Chapter 6

State Finances: Assessment of Revenue and Expenditure

6.1 In making recommendations regarding tax devolution and grants-in-aid to the states, it is necessary to assess the revenues and expenditures of states for the period 2005-10. In this context, para 11 of the terms of reference (TOR) requires us to prepare state-wise estimates of receipts and expenditure. While carrying out this exercise, the Commission, under para 6 of TOR, has to consider the resources of the state governments and their taxation efforts, the need for balancing the revenue account of the states, maintenance of capital assets and completed plan schemes, and ensuring commercial viability of irrigation and power sectors.

Basic approach

6.2 Assessment of states' revenues and expenditures requires to be guided by a normative approach, which serves to ensure inter-state equity and avoids adverse incentives. No state can obtain a larger share than what is warranted by the deficiency of its fiscal capacity. Similarly, a state should not expect expenditure not justified by normative considerations to be taken into account in the assessment. We have, however, recognised that it is not possible to apply fully the normative principle because of the heterogeneity of the states with respect to various dimensions affecting capacities and costs, and problems related to the availability of relevant data. In our projections for the receipts and expenditure of the states during the forecast period 2005-10, we have relied on the fiscal data of 1993-2003 as contained in the finance accounts, as well as on the revised and budget estimates for 2003-04 and 2004-05 respectively. The projections of revenue and expenditure were also obtained from each state for the period 2005-10. While seeking these projections, it was indicated to the states that these should broadly conform to the objectives being pursued under their Medium Term Fiscal Reform Programme (MTFRP).

6.3 Table 6.1 shows, in aggregate, a comparison of past period data for certain broad fiscal parameters with the projections received from the states, while state-wise details of projections are furnished in annexure 6.1.

6.4 The pre-devolution deficit, in aggregate, is seen as coming down from a level of 4.5 per cent of GDP in 2002-03 to 4 per cent in 2004-05 (BE), and finally to 3.8 per cent in 2009-10. However, the reduction over 2004-10 is driven entirely by the projected compression in non-plan revenue

Table 6.1

Comparison of Past Fiscal Data with Projections made by the States

(Rs. crore/per cent)

Item	1993-94 (Actuals)	2002-03 (Actuals)	2004-05 (B.E)	2009-10 (States' projection)	2005-10 (States' projection)
1. Own Revenue Receipts	59081 *(6.9)*	166484 *(6.7)*	215941 *(7.0)*	328482 *(6.0)*	1391002 *(6.3)*
2. Non-Plan Revenue Expenditure	87552 *(10.2)*	277630 *(11.2)*	340444 *(11.0)*	534054 *(9.8)*	2315499 *(10.5)*
3. Pre-devolution deficit (1 – 2)	-28471 *(-3.3)*	-111147 *(-4.5)*	-124503 *(-4.0)*	-205572 *(-3.8)*	-924497 *(-4.2)*
4. GDP (Current prices)	859220	2469564	3104857	5471819	22091645

Figures in parentheses are percentage of GDP.
GDP at current prices for 2004-10 has been projected by the Finance Commission.

expenditure to the tune of 1.2 percentage point of GDP, which is substantially offset by projected reduction in own revenue receipts going down by 1 percentage point of GDP over this period. A fall in own revenue receipts as a percentage of GDP can not help in achieving the objective of restructuring the overall public finances aiming at a healthier fiscal situation.

6.5 We, therefore, decided to make our own assessment of the revenue and expenditure for each state. Our macro approach has been guided by the overall objective of restructuring the public finances of the states outlined in Chapter 4. Norms have been used for making projections for each of the 28 States in the forecast period. This was a two-step process. In the first step, revenue and expenditure for the base year 2004-05 were estimated. Some corrections in the base year were necessary, as accepting the budget estimates may amount to endorsing laxity in expenditure or inefficiency in raising revenues on the part of the states. Thereafter, revenue and expenditure were normatively projected for 2005-10 in consonance with the overall goals of fiscal restructuring.

Gross State Domestic Product

6.6 The Gross State Domestic Product (GSDP) provides an indication of the fiscal capacity of a state government to raise revenues. GSDP levels also give an idea of the level of expenditure required to pursue the chosen trajectory of economic growth. One of our first tasks, therefore, has been to project the GSDP of each state during the forecast period.

