest differential, being negative, worked in the reverse by adding to the debt-GDP ratio. For the period 1996-97 to 2002-03, therefore the excess of growth over interest could not absorb any part of the impact of cumulated primary deficits, the benefit in the first three years being negated by the opposite effect in the latter three years. The entire increase therefore was due to accumulation of primary deficits, which remained unabsorbed by any excess of growth over interest rates.

4.31 High levels of debt-GDP ratio result in high interest payments relative to revenue receipts. Since interest payments are committed expenditures, revenue deficits are bound to increase when revenue receipts to GDP ratios remain sluggish. This has the effect of lowering the saving rate on the one hand and increasing the fiscal deficit on the other to maintain primary expenditures. Eventually, these changes have the potential of developing into a spiral of rising fiscal deficits, debt, interest payments, revenue deficits, and back to a higher fiscal deficit. This gives rise to the issue of sustainability of debt.

Fiscal Deficit and Debt: Issues of Sustainability

4.32 Government debt is the outcome of accumulation of borrowing that is used to finance fiscal deficits. If the revenue account is balanced, the entire fiscal deficit would be spent on capital expenditures. Such investment can provide direct as well as indirect returns. The direct returns are in the form of interest receipts or dividends. The indirect returns arise when government investment stimulates growth, which results in higher revenue receipts. Debt becomes a problem when the increase in revenue receipts, whether direct or indirect, is not adequate to cover the interest liabilities that are required to service the debt. When large interest payments, remaining uncovered by an increase in revenue receipts, result in growing revenue deficits, the portion of fiscal deficit that is used for revenue expenditures becomes progressively larger and any revenue increases linked with increased expenditures remain small. Eventually, debt becomes unsustainable.

4.33   While the views of economists differ, the circumstances under which debt, and its increment, i.e. fiscal deficit, become unsustainable have been discussed extensively in the relevant literature. There are three main theoretical perspectives, namely, neo-classical, Ricardian equivalence, and Keynesian. Depending on circumstances and the relevant theoretical perspectives, fiscal deficit may be bad, indifferent, or good. The neo-classical view considers fiscal deficits detrimental to investment and growth, while in the Keynesian paradigm, it constitutes a key policy prescriptive. Under Ricardian equivalence fiscal deficits do not really matter except for smoothening the path of adjustment to expenditure or revenue shocks. While the neo-classical and Ricardian schools focus on the long run, the Keynesian view emphasizes the short run effects.

4.34   In the neoclassical perspective, fiscal deficits will have a detrimental effect on growth if the reduction in government saving, which is equivalent to revenue deficit [8], is not fully offset by a rise in private saving. Besides affecting the overall savings, when there is a net fall in the saving rate, there will be pressure on the interest rate which may crowd out private investment, and therefore adversely affect growth. The neo-classical economists assume that markets clear so that full employment of resources is attained. The Keynesian view argues, particularly when there are unemployed resources, that an increase in autonomous government expenditure, whether investment or consumption, financed by borrowing would cause output to expand through a multiplier process. The traditional Keynesian framework does not distinguish between alternative uses of the fiscal deficit as between government consumption or investment expenditure, nor does it distinguish between alternative sources of financing the fiscal deficit through monetization or external or internal borrowing. Although there is no explicit budget constraint in the analysis by Keynes, subsequent developments that do incorporate the budget constraint show that, as a result, some of the Keynesian conclusions are weakened. In Ricardian equivalence, fiscal deficits are viewed as neutral in terms of their impact on growth. The financing of budgets by deficits amounts only to postponement of taxes. The deficit in any current period is exactly equal to the present value of future taxation that is required to pay off the increment to debt resulting from the deficit. Since government spending must be paid for, whether now or later, the present value of spending must be equal to the present value of tax and non-tax revenues. If household spending decisions are based on the present value of their incomes that takes into account the present value of their future tax liabilities, fiscal deficits would not have an impact on aggregate demand.

4.35   The relevance and applicability of these alternative analytical frameworks depend on the empirical characteristics of a given economy as also the initial conditions. It depends particularly on the saving behavior of the household sector. If consumers are myopic or liquidity constrained, aggregate consumption becomes very sensitive to changes in disposable incomes, and the Keynesian

prescriptions may be more applicable. If individuals are rational, fully informed and motivated by altruistic behavior, Ricardian equivalence may have some validity. In general it has been argued that for short term demand management, Keynesian prescriptions apply and for long term growth, the neo-classical view should be considered relevant. The critical difference in these alternative perspectives comes from how the saving of the private sector is affected by the existence of fiscal deficit of a given order. If fiscal deficits are meant to largely finance revenue deficits, there would be a fall in government savings. To some extent, this fall may be offset by an increase in the private savings as their wealth in terms of holding government bonds increases with an increase in fiscal deficit. The latter effect

is often much smaller than the former effect [10], and there is a fall in the overall saving rate.

4.36   A review of the performance of different sectors in terms of the saving-investment balance provides one approach to determining the levels of permissible fiscal deficit. In India, it is the household sector that has surplus savings that are absorbed by the private corporate and government sector. These surplus savings are their savings in the financial form. Table 4.10 gives a perspective on the surplus saving of the household sector that is available for use in other sectors. The financial savings of the household sector were roughly of the same order since 1993-94, being in the range of 10-11 per cent of GDP with small variations. Comparing

Table 4.10

Sector-wise Balance in Saving and Investment (per cent to GDP)

(per cent points)

Year	Deficit Sectors		Surplus sector	Difference
	Pub sector	Private corporate sector	Saving of house-hold sector in financial assests	Excess of investment over saving
	Ip-Sp	Ic-Sc	Sh-Ih	I-S
Average(1985-86 to 1989-90)	7.72	2.37	7.20	2.33
1990-91	8.23	1.47	8.73	3.20
1991-92	6.85	2.56	9.51	0.52
1992-93	6.97	3.79	8.73	1.85
1993-94	7.61	2.14	11.03	0.56
1994-95	7.05	3.43	11.92	1.17
1995-96	5.63	4.65	8.90	1.75
1996-97	5.36	3.58	10.35	1.30
1997-98	5.28	3.80	9.64	1.46
1998-99	7.57	2.65	10.36	1.05
1999-00	7.98	2.11	10.62	1.14
2000-01	8.61	0.94	10.66	0.61
2001-02	8.58	1.42	11.14	-0.32
2002-03	7.54	1.39	10.30	-0.92

Source (Basic data): National Income Accounts, CSO

the trend since 1995-96, it is apparent that the public sector has been absorbing a larger part of the financial savings of the household sector. The demand for this surplus by the private corporate sector came down from 4.65 per cent of GDP in 1995-96 to 1.4 per cent in 2002-03. That is why there was no pressure on the interest rates in the late nineties. Once the private sector demand picks up, a growth augmenting scenario would emerge only if the government is able to reduce its revenue deficit. Only then would the interest rates also remain benign. Further, if the government is able to eliminate its revenue deficit, and increase its savings and capital expenditures, demand for private investment would be further strengthened. Studies have shown that government investment in infrastructure crowds-in private investment.

4.37   Questions have been raised whether government debt in India has become unsustainable as it has been rising faster than GDP. 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, 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 current government expenditures net of interest payments and pensions.

