
Chapter 5

Union Finances: Assessment of Revenue and Expenditure

5.1 According to the terms of reference (TOR), in making recommendations on transfers to states in the form of tax devolution and grants, the Commission shall have regard, among other considerations, to the resources of the central government for the five years commencing on 1st April, 2005 on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2003-04. The Commission is, further, required to take into consideration (a) the demands on the resources of the central government, in particular, on account of expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditures and liabilities, (b) the objective of not only balancing the receipts and expenditure on revenue account of the centre, but also generating surpluses for capital investment and reducing fiscal deficit, and (c) the taxation efforts of the central government as against targets, if any, and the potential for additional resource mobilization in order to improve the tax-GDP ratio. Related to these considerations is para 5 of the TOR, which requires us to review the finances of the central and state governments and suggest a plan for restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and

debt reduction along with equitable growth.

5.2 As in the case of earlier finance commissions, the central government's memorandum and forecast have provided the basis for our assessment of the finances of the centre during the reference period (2005-2010). We held detailed discussions on the subject with the senior officials of the Ministry of Finance and various central ministries before formulating our approach. We have taken note of the fiscal responsibility legislation enacted by government of India, that has implications for the projection of revenues and expenditure. The Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) came into force on 26th August, 2003 and rules thereunder were notified on 2nd July, 2004. In terms of the Act, the centre's revenue deficit was required to be eliminated by 31st March, 2008. The rules under the Act further require the central government to reduce the revenue deficit by an amount equivalent to 0.5 per cent or more of GDP at the end of each year beginning with 2004-05. The fiscal deficit is to be reduced by 0.3 per cent or more of GDP at the end of each financial year beginning with 2004-05, so that it is brought down to 3 per cent of GDP in 2008. The Finance Act, 2004 has shifted the targets fixed for 31st March,

2008 with respect to the revenue deficit and the fiscal deficit to 31st March, 2009.

5.3 After the FRBMA was passed, the central government set up a Task Force for drawing up a medium-term framework for fiscal policies to achieve the objective of the FRBMA and to formulate annual targets indicating the path of adjustment as well as the required policy measures. The report of the Task Force, presented to the central government in July 2004, was made available to us. Besides, we had the benefit of meeting the chairman of the Task Force. The Task Force has presented two scenarios for the future – the baseline scenario and the reform scenario. The base line scenario assumes that the four years from 2005-06 till 2008-09 will prove to be similar to recent years in terms of progress on policy and administration. It does not assume any major new tax reforms. The projections in the baseline scenario indicate that, under this scenario the targets prescribed in the FRBMA with regard to the revenue and fiscal deficits will not be achieved. The second scenario, which the Task Force calls the reform scenario, incorporates substantive reforms in taxes and follows the principle of a revenue led and front loaded fiscal consolidation. The adoption of the suggested reforms is expected to help the achievement of the required fiscal corrections for eliminating revenue deficit and reducing fiscal deficit.

5.4 The FRBMA requires that three statements, namely, a macro-economic framework statement, a fiscal policy strategy statement and a medium-term fiscal policy statement containing three-year rolling targets for prescribed fiscal indicators and the underlying assumptions, be placed

before the Parliament every financial year. The first such set of statements was placed in the Parliament in July, 2004 alongwith the budget of 2004-05. We note that the rolling targets in the medium-term fiscal policy statement correspond to the projections made in the reform scenario of the report of the Task Force. While we have considered the statements laid in the Parliament and the suggestions made in the report of the Task Force (although the recommendations are still to be accepted by the central government), we have made our own assessment of the feasibility of implementing the suggested reforms during our award period. Our assessment of the resources of the centre has, therefore, been made in the light of the considerations mentioned in our terms of reference and in consonance with the restructuring programme outlined by us in chapter 4. We have also been guided by the targets in regard to revenue and fiscal deficits and the minimum annual adjustments prescribed under the FRBMA and the rules framed thereunder.

Memorandum and Forecast of the Central Government

5.5 The central government submitted its memorandum to the Commission in September, 2003. A number of statements containing item-wise projections of revenues and expenditures were also forwarded to us from time to time by the Ministry of Finance, spelling out assumptions and growth rates adopted for various items. The forecast of the summary position of the finances of the central government containing the projections of revenue and fiscal deficits was made available to the Commission in September,

2004. We were informed that the forecast of the summary position, though submitted after a medium-term fiscal policy statement was laid in Parliament, did not factor in the budget estimates of 2004-05 or the targets under the FRBM Act/rules. It was, however, consistent with detailed statements submitted to us earlier, projecting large revenue and fiscal deficits for 2009-10. However, in a meeting with us, the senior officials of the Ministry of Finance indicated that the implementation of the measures recommended by the Task Force under the reform scenario will be necessary for achieving the targets prescribed in the FRBM Act/rules with regard to the revenue and fiscal deficits.