6.7 The time series data on comparable levels of nominal GSDP at factor cost were provided upto 2001-02 for each state by the Central Statistical Organisation (CSO). The non-comparable nominal GSDP series received individually from each state was available up to 2002-03. The growth rates for 2002-03, available from the states' series, were applied on the GSDP of 2001-02 of the comparable series to obtain comparable nominal GSDP for 2002-03 for each state. The next step was to project nominal GSDP for 2003-04 and thereafter upto 2009-10. Since the nominal growth rate of aggregate GSDP has been marginally lower than that of GDP, the ratio of aggregate GSDP's trend growth rate (TGR) to that of GDP was obtained for the period 1993-2002. This ratio was applied on 12.25 per cent growth rate adopted for GDP in

2003-04. This yielded a figure of 11.1 per cent nominal growth rate for aggregate GSDP for 2003-04. For arriving at the state-specific nominal growth rates, the average annual growth rate of each state's comparable GSDP was worked out for the period 1997-2002 and proportionately adjusted in a manner that in the aggregate, the nominal GSDP growth rate came to 11.1 per cent. These state-specific growth rates were applied on the 2002-03 levels to arrive at 2003-04 levels for each state. In a similar manner, state-specific growth rates were derived for 2004-05 and applied on the estimated 2003-04 levels to arrive at state wise nominal GSDP estimates for 2004-05. It may be noted that for 2004-05, the projected nominal GDP growth rate of 12 per cent yielded a growth rate of 10.9 per cent for aggregate GSDP.

6.8 In the forecast period 2005-10, the annual nominal growth rate of GDP has been projected at 12 per cent. For the purpose of GSDP projections, the same growth rate (i.e., 12 per cent) has been adopted for aggregate GSDP in order to achieve the overall goals for restructuring the states' finances. In conformity with the view expressed in the Tenth Five Year Plan document that GSDP should grow at different rates for reducing regional inequalities, we have prescribed an annual nominal growth rate of 12.8 per cent for states projected to achieve average real annual growth rate of 8 per cent and above in the Tenth Plan document. Similarly, 12 per cent and 11 per cent nominal growth rates have been prescribed for states expected to achieve a real annual growth rate between 8 per cent and 7 per cent and below 7 per cent respectively during the Tenth Plan. Annexure 6.2 gives the state-wise growth rates of GSDP. The annual nominal growth rate of aggregate GSDP then works out to 12 per cent during the forecast period 2005-10.

Own Tax Revenues

6.9 Our approach to projecting own tax revenues of states was guided by para 6(iii) of TOR, which reads, "In making its recommendations, the Commission shall have regard, among other considerations, to the resources of the state governments 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". Para 6(v) further stipulates that the Commission should take into account the taxation efforts of each state government as against targets, if any, and the potential for additional resources mobilization in order to improve the tax-GSDP ratio.

6.10 The own tax revenues of states consists of sales tax, excise, stamp duty and registration fee, motor vehicles and passenger tax, and others. The Tenth Finance Commission had projected each of these categories separately for each state. The Eleventh Finance Commission, however, reasoned that possibilities of substitution among different tax streams made it more desirable to project own tax revenues as one omnibus group. We are in agreement with the view expressed by the Eleventh Finance Commission.

6.11 In keeping with the TOR, the improvement in the tax-GSDP ratio became the underlying principle for projecting own tax revenues of states. This was achieved by first adjusting for the under-utilisation of taxable capacity in the base year for some states, and then by further improving its utilisation through prescriptive levels of tax buoyancy specific to each state.

Base year estimates

6.12 The TGR of own tax revenue (OTR) has been estimated for each state for the period 1993-2003 and applied on their respective 2002-03 levels (the latest year for which accounts figures are available) to arrive at the TGR-based estimates for the base year 2004-05. For the six bifurcated states, the same TGR has been used for the parent and the successor states, which was obtained from their combined accounts for the period 1993-2003. The TGR so determined has been applied on the separate accounts of 2002-03 for the bifurcated states to arrive at the TGR based estimates of 2004-05. Thereafter, the TGR based estimate of OTR of each state has been compared with its respective budget estimates of 2004-05 and the higher of the two chosen as the initial estimates for the base year. The initial estimates were next expressed as a ratio to GSDP for each state, and the averages of this ratio for special and general category states were computed separately for 2004-05.