4.38   Considering that borrowing is often the easier option than raising revenues, attempts are often made to set predetermined targets for borrowing to provide an exogenous benchmark for the policy makers. The Maastricht Treaty, for example, has two convergence conditions for the members of the European Monetary Union:(i) country's overall budget deficit for each fiscal year must be equal to or below 3 per cent of the GDP and (ii) a country's stock of public debt must be equal to or less than 60 per cent of the GDP. In the U.K., a 'golden rule' is being followed since 1997 whereby fiscal deficit is kept equal to government investment. In India, also there have been attempts to tie down fiscal deficits to some target levels. The EFC had suggested a fiscal deficit of 6.5 per cent of GDP as the desirable target to be achieved by 2004-05. The Tenth Plan has envisaged the average size of fiscal deficit as 6.8 per cent of GDP during the plan period. The FRBMA targets for the central government have provided a target for fiscal deficit at 3 per cent of GDP be achieved by 2008-09.

4.39   The targets for revenue and fiscal deficits are essential ingredients of a restructuring program. Like the central government, similar targets would need to be fixed for the states, jointly and individually. These targets need to take into account an underlying growth scenario along with levels of interest rates and other macroeconomic parameters. In fixing such targets, it is useful to take into account the determinants of debt dynamics. In this analysis, growth in the debt-GDP ratio depends on two factors: (a) primary deficit to GDP ratio and (b) the excess of growth over interest rate. If growth rate is equal to interest rate, debt relative to GDP would be the outcome of accumulated primary deficits

only. However, as long as growth rate is higher than interest rate, it absorbs some of primary deficits being translated into higher debt relative to GDP. On the other hand, if interest rate exceeds growth rate, the debt-GDP ratio would increase as a result of both factors. One critical limitation is that the nominal growth rate (g) and the nominal interest rate (i) cannot in reality be taken as exogenous. In particular, increasing levels of fiscal deficit, particularly when these are for investment, can increase the growth rate while high levels of fiscal deficit can put pressure on interest rates, particularly when the household savings in the financial form are not adequate to cover the demand for those savings from the government leaving enough for the private corporate sector. Using the equation of debt dynamics, under certain assumptions, conditions can be derived that stabilize debt and fiscal deficit relative to GDP. It is assumed that the nominal growth rate (g) and the nominal effective interest rate are given and exogenous. The relevant conditions state [11] that:

(a) The debt-GDP ratio will be stabilized at a level b* where b*= p (1+g)/ (g-i).

(b) The fiscal deficit to GDP ratio will be stabilized at f* where f*= p.g/ (g-i).

4.40   Indicating the ratio of revenue receipts to GDP indicated by (r), these conditions could be written equivalently, in terms of the ratio of interest payments to revenue receipts (ip)* instead of primary deficit, as follows [12]:

(a) The debt-GDP ratio will be stabilized at a level b* where

b*= (ip)*r (1+g)/ i.

(b) The fiscal deficit to GDP ratio will be stabilized at f* where f*= (ip)*r.g/ i.

In the case of states, the ratio of revenue receipts to GSDP and that of interest payment to revenue receipts differ widely across states. Revenues accrue to the states also as transfers. It is more useful to cast the debt-sustainability conditions in terms of the ratio of interest payments to revenue receipts although the two sets of conditions are equivalent.

4.41   In the present Indian context, the FRBMA has fixed a fiscal deficit target for the central government at 3 per cent of GDP. Using relations (a and b), which imply [b*=f*(1+g)/g], it is seen that for this level of fiscal deficit and a nominal growth rate of 12 per cent, the debt-GDP ratio will eventually be stabilized at 28 per cent. At present, the centre's debt-GDP ratio is close to 53 per cent, with external debt measured at historical exchange rates, and not taking into account that part of the NSSF liabilities against which there are assets in the form of state securities and also excluding the Market Stabilization Scheme (MSS) liabilities against which an equal amount of cash balance is held. Since the fiscal deficit target is given by the FRBMA, as long there is an excess of growth over interest rate, a primary deficit can be maintained in the stabilization phase. For a combination of 12 per cent nominal growth rate and 7 per cent interest rate, this would be equal to 1.25 per cent of GDP. We think that a combined fiscal deficit target, relative to GDP, of 6 per cent would be consistent with the availability of savings of the household sector in financial assets, which is of the order of 10 per cent,

the desirable level of current account deficit, and the requirements of the corporate sector and the non-departmental public sector undertakings. The transferable savings of the household sector of 10 per cent of GDP combined with an acceptable level of current account deficit of 1.5 per cent would be adequate to provide for a government fiscal deficit of 6 per cent, an absorption by the private corporate sector of 4 per cent, and by non-departmental public enterprises of 1.5 per cent of GDP. When the revenue deficit becomes zero, the entire fiscal deficit would lead to an augmentation of investment with the total investment as percentage of GDP touching a level in the range of 28 to 30 per cent. Of this total, the household sector could invest about 12 per cent of GDP, the private corporate sector, about 8 per cent of GDP, and the public sector, about 8 to 10 per cent of GDP.

4.42   Limiting the combined fiscal deficit at 6 per cent of GDP is also necessary to bring down the ratio of interest payments to revenue receipts from the very high levels of almost 50 per cent in 2002-03 for the centre, 26 per cent for the states, and 37 per cent on their combined account. In the proposed plan for restructuring government finances, these are to be brought down by 2009-10, respectively, to 28 per cent for the centre, 15 per cent for the states, and 22 per cent, on their combined accounts.

4.43   Given the desirability of 6 per cent of GDP as the overall fiscal deficit, as the centre has already fixed a target for its own borrowing at 3 per cent of GDP, a similar level of fiscal deficit for the states considered together can be permitted. Thus, the borrowing of the public sector including the non-departmental enterprises could be

of the order of 7.5 per cent. The corresponding debt-GDP ratio for the combined account is set at 56 per cent, with external debt measured at historical exchange rates, which is close to the actual level of combined debt relative to GDP at the end of 1996-97. Targets for individual states can be determined in terms of the ratio of interest payments to revenue receipts by using the conditions specified in para 40. This is discussed in detail in appendix 4.1.

4.44   It may be noted that there is a difference between stabilizing the debt-GDP ratio at the existing levels and stabilizing them at lower levels consistent with sustainability or desirable debt-GDP ratios derived from some considerations of optimality. In fiscal consolidation, two phases can be distinguished: adjustment phase and stabilization phase. In the adjustment phase, the debt-GDP ratio will steadily fall as primary deficit follows a path of adjustment so that the fiscal deficit target of 6 per cent is achieved. After the debt-GDP ratio has fallen to the desirable levels, primary deficit and fiscal deficit will be stabilized.

4.45   Keeping in view these consi-derations, we recommend that

(i) The overall debt-GDP ratio on the combined account (with external debt measured at historical exchange rates) may be targeted to be brought down to 56 percent of GDP over a period of time. Since the level is estimated to be as high as 81 percent of GDP at the end of 2004-05, it should be brought down to at least 75 per cent by the end of 2009-10.

(ii) The level of combined interest

payments relative to revenue receipts should be brought down from 34 per cent in 2004-05 to 22 per cent in 2009-10, and eventually to about 17 per cent.

(iii) The system of on-lending by the centre to the states should be phased out. The long term goal for the centre and state for the debt-GDP ratio should be 28 per cent each. Their fiscal deficit to GDP ratio targets should be 3 per cent each.