5.6 In the memorandum, the central government has urged the Commission to take due note of the centre's commitments and strike a balance between the requirements of the Union and the states while determining the quantum of transfer from the centre to the states. The Commission was also urged not to view the share of central taxes and the grants under article 275 in isolation but calibrate these transfers taking into account the overall resource transfers from the centre to the states.

5.7 The central government expressed concern on the inability of the centre and the states to apply fiscal corrections with a view to reducing deficits and ultimately generating surpluses which can be gainfully deployed in sectors that need large infusion of public resources in order to achieve the policy goals and objectives of the government. The central government's memorandum further states that in accordance with the provisions of the

FRBMA, the central government is required to take appropriate measures to reduce the fiscal deficit and revenue deficit, so as to eliminate revenue deficit by March 31, 2008 (since extended to March 31, 2009) and thereafter build up adequate revenue surplus. This mandatory requirement on the part of the central government needs to be taken into account by the Finance Commission while making its recommendations. In view of the large revenue deficit of the centre and the states, as also the low level of tax-GDP ratio, fiscal consolidation together with enhancement of the tax-GDP ratio is imperative for the period 2005-10. In this context, the memorandum further states that "this has to be done to reduce the combined fiscal deficit of the centre and states to 3 per cent of GDP by the year 2009-10, keeping in view the consideration that central government fiscal deficit is required to be brought down to 2 per cent by March, 2008 and thereafter revenue surplus is required to be generated".

5.8 The memorandum, while indicating the trends in central government's expenditure, has drawn our attention to the inflexibility of non-plan expenditure comprising *inter alia*, interest payments, defence expenditure, subsidies, pensions, and transfers to states. These together pre-empt over 100 per cent of total revenue receipts of the central government. It has also been stated that Union taxes are not expected to be particularly buoyant because of reduction in rates and continuation of exemptions. The Commission has been urged to take the sluggish growth of tax revenue into account together with the commitments on the expenditure side. Our attention has also been drawn to the possible

reduction in customs duties on account of the WTO commitments.

5.9 With regard to the value added tax (VAT), which is expected to be implemented from April, 2005, the central government has stated that the introduction of VAT should lead to a net gain in revenue resources, but a compensation mechanism for three years has been thought of as a measure of 'comfort' to the states. Details of the possible revenue loss and the likely quantum of compensation have not been made available to us.

5.10 The central government has urged the Commission to review the level of user charges which form part of non-tax revenue of the government and make suitable recommendations with a view to boosting non-tax revenues of the centre and states. It has been suggested that international experience in this regard may be drawn upon especially in emerging areas like those in the telecom sector. It has been mentioned that the auction of radio spectrum in the case of this sector has fetched billions of dollars in revenues in countries like the U.K., Germany etc. and its levy in the Indian context may merit attention of the Commission.

5.11 Referring to the need for capping the level of guarantees given by state governments, the central government has stated that in so far as the central government is concerned, efforts will be made to limit fresh guarantees to 0.5 per cent of GDP each year, as provided for in the FRBMA. The central government has also stated that in the light of the tight fiscal situation of the centre and the external macro-economic imperatives of containing centre's fiscal deficit and debt, there should be a gradual

reduction in devolution to states. Given the likely levy of sales tax by states on sugar, tobacco and textiles and the availability of collection of service tax by states on items to be specified, the Commission may also review the maximum level of overall transfers from centre to states and prescribe a ceiling that is lower than that recommended by the Eleventh Finance Commission.

5.12 In a subsequent submission dated 9th August, 2004, which in many ways differs from the earlier memorandum, the central government has suggested that in respect of the share of states in the net proceeds of taxes, the Commission may take a view consistent with National Common Minimum Programme objectives (*which, inter alia, states that the share of states in the single divisible pool of taxes will be enhanced*) and after taking into account the following considerations:

- (i) under the eighty-eighth Constitutional amendment, "Taxes on Services" are to be excluded from the single, divisible pool of central taxes/duties;
- (ii) the centre is presently discharging a number of expenditure obligations pertaining to subjects/areas in the State list, both through plan transfers and non-plan transfers/expenditures; and
- (iii) demands on the resources of the central government and statutory requirements of eliminating revenue deficit of the centre as stipulated in the FRBMA and rules framed thereunder.