6.13 For the purpose of normative assessment, at least partial adjustment for under-utilization of taxable capacity in the base year 2004-05, was deemed reasonable for states where the ratio of OTR to GSDP was below the respective category average. Specifically, for the purpose of normative base year estimation in respect of below average states, we increased the initially estimated tax-GSDP ratios by 30 per cent of their distance from the respective group average of the special and general category states. Having determined the normative OTR/GSDP ratio of each state in this manner, this was applied on the estimated GSDP level of 2004-05 to arrive at the base year adjusted level of OTR in absolute (rupee) terms. This has resulted in adjusted own tax revenue aggregated for all states bearing a ratio of 5.9 per cent to national GDP in the base year.

Projections for forecast period

6.14 We have incorporated an increase of a little less than 0.9 percentage point in the aggregate OTR as a percentage of GDP over the forecast period, i.e., from 5.91 per cent in the base year to 6.75 per cent in the terminal year. This is in accordance with the plan for restructuring government finances. The increase in OTR/GDP ratio implies that aggregate OTR should grow at an annual rate of 15 per cent in the forecast period. Keeping this in view, prescriptive buoyancy levels of 1.1, 1.2, 1.25, 1.3 and 1.35 were assigned to individual states as detailed in annexure 6.2. While assigning prescriptive buoyancies to the individual states, the impact of the introduction of VAT was assumed to be revenue neutral, if not revenue augmenting.

6.15 For assigning the prescriptive buoyancies, the following factors have been taken into consideration:

(i) Average OTR/GSDP ratio achieved in 2000-03.

(ii) Improvement in OTR/GSDP ratio in 2000-03 over 1993-96.

(iii) Average per capita GSDP for 1999-2002.

A state, for example, was prescribed a higher buoyancy if its recent OTR/GSDP ratio as well as its improvement over time were relatively low, provided its per capita income was relatively high. The assigned buoyancy was multiplied by the projected state-specific GSDP annual growth rate to arrive at annual growth rate of OTR for each state, which was then applied on the base year estimates to generate OTR levels in the forecast period. Annexure 6.2 indicates the projected GSDP growth rates of states during the forecast period.

Own Non-Tax Revenues

6.16 Unlike OTR, own non-tax revenues (ONTR) have not been treated as one omnibus category since these included receipt items which have little in common with each other. Major receipt items under ONTR, therefore, have been projected individually. In view of the data constraints, the remaining items were clubbed under one residual category and a uniform norm was applied for the projection period. The items projected are as follows:

(i) Interest receipts and dividends

(ii) Royalty

(iii) Receipts from forestry and wildlife

(iv) Other miscellaneous general services and lotteries

(v) Irrigation receipts

(vi) Other own non-tax revenues

Interest Receipts and Dividends

6.17 Interest receipts accrue to states against institutional and non-institutional loans given by the state governments. Institutional lending is mainly to state level public sector undertakings (PSUs), which include state electricity boards (SEBs), state road transport corporations (SRTCs) and other commercial and promotional enterprises. Non-institutional loans are extended mostly to government employees. It was found that the effective rate of return on outstanding loans was extremely low at around 2 per cent in 2002-03 for all states put together. This was much lower than the cost at which the state governments borrow. In particular, SEBs and SRTCs routinely defaulted in interest payments and loan repayments. Similar was the case for dividends as well, where the average rate of return was even lower at 0.6 per cent in 2002-03.

6.18 Para 6(vii) of the TOR mentions the need to ensure commercial viability of public sector enterprises, including power projects, through means such as adjustment of user charges and relinquishing of non-priority enterprises through privatization or disinvestment. We have assumed a 7 per cent return on outstanding loans and advances and 5 per cent on equity, to be achieved in a graded manner by the terminal year of the forecast period. For this purpose, the amount of loans and advances as on 1.4.2005 and equity level as on 1.4.2003 have been kept constant throughout the forecast period.