Fiscal Adjustment: 2005-10

4.46   In this section, we discuss the contours of fiscal adjustment up to 2009-10. Clause 3 of the FRBMA provides that the central government shall lay in each financial year before both houses of Parliament, three statements relating to (i) Medium Term Financial Policy Statement (ii) Fiscal Policy Strategy Statement, and (iii) Macroeconomic Framework Statement, which shall contain an assessment regarding (a) growth in GDP (b) fiscal balance of the Union government as reflected in the revenue balance and gross fiscal balance, and (c) external sector balance of the economy as reflected in the current account balance in the balance of payments. The 2004-05 budget estimates the central revenue deficit at 2.5 and fiscal deficit at 4.3 per cent of GDP. As part of the requirement of the FRBMA, one set of forecasts covering the period up to 2006-07 has been presented to both houses of Parliament as part of the medium term fiscal strategy statement. In the meanwhile, the central government appointed a Task Force for the implementation of the FRBMA to draw up the medium term fiscal framework

to achieve the FRBMA objectives. The Task Force forecasts cover the period up to 2008-09 and relate to a base scenario that is premised on the continuance of existing trends and a reform scenario that proposes certain basic changes in the framework of indirect taxation in the country. The central government has given to the Commission its own memorandum and forecasts and also referred the Task Force Reform Scenario forecasts by extending these upto 2009-10.

a. Task Force Forecasts

4.47   The Task Force has come out with a plan of restructuring central finances. This plan also has significant implications for state finances. The salient features of the Report of the Task Force may be summarized as below:

i. Vide article 268A, the power to tax services has been vested in the central government.

ii. The value-added in the case of goods beyond manufacturing is in the nature of trade arising from wholesaling or retailing, which can be considered as a service. The centre is therefore entitled to tax this value added.

iii. States are not entitled to tax services as the subject is in the Union list. However, under article 268 A the taxation of services can be assigned fully or partially to the states.

iv. A 'grand bargain' can then be proposed to the states whereby they may agree to participate in a national Goods and Services Tax (GST), which can be levied at the rate of 20

per cent, of which the centre will levy 12 per cent and states can levy 8 per cent.

4.48   As per the estimates provided by the Task Force, these changes will have significant revenue implications. The base scenario assumes a buoyancy of 1.87 for direct taxes and 0.74 for indirect taxes, which include taxation of services under the present laws. These result in considerable improvement in the ratio of centre's gross tax revenues to GDP, which rises from 9.2 per cent of GDP in 2003-04 to 10.7 in 2008-09, showing an improvement of 1.5 percentage points. Even after this margin of improvement, the FRBMA target is not met, with revenue deficit at 1.66 per cent of GDP in 2008-09. In the reform scenario also, the core adjustment comes from a substantial improvement in the ratio of gross tax revenues of the centre to GDP taking it above 13 percent in 2008-09. In relation to Task Force's recommendation of GST under a 'grand bargain', several issues have been raised in the related discussions.

   i.   The legal status of centre's power to tax value added of goods interpreting as services has been questioned. It is a matter that can lead to legal issues, once the actual legislation is made and notified.

   ii.   The 12: 8 ratio of in favor of the centre can increase the vertical imbalance in the system, particularly because stamp fees, registration duties and sales tax on works contracts will be merged under the GST. The states will also lose the autonomy to fix rates, which is the essence having autonomy over tax bases.

   iii.   Aspects of inter-state taxation of services raise additional problems. Some have argued for the need for a negative list of taxes that have an inter-state character. The proposal of a clearing house mechanism to address issues of inter-state taxation and settlement of rebate claims and counter claims may run into a variety of practical problems.

   iv.   Inefficiencies will increase, if decisions to spend are totally divorced from decisions to tax.

   v.   The status of divisibility of the tax on services will remain open-ended as these will not be subject to sharing under article 270, and therefore, under the recommendations of the finance commission.

4.49   In our view, the proposal of a comprehensive GST is an attractive one, and should be pursued. However, the relevant legal and administrative aspects should be extensively discussed, particularly with the states. The implementation of a state-level VAT would facilitate its introduction in due course. However, even without this radical change, it should be possible to raise the tax-GDP ratio adequately. It may be noted that the central budget for 2004-05 is predicated on the gross central tax revenue to GDP ratio rising by 1 percentage point in one year.

b. Statements under FRBMA

4.50   A Macro Economic Framework Statement providing an overview of the economy and that of the central finances was presented for the first time to Parliament along with the 2004-05 budget. The Medium Term Fiscal Policy Statement gives

rolling targets until 2006-07. It projects tax revenues based on the assumption of average annual growth rate of 12 per cent in GDP in nominal terms. Under this assumption, gross tax revenues of the centre is expected to grow by an average 22 per cent per annum based on an average annual growth of 26 per cent in direct taxes and 19 per cent in indirect taxes. The implied buoyancy for direct taxes therefore is equal to 2.15 and that of indirect taxes is equal to 1.58. The tax revenues as proportion of GDP are targeted to increase from 10.2 per cent in BE 2004-05 to 11.1 per cent in 2005-06. It is argued that since 1991, reforms have sought to reduce tax rates, simplify procedures, reduce litigation, cast the tax net wider and generally increase voluntary compliance. The Fiscal Policy Strategy Statement (FPSS) notes that the financing of fiscal deficit is now almost entirely domestic. It also notes that there are some discernible moderation in growth of public expenditure. It speaks of restructuring of subsidies so that benefits are usurped by those not intended to be the beneficiaries of these subsidies. The FPSS conveys the commitment of the government to gradually move towards integrated taxation of goods and services and bring down custom tariff to levels prevailing in ASEAN countries.

c. Fiscal Adjustment

4.51   In considering a plan for restructuring, generally a base scenario is constructed, which reflects the likely outcomes on the assumption that prevailing fiscal trends would continue in future. In comparison, the reform scenario presents a path of corrections. In our analysis, as a result of the FRBMA, and also following from our own recommendations, the

existing trends cannot continue. As such there would no relevance in drawing up a base scenario. Instead, we will focus on a core reform scenario and consider alternative paths of adjustments around this reform scenario. Table 4.11 indicates the salient differences in the macroeconomic scenario before and during the period 2005-10. The fiscal deficit is to be reduced to 6 per cent on the combined account of the centre and the states, and revenue deficit is to be reduced to zero. This enables increase in the aggregate saving rate as well as an increase in government capital expenditure as percentage of GDP. In consequence, as the aggregate investment rate increases, growth is stabilized at above 7 per cent. It is assumed that, at the margin, nominal interest rates will remain at the present levels, which would imply a continuing fall in the average interest rate for the centre and the states. As fiscal deficits are reduced and inflation is kept under control, there will be no pressure on the interest rate to rise.

Table 4.11

Macro Economic Scenario: Current and Forecast Period

(per cent to GDP)

	2004-05 (estimates)	2009-10 (projections)
GDP Growth (constant prices) (per cent p.a.)	6.5	7.0
Inflation Rate (per cent p.a.)	6.0	5.0
Saving Rate	24.0	26.0
Investment Rate	24.5	27.5
Current Account Deficit	-0.5	1.5
Fiscal Deficit	8.9	6.0
Revenue Deficit	4.5	0.0
Government Capital Expenditure	5.6	6.6

4.52   The plan for restructuring relies both on augmenting revenues and restructuring expenditures. The main elements in this

programme are increases in the tax revenues and capital expenditures relative to GDP while attaining targeted reductions in revenue and fiscal deficits both for the centre and the states. Table 4.12 shows, for the combined revenue account of the central and state governments that more than 60 per cent of the adjustment comes from the revenue side. The quantum of increase in the tax-GDP ratio is stipulated to be 2.0 percentage points. The increase in the overall revenue to GDP ratio is close to 3.0 percentage points. On the expenditure side, the fall in combined revenue expenditure to GDP ratio is 1.7 percentage points. Even though total expenditure falls, primary expenditure increases as capital expenditure relative to GDP increases by about 1 percentage point. As revenue deficit is eliminated, the entire fiscal deficit supplemented by non-debt receipts in the form of loan recoveries and disinvestment proceeds can be used for capital expenditures. Since the targeted combined fiscal deficit is 6 per cent, capital expenditure would be higher than 6 per cent of GDP. We have provided a small amount as disinvestment proceeds. We expect that the actual amounts would be larger, and accordingly capital expenditure could be higher than what is stipulated.