A statement containing the fiscal projections for 2009-10 under the reform scenario of

the Task Force was also provided along with this submission suggesting that the Commission may make its own assessment in this regard as the Task Force recommendations are based on comprehensive tax reforms and the suggested measures are still to be adopted by the government.

5.13 We have considered the various submissions of the central government: the memorandum dated 1.9.03, the statements of revenues and expenditures submitted from time to time, the statement forwarded in August, 2004 containing fiscal projections for 2009-10, and the statement on the summary position of the finances of the central government submitted in September, 2004. Giving due consideration to these submissions and taking into account the imperatives of the FRBMA as modified by the Finance Act, 2004, we have prescribed a fiscal adjustment path for meeting the FRBMA objectives. In doing so, our attempt has been to maintain an appropriate balance between augmentation of revenue and compression of non-priority expenditure for fiscal consolidation.

Reassessment of the Base Year : 2004-05

5.14 The assessment of the centre's resources needs to be done in two stages. The first step is to arrive at the revenues and expenditure for the base year 2004-05. For this purpose, we have broadly accepted the budget estimates of 2004-05 with some modifications in the revenue receipts and expenditure of the centre. On the suggestion made by the officials of the Ministry of Finance during discussions, we have scaled down the estimate of corporation tax from Rs.88436 crore to Rs.80436 crore on the ground that the Budget Estimates include a

one-time estimated collection of arrears to the extent of Rs.8000 crore. This adjustment is only for the purpose of further projections and does not imply that the estimates will not be realized in the base year. The estimate of income tax has been brought down from Rs.50929 crore to Rs.47929 crore consequent to the amendment brought about in the original scheme of securities transaction tax. The base year figures of Union excise duties have also been revised downwards as the budget estimates (Rs. 109199 crore) did not seem achievable in the context of the performance in recent years as also the trend of collections in the current year which indicates that only 34 per cent of the estimate could be realized till September, 2004. We have, therefore, reassessed the base year estimates as Rs. 103557 crore based on the average growth in revenue during 1999-2000 to 2003-04 (RE). The estimate of education cess had also to be adjusted in accordance with the above modifications. Another item in BE 2004-05 that has been reassessed by us is the interest receipts from states. This appeared to be on the higher side, if the central government loans shown as outstanding against the states on 31.3.04 in the Receipts Budget, 2004-05 is kept in view. We have, accordingly, revised the figure of Rs. 29982 crore indicated in the Budget Estimates 2004-05 to Rs. 23164 crore applying a 12 per cent rate of interest on the loans outstanding on 31.3.04. We have had to make corresponding adjustments in the plan revenue expenditure and minor adjustments with a view to retaining the revenue deficit at 2.5 per cent of GDP and fiscal deficit at 4.5 per cent close to the budget estimates. For the remaining items of revenues and expenditure, the BE

2004-05 figures have been adopted by us. However, while computing the outstanding debt of the government of India in the base year, we have excluded the borrowings of Rs. 60000 crore under the Market Stabilization Scheme as these are to be held as cash balance and investments in special securities of states under NSSF as the latter would be serviced by the state governments.

5.15 The recovery of loans from states in the year 2004-05 indicated in the budget documents incorporates a debt-swap of Rs. 11000 crore. This has been retained in our reassessment, although we have separately been informed that the total debt-swap expected to take place during the year is nearly Rs. 46000 crore and a swap of around Rs. 29300 crore has already been effected. The adjustments in this regard are, however, expected to be made at the stage of working out the revised estimates for 2004-05.

Revenue Receipts : 2005-10

Tax Revenues

5.16 The next step is to make an assessment for the period 2005-10. In the central government's forecast, the income tax and corporation tax were assumed to grow at 20 per cent per year during the Commission's award period. Customs duties and service tax were both assumed to grow at the rate of 10 per cent per annum. The projection of Union excise duties was done using a double log regression with index of industrial production (manufacturing) as the independent variable, assuming an average growth of index of industrial production at 6.6 per cent for the period 2004-05 onwards. This translated into an annual growth rate of 10.47 per cent in Union excise duties.