Royalty

6.19 Under this head, royalty from minerals, coal and petroleum has been considered. We took note of the fact that the power to revise the rates of royalty in most of the cases vests in the central government. Government of India has not been revising the royalty rates as regularly as provided for. This is particularly true of coal and lignite. We recommend that since royalty is an important source of revenue for some of the states, the rates of royalty should be fixed on an ad valorem basis.

6.20 For projecting this revenue stream, we took a view that since the states did not have the power to revise the royalty rates, the best that can be expected is that revenue under this head will keep pace with inflation. The average of three years 2002-05 was compared with 2004-05 (BE), and the higher of the two was adopted as the base year figure, and an annual growth rate of 5 per cent was applied to project the figures for 2005-10.

Receipts from Forestry and Wild Life

6.21 The receipts under this head do not show a clear trend for any of the states. The Supreme Court has placed restrictions on the exploitation of forest wealth, which has a consequential impact on states' revenues. In this case, the average revenue of three years 2002-05 was compared with 2004-05(BE) and the higher of the two adopted as the base year estimate, and held at that level for the forecast period.

Receipts from Other Miscellaneous General Services and Lotteries

6.22 The items under this head include sundry receipts not included under any other major head. Due to unpredictability of receipts under this head, it was considered best to take the average of three years 2002-05 as the base year estimate, on which an annual growth rate of 5 per cent was applied in the forecast period. Net positive lottery receipts were averaged for 2000-03 (2001-03 for bifurcated states), and held constant at that level in the forecast period.

Receipts from Irrigation

6.23 Para 6(vii) of TOR refers to the need for ensuring commercial viability of irrigation projects. It was, therefore, decided that for projecting receipts under this item, the principle of recovery of current costs be adopted explicitly. Irrigation receipts in 2004-05 (BE), which have been adopted as the base year estimates, were 32.3 per cent of non-plan revenue expenditure on irrigation for all states put together. This recovery rate was considered very low. Without higher rates of cost recovery, the maintenance of irrigation network would suffer seriously. Accordingly, in the assessment of irrigation receipts, cost recovery rates of 50 per cent in 2005-06, 60 per cent in 2006-07, 70 per cent in 2007-08, 80 per cent in 2008-09 and 90 per cent in 2009-10 have been prescribed in relation to the maintenance expenditure on utilised potential projected for the major, medium and minor irrigation projects in the forecast period.

Other Own Non-Tax Revenues

6.24 The receipts under other own non-tax revenues (OONTR) form a residual category after excluding the items mentioned above from total own non-tax revenues, and these largely represent the flows from various user charges. This residual item was dis-aggregated into general, social and economic services. While doing so, receipts under the head "Elections" from general services were excluded, because election expenditure has been projected on a net basis separately. Similarly, receipts from dairy, power and transport were also excluded from economic services. These exclusions from the economic services were in keeping with our stand of not allowing implicit subsidies for departmentally run commercial activities. Thus the adjusted OONTR (service-wise) was obtained for each state for the period 1993-2003 (actuals), 2003-04(R.E) and 2004-05 (B.E). Next, service-wise TGR for the period 1993-2003 was computed for each state and applied on 2002-03 levels to arrive at the initial estimates for 2004-05. For bifurcated states, combined accounts were used to estimate the trend growth rate, which has been applied on their respective accounts of 2002-03 to generate the initial estimates. These initial estimates have been compared with 2004-05(BE) and the higher of the two taken as the base year estimates. On these estimates, 12.5 per cent annual rate of growth has been applied for general services and 25 per cent annual growth rate for both social and economic services in the forecast period, reflecting the need for the states to achieve a greater degree of cost recovery in these services.

Non-Plan Non-Finance Commission Grants

6.25 These are mainly discretionary grants provided by various ministries of government of India. Since these are non-finance commission (non-FC) grants on the non-plan side, it is necessary to take a view about their levels in the forecast period. The Eleventh Finance Commission had taken the average of the latest three years as the base year estimates and applied an annual growth rate of 10 per cent in the forecast period. Since there is no firm basis for projecting these grants in view of their discretionary nature, these are best excluded from the base year assessment of both receipts and expenditure. The average of these grants for the period 2000-03 for each state was taken as the base year level. These were excluded from the base year estimates of non-plan revenue receipts. Correspondingly, since the break-up of expenditure against these grants was not available, an amount equal to the base year estimate of the non-FC grants has been deducted from the base year estimates of "Other general services" under non-plan revenue expenditure.