4.53 Our plan of debt restructuring involves consolidation of the debt of the states to the centre, to be repaid in a specified number of years. It is also suggested that the central government should progressively reduce its intermediation in state borrowing. Where it is essential, as in the case of external assistance, it should be done through a public account. If on-lending to states remains part of centre's fiscal deficit, the 3 per cent fiscal deficit target would prove to be too narrow. As centre stops on-lending to states, the repayments made by the states become available to the centre to meet its capital expenditure targets. States

Table 4.12

Summary of Suggested Restructuring: Combined Finances

Combined Finances	2004-05	2009-10	Adjustment 2009-10 minus 2004-05	Average Adjustment per year
Tax Revenue	15.6	17.6	2.0	0.40
Non tax Revenues	2.5	3.4	0.9	0.18
Total Revenue Receipts	18.1	21.0	2.9	0.58
Interest Payment	6.1	4.5	-1.6	-0.31
Total Revenue Expenditure	22.6	21.0	-1.7	-0.33
Capital Expenditure	5.6	6.6	1.0	0.20
Total Expenditure	28.3	27.6	-0.7	-0.13
Primary Expenditure	22.2	23.1	0.9	0.18
Revenue Deficit	4.5	0.0	-4.5	-0.90
Fiscal Deficit	8.9	6.0	-2.9	-0.57
Primary Deficit	2.8	1.5	-1.3	-0.26
Int. Payment/ Rev. Receipts	33.7	21.6	-12.1	-2.42
Outstanding Liabilities	80.8	74.5	-6.3	-1.26

should be allowed to borrow the repayment amount from the market in addition to its net borrowing requirement according to the stipulated path of fiscal deficit in the plan for restructuring state finances.

4.54   Table 4.13 provides a summary of suggested restructuring separately for the central and state finances. In respect of tax revenues, both central and state taxes show improved tax-GDP ratios in 2009-10, the

Table 4.13

Summary of Suggested Restructuring of Central and State Finances

	2004-05	2009-10	Adjustment 2009-10 minus 2004-05	Average Adjustment per year
Central Finances				
Gross Tax Revenues	9.7	10.9	1.2	0.24
Tax Revenue(Net to centre)	7.2	7.9	0.8	0.16
Non Tax Revenues	2.2	2.2	0.0	0.01
Total Revenue Receipts	9.4	10.2	0.8	0.17
Interest Payment	4.2	2.8	-1.3	-0.26
Total Revenue Expenditure	11.9	10.2	-1.7	-0.33
Capital Expenditure	3.0	3.5	0.5	0.10
Total Expenditure	14.8	13.7	-1.2	-0.23
Primary Expenditure	10.7	10.8	0.2	0.03
Revenue Deficit	2.5	0.0	-2.5	-0.50
Fiscal Deficit	4.5	3.0	-1.5	-0.29
Primary Deficit	0.3	0.2	-0.2	-0.03
Int. Payment/ Rev. Receipts	44.5	28.0	-16.6	-3.32
Debt(end-year adj liabilities)	53.0	43.7	-9.3	-1.86
State Finances				
States' Own Tax Revenues	5.9	6.8	0.8	0.17
Tax Revenues	8.4	9.7	1.3	0.25
Own Non-tax Revenues	1.2	1.4	0.2	0.03
Non Tax Revenues	3.2	3.5	0.3	0.07
Total Revenue Receipts	11.6	13.2	1.6	0.32
Interest Payment	2.9	2.0	-0.9	-0.18
Total Revenue Expenditure	13.6	13.2	-0.4	-0.08
Capital Expenditure	2.6	3.1	0.5	0.10
Total Expenditure	16.2	16.3	0.1	0.01
Primary Expenditure	13.3	14.3	1.0	0.20
Revenue Deficit	2.0	0.0	-2.0	-0.40
Fiscal Deficit	4.5	3.0	-1.5	-0.30
Primary Deficit	1.6	1.0	-0.6	-0.12
Int. Payment/ Rev. Receipts	24.9	15.0	-10.0	-1.99
Debt(end-year adj liabilities)	30.3	30.8	0.6	0.11
Memo:				
States' interest payments to centre	0.9	0.3	-0.7	-0.13

Note: **Combined non-tax revenues are defined as centre's non tax revenue plus states' own non-tax revenue minus interest payments from states to centre.**

margin of improvement being larger for the centre. On the expenditure side, in both cases, capital expenditure increases and interest payments fall as percentage of GDP. In both cases, the fiscal deficit targets have been kept at 3 per cent of GDP, with centre's on-lending to states being minimized or discontinued altogether. Where it is unavoidable, it should be done through a public account rather than through the consolidated fund of India. We discuss below the various dimensions of the proposed restructuring.

Dimensions of Restructuring

4.55   We recommend a multi-dimensional restructuring of government finances aimed at both the qualitative and quantitative aspects of managing government finances. In particular, the proposed restructuring covers the following areas:

i. Taxation reforms aimed at building up non-distortionary and revenue-elastic system of taxation with tax rates that are low, limited in number of rate categories, and stable;

ii. Non-tax revenues where user charges, as a short term objective, ensure recoveries of current costs, and aim at full recovery of costs measured at acceptable efficiency levels in the longer run, in the case of services where there is no clear cut case for subsidization and ensure rates of return on investment that covers the average cost of borrowing;

iii. Expenditure restructuring relating to both its size and sectoral allocations aimed at removing inefficiencies

arising from misallocations, design and implementation of schemes, and delivery of services;

iv. Rationalizing subsidies by reducing their overall volume, increasing their transparency by making them explicit, and improving their targeting;

v. Public sector restructuring where, apart from natural monopolies and strategic reasons, there is a strong case for reducing government's involvement;

vi. Fiscal transfer system where equalizing transfers are given much greater weight and extended to local bodies;

vii. Suggesting a reformed role for the plan process;

viii. Strengthening the role of local bodies to become a more effective instrument in the delivery of local public goods;

ix. Role of the central government in intermediating loans for the states including the need to specify annual ceiling of borrowing for each state and implementing a hard-budget constraint; and,

x. Suggesting institutional frameworks including ceiling on debt and deficits and mechanisms for their monitoring through state level fiscal responsibility legislation.

Revenue Restructuring

4.56   In considering revenue restructuring, we recognize that the fall in the tax-GDP ratio of central commodity taxes has been

only partially mitigated by the rise in the central direct taxes. This has adversely affected the finances of both central and state governments. However, some of these changes might have been efficiency-augmenting by reducing cascading of taxes. Large tax bases and low rates, limited rate categories, absence of tax cascading, minimum exemptions, and absence of tax barriers in inter-state trade would characterize a desirable system of taxation of goods and services. Such a system should also be harmonized across states so that competitive reduction of tax rates can be avoided. Where tax related decisions of the central government affect the tax bases of the state governments and vice versa, such as in the case of sales tax and Union excise duties, there is need for vertical coordination in using common tax fields. Implementation of state level value added tax (VAT) and removal of tax-related barriers to an integrated country-wide market like the central sales tax would therefore strengthen the efficiency effects of tax reforms.