5.17 Compared to these projections, the

statement laid by the central government before the Parliament under the FRBMA estimates that during the period 2004-05 to 2006-07, gross tax revenues will grow at an average of 22 per cent per annum based on an assumed average annual growth of 26 per cent in direct taxes and 19 per cent in indirect taxes. The tax-GDP ratio of the centre is projected to rise from 9.2 per cent in 2003-04 RE to 10.2 in 2004-05, 11.1 in 2005-06 and 12.1 in 2006-07. We find that these estimates correspond to the projections in the reform scenario of the Task Force on the implementation of the FRBMA. In our view, the implementation of the tax reforms will take time as it involves far reaching changes, which require the consent of the states. We have, therefore, assessed the tax revenues for the future taking into account the additional resource mobilization possible under the present scenario. We feel that service tax would have a much higher buoyancy than projected by the central government because of significant growth in the services sector. We have also followed the principle that the centre should improve upon its past performance by ensuring better tax compliance and utilizing the scope for mobilizing additional revenues effectively, particularly where service tax is concerned.

5.18 Accordingly, our estimates of tax revenues have been derived by applying growth rates computed on the basis of buoyancy norms for individual taxes. The nominal GDP has been assumed to grow at 12 per cent per annum which, in our view, is realistic in the backdrop of the growth in nominal GDP in the last 2-3 years. The buoyancy of each of the major taxes has been worked out on the basis of the growth rates from 1999-2000 to 2003-04 (RE) and

the scope for additional resource mobilization. We have accordingly used a buoyancy of 1.7 for corporation tax, 1.4 for income tax, 0.6 for customs, 0.9 for Union excise duties and 1.75 for service tax during our award period. For the remaining taxes, namely, wealth tax and taxes of UTs, the average of the growth rates from 1999-2000 to 2003-04 (RE) have been used.

5.19 Our projection of the tax revenues of the centre entails an improvement in the tax-GDP ratio by 0.92 percentage points by 2009-10 over 2004-05 (reassessed) levels but 1.68 percentage points over 2003-04 (RE) figures. The improvement projected by us is modest compared to the reform scenario of the Task Force as well as that envisaged in the medium-term fiscal policy statement of the central government and is, therefore, more likely to be achieved. This facilitates a realistic estimation of tax devolution to states and subsequently grants.

5.20 The eighty-eighth Constitutional amendment envisages exclusion of service tax from the single divisible pool and lays down the manner in which service tax is to be shared. We have, however, for the purpose of our projections treated it as a part of the divisible pool as at present, since the necessary notification on the amendment has not yet been issued. As already indicated in chapter 2, the implications of this may, therefore, be factored in by the central government while issuing the notification in this regard.

Non-Tax Revenues:

5.21 The principal components of the non-tax revenue are interest receipts, dividends

and profits, receipts from the petroleum and telecom sectors and different user charges levied by the central government. The central government's projections with regard to non-tax revenues in respect of most of the items are based on the average rate of growth obtaining over the years 1997-98 to 2001-02. The interest receipts have been projected to grow at the same rate at which overall non-tax revenues have grown during 1997-98 to 2001-02. Similar assumptions have been made in respect of items for which the rate of growth has been seen to fluctuate widely. The receipts on account of dividends and profits have been projected to increase by 4 per cent per year.

5.22 Interest receipts accrue to the central government mainly on the loans given to states, public sector undertakings (PSUs) and the railways. In the central government's memorandum, the declining trend of the share of interest receipts in total non-tax revenues has been noted. It has been further mentioned that in the current regime of softening of interest rates and implementation of debt-swap arrangements, its share in non-tax revenues is likely to decline further. Taking into account the fact that central loans to states to the extent of Rs.114000 crore would have been swapped by 2004-05 and loans to states are expected to be granted in 2004-05 at lower rates of interest, we have projected interest receipts from states by factoring in the interest receipts actually due from past loans during our award period and allowing for continuation of the present interest rate regime with regard to future central loans to states. As regards interest receipts from public sector undertakings, we have been informed that the centre has been supporting

many sick PSUs for meeting their immediate needs of salary payment and for covering their gap in resources. The exercise in restructuring of sick PSUs has reduced the revenue streams of the Government on account of foregoing of loan/interest payments, conversion of loan into equity, write-off etc. Our analysis of the returns from PSUs based on data in the Public Enterprises Survey shows extremely low returns varying from 4 to 6 per cent from 1999-2000 to 2001-02 on loans given to PSUs. In our view, this is an area in which greater discipline is called for and the centre should ensure reasonable returns on loans given to PSUs. We have, accordingly, assumed an average return of 10 per cent per annum on outstanding loans to PSUs during our award period.