Expenditure: Non-Plan Revenue Expenditure

6.26 In projecting non-plan revenue expenditure (NPRE), an approach similar to that for non-tax revenues has been followed and item wise projections made, wherever possible. In other cases, items have been clubbed under some broad categories either for want of adequate information or for the purpose of applying category-wise norms. Further, while our aim in general has been to achieve some compression in the growth of non-plan revenue expenditure in a normative manner, we also believe that certain components of this expenditure deserve to be encouraged. These components are education, health and maintenance of roads and buildings. We have provided for a more liberal treatment of these components as compared to other components of NPRE while projecting expenditure.

6.27 Before undertaking the projection exercise, certain adjustments are required in the NPRE data series for the period 1993-2005. The grants as well as expenditure relating to calamity relief have been excluded because this item is projected separately in chapter 9. In the case of local bodies, grants have been excluded from revenue receipt side, but the expenditure on local bodies has been retained on NPRE side. In our view, separate recommendations on local body grants should serve as additional grants over and above those embedded in the deficit grants. Expenditure relating to sinking fund provisions, booked under the head "appropriation for debt avoidance", has also not been considered as it would be inappropriate to allow this expenditure to be met out of deficit grants. Next, all contra-entries have been excluded, which figure in equal magnitude both under non-tax revenues and under non-plan revenue expenditure without having any net impact on the states' deficits. Under this head, interest payments embedded in irrigation expenditure, with a contra-entry under interest receipts, figured prominently. Further, adjustments for "transfer to/from funds" have been made to neutralize the impact of under-statement or over-statement of expenditure. This involved deducting those "transfer to fund" expenditures from respective functional heads, where these have been booked but not translated into actual cash outflows. Similarly, those "transfer from fund" receipts have been added to respective functional heads where actual cash outflows took place without the corresponding budgetary allocation. Expenditure on lotteries has also been excluded as it has been taken to the receipt side on net basis. Further, expenditure on elections has been excluded as the receipts under elections have not been considered in our data series, and because net expenditure on elections has been projected separately.

6.28 These adjustments have made the assessment of NPRE data comparable across states. Further, we have deleted all identified subsidies, including those for power, transport and dairy sectors, by excluding the non-plan revenue expenditure and receipts under these heads. All the above adjustments provided an adjusted NPRE series for each state. Consequently, the base year estimates also did not include these items listed above for exclusion.

6.29 The adjusted series excluded subsidies relating to power, transport, dairy and food. It was felt, however, that some subsidy was needed to ensure adequate outreach of the public distribution system in the remotest corners of a state. Therefore, an annual provision for food subsidy at the rate of Rs.10 per capita per year has been made for each of the states in the forecast period. The amount of food subsidy for each state is indicated in annexure 6.3.

6.30 The adjusted non-plan revenue expenditure of each state has been analysed under four broad categories viz., general services, social services, economic services, and compensation and assignment to local bodies. Within these categories, certain important items have been taken up individually for projection. These items include interest payments and pension payments under general services; education, health, and maintenance of buildings under social services, and maintenance of irrigation projects and roads under economic services. After making separate projections for these items, the remaining items were clubbed under "Other General Services", "Other Social Services" and "Other Economic Services" on which specific norms were applied for projection.

Compensation and assignment to local bodies was projected independently. In addition to these four broad categories, the expenditure relating to transfer of committed plan liabilities at the end of the Tenth Plan to the non-plan revenue expenditure side has also been projected.

Interest Payments

Base year assessment

6.31 It was felt that the interest payments, as budgeted by the states for 2004-05, could not be accepted because it would amount to accommodating excessive borrowings by some states, which would not be fair to those states, which have borrowed more prudently. For assessing the interest payments in the base year, the ratio of interest payments to total revenue receipts (IP/TRR) (net of lotteries) has been estimated for each state for the year 2002-03, and group averages worked out for special and non-special category states. For states with ratios higher than the respective group averages, only 80 per cent of the excess was allowed to be retained. Thereafter, the reduced ratios of such states and unadjusted ratios of the remaining states were applied on respective state's TRR to arrive at the corrected level of interest payments for 2002-03. On the corrected levels of each state, 10 per cent annual growth has been applied to arrive at the base year estimates for 2004-05. This growth rate was the same as employed by Eleventh Finance Commission to project interest payments in their forecast period, 2000-05.