4.57   States initiated tax reforms somewhat later than the centre. In particular, they reduced the rate categories in the case of sales taxes, reduced exemptions, and introduced floor rates. There were tangible revenue benefits after these changes. Efforts have been underway for some time now under the guidance of the empowered committee of the state finance ministers to facilitate the implementation of state level VAT. In his speech introducing the 2004-05 budget, the Union Finance Minister made reference to 'broad consensus among the states to implement VAT' and that 'April 1, 2005 has been set as the date for implementation'. If the state level VAT is

implemented from this date, this would further reduce distortions due to cascading. We recommend that the tax rental arrangement regarding the additional excise duty items, viz., textiles, tobacco and sugar should be formally revoked and these items should be integrated into the overall design of state VAT. Any ceiling of 4 per cent should not be there, and in fact the relevance of the entire mechanism of declared goods should be reexamined. Taxation of services has, however, remained fragmented and piecemeal. If state level VAT is implemented by the states, the question as to how state tax revenues would be affected individually and in the aggregate becomes important, particularly so, as the beginning of the changed system coincides with the recommendation period of this Commission. With the objective of formulating a view on the likely impact of the State-VAT on revenues, we had commissioned two studies [13], one related directly to the revenue-impact of VAT, and the other on the revenue potential of tax reforms at the state level, which takes into account the interdependence of the state and central tax revenues. These studies have affirmed that, properly designed, the state level VAT should prove to be revenue augmenting over the medium to long term. If there are any losses, these are likely to be transitory. The implementation of state level VAT would be facilitated, and its revenue performance improved, if a centralized institutional mechanism for compilation and exchange of information relevant to production, consumption, and dealer-wise flow of goods and services within and across states, is established. We understand that the central government is examining a suitable mechanism by which the states can be

compensated for such transitory losses. It may be mentioned that for augmenting revenues, most commodities should be placed under the proposed core rate of 12 per cent. The states may be given the option to use a higher rate, if desired. A very small number of goods, under well enunciated principles, should be put under the proposed lower rate category of 4 per cent. The central sales tax should be quickly phased out.

4.58   In our restructuring plan, the tax-GDP ratio goes up by 2 percentage points with both centre and states contributing to it. For the states, the adoption of the VAT is likely to be revenue-augmenting in the medium to long term. If there is a fall in revenues for some states, it is likely to be small and temporary. We consider that this change would add to growth and shift resources to some extent towards the consuming states. These changes thus will have both vertical and horizontal benefits. The vertical benefit would be due to augmentation of the tax base as distortion related inefficiencies are reduced. The horizontal benefit will accrue from the fact that consuming states will gain more in relative terms. It is important to resolve the issue of taxation of services following the 88th amendment to the Constitution. Since the service tax has been put under article 268A, the sharing of its revenues with the states will be taken out of the purview of the finance commission. This may not have been the best among possible options for dealing with this subject. As matters stand, the centre can assign certain services to the states for collecting and retaining the revenues, but the tax will be levied by the centre. As already indicated earlier, it is necessary to ensure that the revenue

accruing to the states, under the new arrangement should not be less than the share that would accrue to the states, had the entire service tax proceeds been part of the shareable pool. We have made this assumption in the proposed scheme of tax devolution.

Non Tax Revenues

4.59   Non tax revenues consist of a heterogeneous mix of sources encompassing interest receipts on loans given by the governments, dividends on equity investment, and user charges and tariffs for services provided by the governments. Non-tax revenues have remained stagnant relative to GDP contributing around 3 per cent of GDP in the combined revenues of the centre and states. In the context of goods and services that are private in nature, the principle of cost recovery should apply, and where costs are not meant to be recovered fully, explicit subsidies should be provided. The management of government finances in such a way would impart the necessary transparency and improve the efficacy of fiscal intervention. In the context of interest receipts and dividends, the issue is linked to the reform of public enterprises, and the question of user charges is linked to subsidies. Where royalties are payable, these should be on ad valorem basis. Our restructuring plan proposes a tangible increase in the non-tax revenues relative to GDP.

Expenditure Restructuring

4.60   In restructuring expenditures, there is need to make reference to the basic objectives of government intervention in economic activities, as also to the basic objectives for assignment of responsibilities

as between central and sub-national governments. It is also important to relate government expenditures to outcomes in terms of the quality, reach, and impact of government services. This would be facilitated if governments focus more on their primary responsibilities rather than spreading resources thinly in many areas where the private sector can provide the necessary services. The primary role of government is to provide public goods like defence, law and order, and general administration. This represents one kind of market failure. The role of governments extends to merit goods and services with large positive externalities like education and health. The services should be assigned to the central government if the scope of public goods is nation-wide like defence. The services get assigned to state governments if the scope of the public good is limited to regions or if externalities are more local in character like the health services. Admittedly there may be many examples of benefit spillovers, some of which can be internalized to the state level decision makers by a suitable scheme of grants. There is a felt need to examine whether the central government is not partaking in many responsibilities that legitimately belong to the domain of the states. Governments at both levels have also stepped into the provision of many private goods, which adversely affects the quantum and quality of service in regard to public and merit goods. Two key elements of restructuring government expenditures relate to augmentation of capital expenditure relative to GDP, focused on infrastructure and a reduction of central government's expenditures on subjects listed as state responsibilities.

From Expenditures to Outcomes

4.61   The conventional budget exercises have focused on allocation of resources to different heads, without taking into account how these government expenditures get translated into outputs and outcomes. Outputs are the direct result of government expenditure and outcomes are the final results. Thus, in the context of education, opening a new school or appointing a new teacher is an output and reduction in the rate of illiteracy is an outcome. Issues of efficiency require consideration whether the same outcome can be achieved at lower costs and whether the same costs can produce better outcomes. A critical part of budgetary reforms must include information on the relationship between expenditures and the corresponding performance in producing real results as in determining the size of the budget and its allocation among different heads. Although in the past there have been attempts at introducing performance budgeting, such endeavors have receded in importance. There is need to bring back performance budgeting as an integral part of the preparation and evaluation of budgets, both for the centre and the states. Thus, the management of public expenditures should be guided by economy, efficiency, and effectiveness.

Subsidies

4.62   Budgetary subsidies can be explicit or implicit. When subsidies are explicitly stated in the budget it adds to transparency in expenditure management. According to the Discussion Paper brought out by the Ministry of Finance in 1997, there are many hidden subsidies in the budget. These arise because the costs of providing these are not

recovered from the users or beneficiaries. In the case of merit goods like education and health, subsidization may be desirable. But the desired extent of subsidization should be clearly worked out. Various studies [14] have highlighted that government subsidies, measured as un-recovered costs in the public provision of private goods, are large in volume, amounting to 13 to 14 per cent of GDP. In many instances, subsidies promote or subsidize inefficiencies. Subsidies are often wasted as these do not reach the intended beneficiary. The Discussion Paper brought out by the Ministry of Finance in 1997 did highlight many of these problems and suggested a course for subsidy reforms that included reducing their volume, eliminating input-based subsidies, making these subsidies explicit, and improving their targeting. The Expenditure Reforms Commission also examined food and fertilizer subsidies at length and suggested an agenda of reforms. Some changes were introduced in the regime of subsidization of fertilizers. In spite of these efforts, the volume of subsidies in the central budget has remained large. It accounted for about 18 per cent of centre's gross revenue receipts in 2002-03. Some of the earlier commitments for reducing subsidies, particularly in areas of fertilizers and petroleum, should not be diluted. The centre should draw up a programme for containing the growth in subsidies. In the case of states, a large part of the subsidization process remains hidden as cost of services keep increasing, while recoveries as proportion of costs become less and less. There is a clear need to link user charges with costs. The determination of user charges for a variety of private services provided by the

governments should be supervised by an autonomous regulatory commission, which can protect both the interests of the consumer and the revenues of the government.