5.23 Based on the recommendations of the eighth report of the Railway Convention Committee, the railways are expected to pay interest in the form of dividend at the rate of 7 per cent on the entire dividend paying capital, except the capital cost of residential buildings which carries a dividend of 3.5 per cent. Dividend concessions are given to the railways in the form of subsidy from general revenues in respect of unremunerative branch lines, ore lines and in respect of some other specified areas. We find that the projections made by the Ministry of Railways for dividend payment are based on the prescribed rate of dividend payment as recommended by the Railway Convention Committee. We have, therefore, accepted the projections made by the Ministry of Railways in regard to interest receipts from railways. We, however, urge that the dividend concessions given to railways be reviewed at regular intervals not exceeding three years to ensure a rational

and properly targeted subsidy.

5.24 As far as the receipts on account of dividends and profits are concerned, we have projected the dividends from PSUs on the basis of the trend growth rate from 1993-94 to 2003-04 keeping in view the fact that disinvestment as earlier planned may not take place. Profits from RBI/Banks have been projected to grow at the rate of 12 per cent from 2005-06 onwards in keeping with the growth rate of nominal GDP. The Comptroller and Auditor General's Report on PSUs (2003) has pointed out that a number of profit making PSUs do not declare dividends, although instructions have repeatedly been issued by the Ministry of Finance that all profit making PSUs should declare a minimum dividend of 20 per cent either on equity or on post-tax profit, whichever is higher. For PSUs in oil, petroleum, chemical and other infrastructure sectors, the prescribed figure for dividend declaration is 30 per cent of post-tax profit. We feel that the government of India needs to take concrete steps to ensure reasonable returns from PSUs on account of dividends.

5.25 Receipts from economic services also contribute significantly to the non-tax revenues of the centre. Our projections for various receipts under economic services are based on norms regarding their potential for generating resources. We notice that the telecom receipts of the centre have shown a marked increase in the last decade as a result of revenue sharing arrangements with the telecom service providers. We expect the central government to move towards alignment of license fees to the cost of regulation and administration of the Universal Service Obligation. The auction of radio spectrum is another area where the

exchequer may be able to derive fresh non-tax revenues. We find that the Task Force has recommended that the Ministry of Finance should work with TRAI to explore these issues and identify mechanisms through which the spectrum can be effectively auctioned to telecom and computer industry service providers. The government of India should exploit the potential of auction of spectrum for additional revenue generation. In the meantime, keeping the historical growth and scope in regard to license fee alignment in view, we have assumed an annual growth of 20 per cent in telecom receipts. Similarly, keeping in view the scope for additional royalty and the resources generated due to the license fee for the right to exclusive exploration of oil and gas in a particular region, we have provided for an annual growth of 15 per cent in petroleum receipts. The receipts from the remaining economic services have also been projected to grow at 15 per cent per annum. In the case of user charges, which accrue by way of UPSC/SSC examination fees, receipts from stationery, printing, cantonment and defence lands, visa and immigration fees etc., we feel that realignment to cover costs will result in increased revenues and the centre should move towards that objective. Pending a rationalization of user charges, we have projected the remaining items of non-tax revenues on the basis of past growth rates.

5.26 In terms of our projections, the total non-tax revenues of the centre as a percentage of GDP are not expected to grow substantially and will reach 2.45 per cent of GDP in 2009-10 as compared to 2.21 per cent as per our reassessment of 2004-05. The gross revenue receipts of the centre are expected to rise from 12.16 per cent of GDP

in 2004-05(reassessed) to 13.33 per cent of GDP in the terminal year of our award period, an increase of 1.17 percentage points. The centre's net revenue receipts will similarly rise from 9.55 per cent of GDP in 2004-05 (reassessed) to 10.39 per cent in the terminal year of our award period.

Non-plan Revenue Expenditure: 2005-10

5.27 Interest payments, defence revenue expenditure, subsidies and pensions form the major component of revenue expenditure of the central government and constitute almost 80 per cent of the total non-plan revenue expenditure. In making projections for various items of non-plan revenue expenditure, the central government has generally used the average rate of growth in each major head over a four-year period (1997-98 to 2001-02). In the case of some of the items, however, the average rate of growth of non-plan expenditure over the four-year period has been used. For projecting plan expenditure, the growth rate indicated in the base line scenario of the Task Force report has been adopted.

5.28 Like the Eleventh Finance Commission, we have, in our forecast, adopted different rules for projecting different items of non-plan revenue expenditure. Our projection of interest payments is based on the assumption of continuation of the present interest rate regime. We find that the effective interest rate on the centre's outstanding debt as on 31.3.04 is 8.56 per cent. The weighted average cost of market borrowings during 2003-04 has been 5.74 per cent. We, therefore, estimate that by 2009-10 the effective interest rate on outstanding debt will decline to 7 per cent. Accordingly, for

arriving at interest payments, the outstanding debt of the centre has first been worked out based on the adjustment path prescribed by us for fiscal deficit and thereafter, a declining effective interest rate has been applied such that the effective rate in 2009-10 is 7 per cent.