Projections for forecast period

6.32 Interest payments have grown at an annual rate of 18.2 per cent during the period 1993-2003 for all states combined. There has been a fall in the nominal interest rates in recent years, and the states have also been able to benefit from the debt-swap programme of the central government. Taking into account the strategy for restructuring state finances, the growth rate of interest payments for all states taken together was pegged at 7.5 per cent per annum. Using this level as the bench mark, general category states were assigned differential growth rates, namely 6.5 per cent, 7.5 per cent and 8.5 per cent for projecting their interest payments. States having IP/TRR ratio above 30 per cent in 2003-04 (RE) were assigned lower growth rate of 6.5 per cent, because these states have a very heavy burden of interest payment on account of excessive borrowings in the past, and this burden needs to be reduced in the forecast period. States with IP/TRR ratio between 23 per cent and 30 per cent were assigned a growth rate of 7.5 per cent, and those below 23 per cent were assigned a growth rate of 8.5 per cent during the forecast period. All special category states were assigned a growth rate of 7.5 per cent, except one which was assigned a rate of 6.5 per cent due to its excessively high debt burden. Thereafter, state-specific growth rates have been applied on the base year estimates for projecting the interest payments during 2005-10. This was compared with the state's own projection, and the lower of the two adopted.

Pension Payments

6.33 In projecting pension payments, our effort was to make minimum departure from the existing trends, given the inability of the states to influence the pension profile in the short or medium term. Accordingly, 2004-

05 (BE) figures have been adopted as the base year estimates for pension payments. Thereafter, the annual growth rate of pension payments in the forecast period has been worked out. Our analysis of states' aggregate pension payments revealed a growth rate of 23.9 per cent for the period 1993-2003. Since this period included the period of upward revision of pensions on account of Fifth Pay Commission's recommendations, it was decided to look at the growth of pension payments in the recent years. The states' aggregate pension payments have grown at a rate of 14.8 per cent and 8.7 per cent in 2003-04 and 2004-05 respectively. We have adopted an annual growth rate of 10 per cent and applied it on the base year estimates of each state to generate pension payment levels in the forecast period. It may be noted that this rate being higher than the rate of inflation, factors in the increase in the number of pensioners during 2005-10.

General Education and Health

6.34 As already pointed out earlier, we have allowed for expenditure restructuring in favour of these two sectors. This has been reflected both in providing higher growth rate for non-salary component in projecting the expenditure in this chapter, as well as in providing additional grants-in-aid for these sectors as discussed in Chapter 10. For estimating the base year figures, the TGR for 1993-2003 was applied on the figures for 2002-03 to arrive at the corresponding number for 2004-05. This was compared with the budget estimates for 2004-05 and lower of the two taken as base year estimates.

6.35 Thereafter, the growth rates to be used during the forecast period have been determined. In the case of education, it has been found that for the states as a whole, roughly 85 per cent of the non-plan revenue expenditure consisted of salaries, while the corresponding figure for health was about 75 per cent. In general, we have been providing only 5 per cent growth rate in salaries so as to ensure that salaries are held constant in real terms. While this norm has been followed for the health sector, a slightly higher growth rate of about 6 per cent was adopted for the salary component in education sector in order to factor in the additional recruitment of teachers, which would be necessary to achieve the goals of Sarva Shiksha Abhiyan. Separately, a high growth rate of 30 per cent in the non-salary part of these two sectors has been provided. Combining the growth rates of salary and non-salary components with their respective weights as above, a composite growth rate of 9.5 per cent for general education (major head 2202) and 11.5 per cent for health (major heads 2210 and 2211) was obtained. These growth rates were applied to each state. The projected expenditure for these two sectors (excluding expenditure relating to additional grants-in-aid provided separately in chapter 10) for 2005-10 is indicated in annexures 6.4 and 6.5.