Government Salaries

4.63   Many states have represented to the Commission that salaries and allowances have tended to converge with those of the central government and that they find it difficult to implement a salary structure that is different from that of the centre. The problems have become acute for some states as the share of salaries in their total expenditure is very large. The initial conditions for the states differ because in the past their salary scales were different from the centre and they also followed different recruitment policies. If salary structures across the states are allowed to converge, the number of employees in a state also needs to follow some comparable norms in relation to the size of population, fiscal capacity, and other relevant considerations. The per employee salary expenditure may still differ because of the composition of the workforce. Normalization can be done in respect of the total salary bill relative to their fiscal capacities. The salary burden is already heavy and at the minimum, the ratio of salaries to revenue expenditure net of interest payments and pensions must not be allowed to increase. It should be progressively brought down to levels prevalent in 1996-97. Appendix 4.2 provides a discussion of the relative profile of employment and salary bills of the government. It can be seen that expenditure on salaries relative to revenue expenditure excluding interest payments and pensions

has gone up from 35 per cent in 1996-97 to 42 per cent in 1999-00. The EFC had recommended that there is no need to appoint Pay Commissions as a routine at the interval of 10 years. It also recommended that states should be consulted while appointing a new Pay Commission. We agree with these recommendations.

Pension Reforms

4.64 Pension payments constitute an important component of committed expenditures in the central and state budgets. The central government has taken steps for pension reforms, particularly in respect of new appointments. A defined contribution pension scheme was introduced by the central government with effect from January 1, 2004 for central government employees recruited on or after that date, (except armed forces, in the first stage) replacing the existing defined benefit pension system. The central government has also initiated the process for bringing out legislation for the appointment of an independent pension regulatory authority, which can ensure proper investment of pension funds. The pension fund regulator will have the responsibility of regulating, promoting and ensuring the orderly growth of the pension funds. The pension liabilities in the case of the states account for a larger share of its revenue receipts. This share may increase further in view of the increasing longevity and the number of appointments in the late sixties and early seventies, when the size of state governments was expanding. State governments need to take up initiatives similar to those of the central government for pension reforms. This would also be facilitated by the appointment of a regulator.

From Unproductive to Productive Capital Expenditure

4.65 In the proposed restructuring plan, the level of capital expenditure, on the combined account of the centre and the states relative to GDP, is set to rise to about 7 per cent of GDP by 2009-10. We have indicated that this capital expenditure is meant for administrative departments and departmental enterprises. Separate borrowing limits have been prescribed for non-departmental enterprises. The increase in capital expenditure is for augmenting investment and building physical assets for the various publically provided services aimed at promoting growth and improving the quality of services provided by the central and state governments. It is not meant for covering losses of non-departmental public enterprises, by contributing to their share capital, or for servicing debt arising from off-budget borrowing.

Restructuring the System of Fiscal Transfers

4.66 Fiscal transfers from the centre to the states take place through finance commission, Planning Commission, and the central ministries. The over all system of fiscal transfers suffers from many inadequacies and deficiencies, which arise due to segmentation of transfers as well as within each segment of the transfers. We suggest a scheme of reforms that can be implemented over a period of time in respect of the different channels of transfers.

a. Finance Commission Transfers

4.67 The system of transfers should be guided by equalization, which is consistent

with equity as well as efficiency. To some extent the exercise of using a normative approach is constrained by information lags. The data on population pertains to 1971. By the time the recommendation period of this Commission is over, it will be out of date by nearly 39 years. Even the data on GSDP, which serves as indicator of revenue base, will be dated by about 8 years by 2009-10. In a context where disparities are increasing, the transfers system could become regressive by the time actual transfers take place even when transfers are designed to be progressive under an equalization approach with respect to data used. It is difficult to see the relevance of 1971 population census data when population of all states was about 54 crore, when 2001 census puts the population of all states at more than 100 crore. This is out-of date by nearly 100 per cent. We recognize that the implicit objective is to penalize states, which have done less well in comparative terms in controlling population growth. But population growth is the outcome of the birth rate, the death rate, and net migration. It would be better to state the objective in the TOR and leave the principle by which it is implemented in the transfer mechanism for the finance commission to decide. The information lag problems would be finally overcome when the finance commission determines the formula and the weights of transfers, which holds for 5 years, but actual shares are updated every year by application of the most recent data. This is the method of 5-yearly review and annual updates followed in Australia. The major concerns relating to finance commission transfers have been discussed in detail in the earlier chapter.

b. Planning Commission Transfers

4.68   In the case of plan assistance, the proportion between grants and loans at 30:70 for the general category states and 10:90 for the special category states has a counterpart in the interest rate charged by the central government on the plan loans to the states, which has been, in the past, sometimes, 300 to 400 basis points higher than the cost of funds to the centre. In other words, plan grants are not really interest-free grants. Over the time, these are recovered back in the form of higher interest receipts. Plan grants should be given as genuine grants and states may be encouraged to borrow from the market directly. Such a change would require delinking of grants from loans in plan assistance. This would facilitate determination of grants according to needs and loans according to capacities. The plan size of each state needs to take into account the sustainable level of debt and the capacity to borrow from the market.

4.69   A restructuring plan must include reforms relating to the planning process. Part of the distortion in the structure of expenditure derives from the distinction between plan and non-plan expenditures. It is inefficient to show preference for creating new assets or undertaking new schemes being part of the plan, while sacrificing maintenance of already created assets. As a result, there remain many incomplete projects/schemes not yielding services on one side, and ill-maintained and fast depreciating assets, on the other. Over the time, plans have become more scheme-oriented rather than project-oriented, so that assets that could provide returns to service the debt that was used to finance plan expenditures are neither being created nor

maintained.

4.70   In the case of centrally sponsored schemes also there should only be the grant element and no loans linked to grant. A state should be given its total entitlement of grants and allowed to select its own mix of centrally sponsored (CS) schemes floated by different ministries, within the limit of the total grant. The CS schemes would then start competing among themselves and pressure would come on the ministries to design schemes that are in demand. This would do away with the present supply-driven approach where schemes are characterized by large numbers, duplication, and lack of monitoring. The CS schemes have been the subject of study by many committees. The general consensus has been towards reducing their number, but the follow-up action has been weak.

Restructuring Debt

4.71   In 2002-03, the central government brought out a debt-swap scheme to facilitate the state governments to swap their high cost debt owed to government of India with additional market borrowings and a part of current small saving transfers. During 2002-03, the state governments swapped Rs. 13766 crore with 20 per cent of small saving share and additional market borrowings. During 2003-04, according to provisional data, loans amounting to Rs. 46211 crore have been swapped with 30 per cent of small saving transfers and additional market borrowings. The central government has used the receipts under the debt-swap scheme to repay its liabilities to the National Small Savings Fund (NSSF). This has the effect of bringing down centre's overall debt as well as its effective interest rate. During

2004-05, additional debt swap amounting to Rs. 43887 crore has been envisaged.

4.72   The total liabilities of the government of India according to receipts budget of 2004-05 are shown as Rs.1985866 crore. These include liabilities in the public account of NSSF against loans to the state governments and Rs. 60000 crore worth of market stabilization scheme (MSS). The MSS funds are not available to the government for current expenditures and are held as cash with RBI. Against the lending to the states from the NSSF, states have issued special securities. Adjusting for these two amounts from the asset side, the outstanding liabilities of the central government at the end 2004-05 are estimated to be about 53 per cent of GDP. There has been a fall in centre's liabilities relative to GDP because of the redemption of special securities issued to the NSSF based on the debt-swap programme for the states.