5.29 With regard to the expenditure on pensions, we found that the growth in the past few years has been erratic (varying between 0.4 per cent and 6.01 per cent) resulting in an average annual growth rate of 1.87 per cent. We find that the growth assumed in BE 2004-05 is 3.65 per cent. The projections of the Ministry of Finance indicate a growth rate of 4 per cent per annum which, we feel, is reasonable taking into account the annual revision of dearness relief and the annual accretion to the number of pensioners. The new pension scheme introduced by the central government is not likely to have a significant impact on the pension bill during our reference period. We have, therefore, allowed for an annual growth of 4 per cent in expenditure on pensions during our award period.

5.30 The projection of defence revenue expenditure made by the Ministry of Finance assumes an annual growth of 9.10 per cent. The Ministry's memorandum mentions, *inter alia*, that the need of defence preparedness and the acquisition of modern armaments for the three Services is likely to add to the commitments of the central government in the area of defence spending in the years ahead. The Ministry of Defence has separately stressed before us the 'need-based' requirement of the three Services as reflected in its long-term perspective plans. Its projections imply a steep rise of 52 per

cent in defence revenue expenditure in 2005-06 and thereafter, a growth rate ranging from 8.3 to 10.96 per cent. Similarly, in defence capital expenditure, a 37 per cent growth over 2004-05 levels has been sought in 2005-06 after which defence capital expenditure is expected to grow at rates ranging from 7.3 to 10.8 per cent. We have considered the suggestions of the Ministry of Defence. While we appreciate the perceptions of the Ministry of Defence, these need to be viewed in the overall context of the resource position of the central government and various demands on its resources. We further feel that defence spending should have a bias towards capital expenditure and have, therefore, projected defence revenue expenditure based on past growth rates after allowing for some increase. Considering that the defence revenue expenditure has grown at an average rate of 5.38 per cent annually from 1999-2000 to 2003-04 (RE), we feel that an annual growth of 6.5 per cent in defence revenue expenditure for the purpose of forecast during our award period is reasonable. The increase in capital expenditure as a percentage of GDP estimated by us later is expected to take care of the additional requirements of capital expenditure on defence.

5.31 Subsidies form an important component of the centre's expenditure. In addition to food and fertilizer subsidy, the central government has, since 2002-03, been incurring substantial expenditure on petroleum subsidy, despite the decision to dismantle the administered price mechanism in the petroleum sector. The central government's memorandum states that there does not appear to be any likelihood of the subsidy bill getting reduced in spite of

“exhortation/pronouncements” on this account. A fairly low growth in the expenditure on subsidies has, however, been projected by the centre based on the inputs of the concerned Ministries. In the context of subsidies, attention needs also to be paid to the recommendations of the Expenditure Reforms Commission (ERC), the implementation of which would ultimately result in savings. It is further seen from the medium-term fiscal policy strategy statement that the central government intends to take up an intensive review of the operational aspects of the subsidies and restructure them so that the benefits are not usurped by those not intended to be the beneficiaries of these subsidies. Our projection of subsidies reflects to a great extent these policy decisions. Keeping in view these initiatives, we have held constant the food subsidy at Rs. 22000 crore per year during 2005-10 as against the BE 2004-05 figure of Rs. 25800 crore on the consideration that the BE 2004-05 levels include some arrears which are not likely to be repeated during our award period. It may be noted that the Task Force Report has assumed that the food subsidy would decline by 5 per cent per year. In regard to petroleum subsidy, we have assumed that it would be phased out by 2007-08. Fertilizer subsidy has been frozen at BE 2004-05 levels during our award period in the light of ERC’s recommendations and the recent decision to carry out a review of subsidies. Other subsidies have similarly been held constant at BE 2004-05 levels. Consequently, in our reassessment, subsidies as a percentage of GDP would decline from 1.40 per cent in the base year to 0.66 per cent in the terminal year of our award period.

5.32 As per our terms of reference, we are

required to consider the demands on the centre on account of expenditure on internal and border security. The average annual growth in expenditure on police from 1999-2000 to 2003-04 (RE) has been 7.04 per cent. The central government’s memorandum has pointed out that in the present internal security environment, it is likely that expenditure on central police forces will increase rapidly in the coming years. The likelihood of raising additional battalions of police to meet the needs of internal security has also been mentioned. The Ministry of Home Affairs, in its submissions to the Commission has highlighted the need for higher allocations not only for recurring expenditure but also on account of certain new initiatives. In view of this, we have provided for an annual growth of 7.5 per cent for the expenditure on police.