Maintenance of Irrigation Works

6.36 We have obtained the norms for maintenance of irrigation works (major heads 2701 and 2702) from the Ministry of Water Resources. Normative expenditure requirements of Rs.600 per hectare for utilised potential and Rs.300 per hectare for unutilised potential of major and medium irrigation projects in the base year 2004-05 were indicated to us. In the case of minor irrigation works, the Ministry suggested a norm of Rs.400 per hectare in 2004-05 for utilised potential. The Eleventh Finance Commission had, however, taken a view that the maintenance norms for minor irrigation works should be half of those for major and medium projects. We decided to follow the practice of the Eleventh Finance Commission and adopted a rate of Rs.300 per hectare in 2004-05 for utilised potential of minor irrigation. It was decided to ignore the unutilised potential of minor irrigation works as being insignificant. For special category states, a step up of 30 per cent has been applied on the maintenance norms, as suggested by the Ministry. State-wise utilised and unutilised potential as reported by the Planning Commission at the end of the Ninth Plan have been taken for working out maintenance expenditure. For each state, the norm based estimates for 2004-05 have been compared with that of 2004-05 (B.E), and the higher of the two estimates adopted as the base year estimates. This was felt necessary to provide larger provision for maintenance. On the base year estimates so worked out, 5 per cent annual rate of growth was applied to generate projected levels in the forecast period. Annexures 6.6 and 6.7 indicate the projected level of maintenance expenditure on major & medium and minor irrigation schemes during the forecast period.

Maintenance of Roads and Buildings

6.37 The TGR for non-plan revenue expenditure for maintenance of roads and bridges (major head 3054) and for buildings (major heads 2059 and 2216) for the period 1993-03 (combined TGR in the case of bifurcated states) was ascertained under the relevant major head and applied, subject to a minimum of 5 per cent, on 2002-03 levels of respective states to generate the initial estimates for 2004-05. These initial estimates have been compared with 2004-05 (BE), and the higher of the two adopted as the base year estimates. Here also, the minimum TGR of 5 per cent and the choice of the higher of the TGR-based estimates and budget estimates reflected the need to provide adequately for maintenance. On the base year estimates, an annual growth rate of 5 per cent has been applied to generate projected levels in the forecast period. Annexures 6.8 and 6.9 indicate the projected levels of maintenance expenditure of roads and buildings in the forecast period. These expenditures do not include the expenditure corresponding to additional grants-in-aid being provided separately in chapter 10.

Other General, Other Social and Other Economic Services

6.38 For each state and for each of these three services, the lower of the TGR-based estimates of 2004-05 and budget estimates was adopted as the base year estimates. While doing so, the minimum value for TGR was taken as 7.5 per cent. For the bifurcated states, the TGRs of the combined states have been derived for each of the services, but applied on their respective 2002-03 levels to arrive at the TGR-based estimates for 2004-05.

6.39 The next task was to arrive at state-wise, service-specific annual growth rates of expenditure in the forecast period for these three service categories. Within each service category, we have adopted a uniform growth rate for non-salary expenditure for all the states, and a varying salary growth rate for different states as explained below. For non-salary expenditure, 7 per cent annual growth rate has been adopted for all the states under 'Other General services' and 10 per cent both for 'Other Social Services' and 'Other Economic Services'.

6.40 The annual growth rates to be assigned for the salary component under each of the three services, varied across the states depending upon their respective levels of salary intensities ("salary intensity" of a major head being defined as the percentage of non-plan salary expenditure to NPRE under that head). The objective was to discourage increases in salary expenditure for those states, which already had a high salary intensity under a particular service category. Thus, under 'Other General Services', states with salary intensities of 85 per cent and above formed the sub-group with the highest salary intensity and were assigned the lowest annual growth rate of 4.5 per cent for the salary component. Similarly, states with a lower salary intensity in the range of 75 per cent to 84 per cent were assigned a salary growth of 5 per cent, and other states were assigned a salary growth of 5.5 per cent. The non-salary component of "Other General Services" was to grow normatively at 7 per cent for all states, as already mentioned above. By combining the two components, the composite growth rate for "Other General Services" as a whole was obtained for each sub-group.