4.73   At the same time, the central government should phase out its intermediation in borrowing by the states. Where necessary, this should be managed through a public account. However, there is a need to determine borrowing limits for each state taking into account borrowing from all sources including small savings and states public accounts and reserve funds. The prescribed borrowing limit on states' aggregate fiscal deficit in our restructuring plan is 3 per cent. In their case also, revenue deficits should be brought to zero by 2008-09. Once stabilized, these deficit rules should be taken to apply over the medium term with some changes to take into account the cyclical pattern.

4.74   Our suggested debt restructuring

programme for the states as detailed in chapter 12 will have two components: a consolidation of all state debt to the centre outstanding at the end of 2004-05 at an interest rate of 7.5 per cent to be repaid in 20 years, and a debt relief scheme linked to achievement in reducing revenue deficits. We are proposing that as a precondition for availing the benefit of the scheme, all states should enact a fiscal responsibility legislation, that provides for eliminating revenue deficit in the respective states no later than 2008-09, incorporates annual targets for reduction of fiscal and revenue deficits, and presents to the respective legislatures a consolidated growth and fiscal strategy statement along with their budgets. As the states are increasingly exposed to the markets for borrowing, their fiscal positions would be increasingly assessed by the markets. They may be forced to pay higher than average interest rates to cover additional risk if the public finances are not evaluated to be robust by the assessment of the market. We are relying therefore on two mechanisms for fiscal correction: self evaluation under the Fiscal Responsibility Act and exposure to market. These in our view may prove to be effective instruments of fiscal discipline without compromising the autonomy of the states.

Public Sector Reforms

4.75   As pointed out by the Eleventh Finance Commission, large amounts of capital is locked up in the public sector showing extremely low returns in relation to the average cost of funds to the government. As per available information, 109 central public sector companies were running in losses. The problem is particularly acute in the case of the states.

Out of 1003 state level public enterprises (SLPEs), 599 SLPEs are reported to be either non-functioning or running into losses. Not only the returns on government investment are non-existent or low, but also a large number of SLPEs fail to finalize their accounts. The total amount of investment in respect of the SLPEs, where accounts were finalized, was estimated to be Rs. 2,38,220 crore at the end of 2000-01. Many states have, however, taken steps for closing down many of the SLPEs and for disinvestment in others. This process should be further strengthened. In the period of restructuring, that is 2005-10, state governments should draw up a programme that includes closure of almost all loss making SLPEs. Reforms of state electricity boards and transport enterprises are being taken up separately. By the end of 2009-10, states should have a small but viable set of SLPEs.

Fiscal Frameworks for Reforms

4.76   In the nineties many countries around the world were able to achieve fiscal consolidation, attaining primary surpluses. Widespread reforms including debt ceilings and deficit targets have strengthened fiscal frameworks. Expenditure rules and transparency in the fiscal management has also been emphasized in these fiscal frameworks. Evaluations of these fiscal consolidation efforts [15] have identified certain factors that account for reliable and durable adjustments. Accordingly, fiscal consolidation is more likely to be successful when based on cuts in expenditure, particularly when undertaken by countries with high levels of debt. Widespread reforms in fiscal frameworks require institutional reforms aimed at achieving and

maintaining fiscal consolidation, while leaving room for fiscal policy to respond to business cycles through automatic stabilizers and policy actions.

4.77   Recent institutional reforms can be classified into three broad groups: formal deficit and debt rules, expenditure limits, and transparency.   The main examples of this approach are European countries bound by the Maastricht Treaty as supplemented by the Stability and Growth Pact. The U K since 1997 has operated a Golden Rule whereby borrowing is done only to finance capital spending and the limit on net debt is 40 per cent of GDP over a cycle.   Several countries have deficit and debt rules at the sub national level. In the US, all but two states have laws requiring balanced budgets and limiting the   states to raise debt. Nine provinces and territories of Canada have fiscal rules with balanced budgets requiring them to take on debt only for the purpose of financing investment projects. Canada has also focused on instituting a rigorous expenditure review process. Debt ceiling can serve as a useful adjunct to deficit rules. In practice debt ceilings have been driven not by calculations based on theory, but run by the concern about reducing high debt levels and are thus generally chosen on the basis of the experience of the individual countries. The main criticism of the deficit rules in general and balanced budget rules in particular is that they are invariant and therefore tend to be pro-cyclical. This is a more important consideration for national governments as compared to sub national governments. For this reason the deficit rules in the national government have increasingly been defined in terms of a cyclically adjusted deficit measures or as an average over the economic cycle. Thus

these rules allow the operation of domestic stabilizers and to some extent also provide room for discretionary policy within the cycle.

4.78   Transparency in fiscal management has been emphasized by countries like New Zealand, Australia and the U K. The key elements in this approach are an explicit legal basis, elaboration of guiding principles of fiscal policy, requirement that objectives are clearly stated, emphasis on the need for a long term focus to fiscal policy, and fiscal reporting to the public. The UK, US, and New Zealand have enacted legislations for transparency which require statements providing the objectives for deficits and debt. The US places relatively greater emphasis on expenditure and deficit rules. Expenditure rules typically emphasize ceilings on specific areas of expenditure like discretionary expenditure as opposed to non discretionary expenditure and in some cases with respect to particular programmes. Thus, three structural changes can help restore the fiscal health in India, namely, (i) legislative enactments that can restrict fiscal imprudence and set targets such as those relating to fiscal and revenue deficits, debt, and rules for expenditure cuts contingent on specified conditions, (ii) transparency requirements in fiscal management, which help a better understanding of the fiscal health of a government by its citizens and their representatives, and (iii) exposure to market discipline, particularly in raising debt.

Summary

4.79   Our approach to restructuring requires determined and coordinated effort by the central and state governments. It

emphasizes fiscal corrections in a macroeconomic framework with a medium term perspective. It endorses the view that most of the changes in taxation and fiscal framework should be completed by 2005-06, and course corrections should be undertaken on the basis of quarterly and annual reviews. The core strategy of fiscal restructuring, recommended by us, centers on raising the trend rate of growth. This can be done by enhancing the savings ratio, which requires large reduction of government dis-savings. This, in turn, requires elimination of revenue deficit at both levels of government. However, we recommend increase in government investment aimed at infrastructure. The specific suggestions made by us are summarized below.

  i. The suggested reform strategy has to aim for strengthening growth by increasing public sector saving and government's capital expenditures relative to GDP. This would require reducing the share of revenue deficit in fiscal deficit, which itself should fall.

 ii. The macroeconomic scenario that serves as the framework for fiscal corrections is characterized by 7 per cent real growth on average and 5 per cent inflation rate.

iii. Fiscal correction requires increasing, by 2009-10, the combined tax-GDP ratio to 17.6 per cent, primary expenditure to a level of 22 per cent of GDP, and capital expenditure to nearly 7 per cent of GDP.

 iv. In the context of debt and fiscal deficit, keeping in view the FRBMA

targets and the related sustainability requirements, we consider that:

  (a) With a combined fiscal deficit of 6 per cent of GDP and a nominal growth rate of 12 per cent per annum, the system will converge to a combined debt-GDP ratio of 56 percent. The present level is as estimated to be as high as 81 percent of GDP, with external debt measured at historical exchange rates. This should, at a minimum, be brought down to 75 per cent by the end of 2009-10.

  (b) With the system of on-lending being brought to an end over time, the long term goal for the centre and state for the debt-GDP should be 28 per cent each. Their fiscal deficit to GDP ratio targets may be fixed at 3 per cent of GDP each. In both cases, revenue deficit should be eliminated by 2008-09.