5.33 The remaining major items of non-plan revenue expenditure of the central government are broadly divided into Other General Services, Economic Services and Social Services. Salaries constitute a major portion of these expenditures, particularly of Other General Services. Although the Eleventh Finance Commission had segregated the salary and non-salary components of such expenditure and projected these at differential growth rates, we have taken into account the recent trends and projected each of these items based on the composite growth rates after making our own assessment of the expenditure under these heads. Accordingly, the Other General Services and Social Services have been assumed to grow at the rate of 5 per cent while Economic Services have been allowed to grow at a higher rate of 7.5 per cent annually during our award period.

5.34 In the context of the expenditure of the central government on salaries, it is necessary again to refer to the reports of the ERC covering 38 ministries/departments. The ERC studied the working of all ministries/departments and considered whether their activities needed to be carried out by the government and whether these could be tackled more effectively through other methods. After a detailed scrutiny, the ERC recommended abolition of around 42000 posts in the government. Although the ministries and departments were required to implement the recommendations of the ERC, the pace of implementation has been slow. According to the information collected from various ministries by the Commission, only 9833 posts have so far been abolished. Information on the amount of savings which has accrued to government as a result of this is incomplete. Available figures place the annual saving at Rs. 68.21 crore. An attempt was also made by the Commission to ascertain the likely savings that would have accrued to government, had the ERCs recommendations been implemented in full. Although the information is again incomplete due to many ministries/departments being unable or unwilling to make their estimation, it appears that at least an additional sum of Rs. 250 crore could have been saved annually by full implementation. For rationalizing the centre's expenditure on salaries, there is a need to implement all the recommendations of the Expenditure Reforms Commission immediately. There is also a need to have periodic reviews of the functions carried out by various ministries in order to ensure that activities which are not necessary in the current context are not continued.

5.35 The residual categories of non-plan revenue expenditure include expenditure of the union territories (UTs), postal deficit and grants-in-aid to foreign governments etc. Postal deficits have been projected on the basis of the forecast of the Department of Posts showing a declining trend during our award period. Other expenditures including expenditure of the UTs and other non-plan revenue expenditure have been projected by us on the basis of average annual growth rates from 1999-2000 to 2003-04 (RE).

5.36 In making our projections on various items of non-plan revenue expenditure, we have not factored in the compensation that may be payable to states for revenue losses arising from the introduction of VAT with effect from 1.4.2005 and reduction in the central sales tax rate. The central government would, therefore, have to find resources to provide for this compensation separately, should the need arise.

Plan Revenue Expenditure: 2005-10

5.37 We have made an analysis of the plan revenue expenditure of the centre with particular reference to plan grants to states. In this context, a criticism often leveled against the central government is that it interferes in the states' priorities through the mechanism of centrally sponsored/central plan schemes on subjects, which are entirely in the State List or substantially handled by the states though in the Concurrent List. We, therefore, analyzed the demands on the resources of the central government on account of expenditure on subjects which are in the State/Concurrent List. Our study reveals that on an average 9.6 per cent of the total expenditure of government of India is in respect of subjects which are in the State

List. This has a plan component of 7.4 per cent and a non-plan component of 2.2 per cent. Similarly, on an average 9.4 per cent of the total expenditure of government of India is in respect of subjects which are in the Concurrent List. This has a plan component of 3.8 per cent and a non-plan component of 5.6 per cent. The centre incurs a substantial expenditure on its ministries/ departments to administer such schemes. In pursuance of the objective of rationalizing the central plan and centrally sponsored schemes (CSSs) by way of convergence, weeding out or transfer to the states, the Planning Commission carried out a zero based budgeting (ZBB) exercise for all the central ministries/departments in the terminal year of the Ninth Plan. As a result of this exercise, the Planning Commission recommended that out of a total of 360 CSSs in operation, 48 schemes may be weeded out, 161 schemes may be merged into 53 schemes and the remaining 135 schemes may be retained. This implied that 188 CSSs were to be carried forward to the Tenth Plan. In respect of 2247 central sector schemes, the ZBB exercise carried out by the Planning Commission resulted in recommendations for weeding out 539 schemes, merger of 1019 schemes into 233 schemes and retention of remaining 689 schemes, thereby implying carrying forward of 922 central plan schemes to the Tenth Plan. The Tenth Five Year Plan document emphasizes the need to continue this ZBB exercise as a regular feature and recommends that states should also be encouraged to carry out such reviews of their schemes.