  (c) Under the assumptions of revenue to GDP ratios, eventually the centre's interest payment relative to revenue receipts would reach about 28 per cent by 2009-10. In the case of states, the level of interest payments relative to revenue receipts would fall to about 15 per cent by 2009-10.

 v. As part of the proposed fiscal adjustment, revenue deficit relative to GDP for the centre and the states, for their combined as well as individual accounts should be

brought down to zero by 2008-09. This is already provided in the centre's FRBMA.

vi. States should follow a recruitment and wage policy, in a manner such that the total salary bill relative to revenue expenditure net of interest payments and pensions does not exceed 35 per cent.

vii. We recommend that each state should enact fiscal responsibility legislation. This has been stipulated as a precondition for availing the debt-relief scheme as recommended by us in a later Chapter. This legislation should, at a minimum, provide for

  (a) eliminating revenue deficit by 2008-09;

  (b) reducing fiscal deficit to 3 per cent of GSDP or its equivalent

defined as ratio of interest payment to revenue receipts;

  (c) bringing out annual reduction targets of revenue and fiscal deficits;

  (d) bringing out annual statement giving prospects for the state economy and related fiscal strategy;

  (e) bringing out special statements along with the budget giving in detail number of employees in government, public sector, and aided institutions and related salaries.

Endnotes

[1] This includes external debt evaluated at historical exchange rates.

[2] Reserve Bank of India, Report on Currency and Finance, 2000-01, pages IV-12 to14.

[3] According to an estimate by RBI (op. cit.), the cyclical deficit has ranged between a deficit of 0.12 per cent of GDP and a surplus of 0.21 per cent of GDP during the nineties. The structural fiscal deficits have been in the range of about 10 per cent of GDP in the recent years.

As in [2].

[4] We use the Hodrick – Prescott (HP) filter to derive the trend output in real terms and the price deflator. Given a series **y**, the H-P filter computes the smoothed series **s** of **y** by minimizing the variance of **y** around **s** subject to a penalty that constrains the second difference of **s**. The penalty parameter controls the smoothness of the series **s**. The larger the penalty parameter, the smoother is the series. With very large values of the parameter, the smoothed series approaches a linear trend. We have used a value of 100 for this parameter, which is generally recommended in the case of annual series.

[5] Ahluwalia in his article "Economic Performance of States in Post-Reforms Period" (EPW, 2000) lists the necessary qualifications in interpreting estimates of Gini Coefficient, assuming population of a state is centered on the mean income of that state.

[6] Prepared by Dr. Sita Prabhu and her associates at UNDP's India office.

[7] Prepared by IDFC for the benefit of the Finance Commission by Prof. TCA Anant of the Delhi School of Economics and Mr. Nirmal Mohanty of the IDFC.

[8] The standard specification of the equation describing debt dynamics with discrete time periods is given by equation (1) $[b_t = p_t + b_{t-1} \{(1+i_t)/(1+g_t)\}]$. As discussed in Rangarajan and Srivastava (2004), writing $z_t = b_t - b_{t-1}$, equation (1) can also be written as

$$z_t = p_t - b_{t-1} [(g_t - i_t)(1+g_t)^{-1}]$$

or $\quad p_t = z_t + b_{t-1}[(g_t - i_t)(1+g_t)^{-1}]$

Summing up over any two benchmark years 1 and T, we have

$$\Sigma p_t = \Sigma z_t + \Sigma b_{t-1}[(g_t - i_t)(1+g_t)^{-1}]$$
$$(t=1,\ldots, T)$$

The term $A1 = \Sigma z_t / \Sigma p_t \ (t=1,\ldots,T)$ shows the extent to which the cumulated primary deficits translate into accumulation of debt. On the other hand, the term

$$A2 = \Sigma b_{t-1} \ [(g_t - i_t)(1+g_t)^{-1}] \ / \Sigma p_t$$
$$(t=1,T)$$

shows the extent to which the impact of cumulated primary deficits is absorbed by the excess of growth over interest rate.

[9] Discussions with CSO have confirmed that subject to some statistical adjustments, net savings of administrative departments and

departmental enterprises and the combined revenue deficit of the central and state governments are equivalent.

[10] Muhleisen (1997, IMF Staff papers) had estimated that for each increase of 1 percentage point in public saving, there is reduction of 0.25 percentage points in private savings. This relationship would hold in the reverse as well.

[11] Let D= end-period outstanding debt, Y = GDP at market prices, g = growth rate, i = effective interest rate, P = primary deficit, F = fiscal deficit, and I = interest payment. The relevant period is indicated by the subscript t. The debt-GDP ratio is given by b and the primary deficit to GDP ratio is given by p. Thus, $b_t = D_t/Y_t$, and $p_t = P_t/Y_t$.

By definition,

$D_t - D_{t-1} = F_t$

or, $D_t - D_{t-1} = P_t + I_t$ …(a)

We can write, $I_t = i\, D_{t-1}$, and $Y_t = Y_{t-1}(1+g_t)$

Dividing (a) by Y_t, we have

$b_t - b_{t-1}[1/(1+g_t)] = p_t + i_t b_{t-1}[1/(1+g_t)]$

or, $b_t = p_t + b_{t-1}[(1+i_t)/(1+g_t)]$
    …(b)

or, $b_t - b_{t-1} = p_t - b_{t-1}[1-(1+i_t)/(1+g_t)]$

or, $b_t - b_{t-1} = p_t - b_{t-1}[(g_t-i_t)/(1+g_t)]$
    ...(c)

Thus the long run equilibrium value of $b_t = b_{t-1} = b^*$ is given by

$b^* = p(1+g)/(g-i)$ …   (d)
Correspondingly, $f^* = p.g/(g-i)$

    …(e)

Thus, given the values of i and g, for any targeted level of primary deficit to GDP ratio(p), the stabilized debt-GDP ratio is given by (d), and the corresponding fiscal deficit to GDP ratio which will ensure that f* is remains constant year after year is given by (e). It is also implicit by (d) and (e) that the relationship between b* and f* is given by

$f^* = b^*.g/(1+g)$ …(f)

[12] The interest payment to revenue ratio (IP_t/RR_t) can be derived as below.

$IP_t = i.B_{t-1} = ib_{t-1}Y_{t-1}$

As debt is stabilized $b_t = b_{t-1} = b^*$

$IP_t = i.[p(1+g)/(g-i)]Y_{t-1}$ or $i.p/(g-i)]Y_t$ [since $Y_{t-1} = Y_t/(1+g)$]

The revenue receipts can be written as $RR_t = r.\,Y_t$

Thus $(ip)^* = IP_t/RR_t = i.p/r(g-i)$ or $p/(g-i) = (ip)^*r/i$

Further, since with stabilization $b_t = b_{t-1}$, it is implied that $B_t = B_{t-1}(1+g)$

Then fiscal deficit can be written as $F_t = B_{t-1}g$

Or $f_t = b_{t-1}g/(1+g)$

Or $f^* = b_t\, g/(1+g) = p.g/(g-i)$

We can then write

Using $f^* = (ip)^*r\, g/i$ …(g)

And $b^* = (ip)^*\, r(1+g)/i$ … (h)

Accordingly, $f^*/b^* = g/(1+g)$

[13] One study was undertaken by the National Institute of Public Finance and Policy, which focused on two states,

namely, Andhra Pradesh and West Bengal. The other study was done by the Foundation for Public Finance and Policy, which looked into the question of vertical externality in taxation.

[14] Government of India brought out a Discussion Paper on Government Subsidies in India in 1997.

[15] World Economic Outlook, 2001, IMF.

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