5.38 For projecting plan revenue expenditure, we have followed the methodology used by the Eleventh Finance

Commission of working it out as a residual keeping in view the targets laid down for revenue deficit and after arriving at non-plan revenue expenditure. Compared to the average annual growth of 13.76 per cent in plan revenue expenditure of the centre from 1999-2000 to 2003-04, our projections imply a higher growth in plan revenue expenditure except in the first year of the award period. Plan grants to states form a major component of the plan revenue expenditure of the centre. Based on the methodology of the Eleventh Finance Commission, plan grants to states have been worked out by us as a residual of the ceiling on overall fiscal transfers recommended by us deducting the amounts recommended as tax devolution and grants-in-aid to state governments.

Revenue Expenditure : 2005-10

5.39 On the basis of our projections, the total revenue expenditure of the centre is expected to decline from 12.05 per cent of GDP in 2004-05 (reassessed) to 10.39 per cent in 2009-10.

Overall Fiscal Transfers

5.40 Apart from tax devolution and grants, fiscal transfers to states also include devolution of funds through centrally sponsored schemes, block plan grants and other discretionary transfers. The Eleventh Finance Commission had looked at the revenue transfers to states between the period 1979-80 to 1997-98 and had suggested that the centre's fiscal transfers to the states should be around 37.5 per cent of the gross revenue receipts of the central government. We have reviewed the matter. Keeping in view the slight increase

recommended by us in states' share in central taxes and the need to sustain the resource transfers for Plan, we estimate that the total transfers from the centre to states would be 38 per cent of the gross revenue receipts of the centre. This is in keeping with the indicative ceiling we have suggested.

Capital Receipts and Expenditure: 2005-10

5.41 Our terms of reference require us to consider the objective of not only balancing the receipts and expenditures on revenue account of the centre but also generating surpluses for capital investment and reducing fiscal deficit. We have factored in the target of bringing down the fiscal deficit to 3 per cent of GDP by 2009, as laid down in the rules under FRBMA. We have maintained it at 3 per cent of GDP in the terminal year of our award period. The capital receipts of the centre comprise recovery of loans and advances, disinvestment receipts and borrowings. For projecting recovery of loans from state governments, we have taken into account the actual recoveries due from state governments and provided for recovery of additional loans expected to be granted during 2005-10 on the basis of a 20 year repayment schedule with a moratorium of 50 per cent on half the repayment in the first five years. Recovery of other loans is based on the profile from 1999-2000 to 2003-04 (RE). As far as disinvestment receipts are concerned, we have accepted the projections of the central government which indicate that the receipts would be Rs. 4000 crore per annum during our award period.

5.42 The estimates of capital expenditure

during our award period have been worked out as a residual keeping in view the targets for fiscal and revenue deficits and the expectations in regard to non-debt capital receipts. The projections made by us indicate an increase in capital expenditure as a percentage of GDP by 0.66 percentage point by the terminal year of our award period as compared to the base year figures. This compares well with the corresponding increase from 1999-2000 to 2004-05, which has been of the order of 0.44 percentage points if we exclude the payments to NSSF met out of debt-swap receipts.

Statements Containing Projections: 2005-10

5.43 The revenue and expenditure projections based on the above reassessment of central finances for the period 2005-06 to 2009-10 along with item-wise details are given in annexure 5.1. In chapter 12, we have devised a scheme of debt relief for states as a result of which the centre's interest receipts and capital receipts will decline during our award period. After factoring in the impact of the component of the debt relief applicable to all states and assuming a success rate of fifty per cent in respect of debt write-off related to fiscal performance, we have made revised projections as indicated at annexure 5.2. These projections also take into account the impact of our recommendation regarding the disintermediation by the centre as far as loans to states are concerned. As such, we have assumed that additional central lending to states will come down to half of 2004-05 (BE) levels in 2005-06 and will be phased out by 2009-10. We have also assumed that the interest rates charged will be aligned to the marginal cost of borrowing by the centre.

As a result of the debt relief recommended by us, while the centre's tax-GDP ratio remains unaffected, the gross revenue receipts will be 13.13 per cent of GDP in 2009-10 compared to 13.33 in terms of the figures in annexure 5.1, net revenue receipts will be 10.20 per cent compared to 10.39 while revenue expenditure will be 10.20 per cent of GDP compared to 10.39, the impact being felt on plan revenue expenditure. Capital expenditure will reach 3.47 per cent

of GDP in 2009-10 compared to 3.63 per cent otherwise. The targets under the FRBMA are, however, expected to be met in terms of both the projections.

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