6.41 Under 'Other Social Services', states with salary intensities of 45 per cent and above formed the highest salary intensity sub-group, 44 per cent to 30 per cent formed the middle intensity sub-group and below 30 per cent, the lowest intensity sub-group. The sub-group wise salary growth rates were combined with the uniform non-salary growth rate of 10 per cent to arrive at composite growth rates for each sub-group.

6.42 Under 'Other Economic Services', states with salary intensity of 65 per cent and above constituted the top sub-group, those between 64 per cent and 50 per cent, the middle sub-group and below 50 per cent, the lowest sub-group. These growth rates were combined with the non-salary growth rate of 10 per cent to yield the composite growth rates for each sub-group.

6.43 Thus, for all the states, nine composite growth rates were worked out, three for each of the three services. For each service, the appropriate composite growth rate for a given state was applied on its base year estimates to generate the forecast levels. The resultant composite growth rates and the states corresponding to these rates are indicated in annexure 6.10.

6.44 The net expenditure on elections (major head 2015 – minor head 0070-02) has been estimated broadly on the basis of the projections furnished by the states. However, wherever such projections of any state exceeded the net expenditure incurred by that state on elections during 2000-05 by more than 50 per cent, this has been brought down. The net expenditure estimated for each state has been distributed over the period of five years 2005-10, with a major share being earmarked for the years in which elections are due. These projections relating to elections have been added to the expenditure under "Other General Services" (as estimated in the preceding para) for the purpose of overall projection of NPRE for each state.

Compensation and Assignment to Local Bodies

6.45 The expenditure under this item (major head 3604) represents the explicit grants-in-aid provided by the states to their local bodies. As this expenditure stream did not show a clear trend, we took the average of 2000-03 (in case of bifurcated states, 2001-03) and applied an annual growth rate of 10 per cent, to arrive at the base year estimates, assuming that the average is centred at 2001-02. In the forecast period, an annual growth rate of 12.5 per cent was applied on the base year estimates. This is a comparatively high rate of growth, as compared to other items of expenditure, and this is in keeping with our emphasis on increased funding for local bodies.

Transfer of Committed Plan Liabilities

6.46 On the completion of a five year plan period, states are expected to transfer the committed liabilities associated with completed plan schemes to the non-plan side. This arrangement helps the states in funding such liabilities from sources other than central plan assistance. Consequently, central plan assistance becomes available for funding new schemes of the state governments. Para 6(vi) of TOR requires us to take into consideration the non-wage related maintenance expenditure on plan schemes to be completed by 31st March, 2005. Since the transfer of plan schemes to the non-plan side is normally expected to take place at the beginning of Eleventh Plan, we have factored in this consideration from 2007-08 onwards.

6.47 The information obtained on committed liabilities transferred to the non-plan side at the beginning of Tenth Plan was not found to be reliable. Our intention was to estimate these transfers as a percentage of plan revenue expenditure, and apply the same proportion to the projected plan revenue expenditure of states in 2006-07, the terminal year of the Tenth Plan, in order to estimate the committed liability to be transferred in the last three years of our forecast period. Most of the states could not provide us with this information and the ones that did, showed varying proportion of transfers. We, therefore, decided to use the proportion adopted by the Eleventh Finance Commission for general category states. Thus, 30 per cent of the plan revenue expenditure in 2006-07 has been proposed for transfer to non-plan side in the next year for the general category states. Further, even though the Eleventh Finance Commission did not provide for any such transfer in the case of special category states, we have assumed a transfer of 10 per cent of their plan revenue expenditure to non-plan side.

6.48 For working out the plan revenue expenditure in 2006-07, we applied 5 per cent annual growth rate on the plan revenue expenditure of 2004-05(BE) of each state to obtain the level of 2006-07. Of this, 30 per cent has been provided as transfer to non-plan revenue expenditure side in 2007-08 for general category states, and 10 per cent for special category states. We decided on a lower proportion for special category states as the Planning Commission allows them to divert 20 per cent of central plan assistance for meeting non-plan expenditure. Thereafter, the level of committed liabilities estimated for 2007-08 was grown at an annual rate of 7.5 per cent in the remaining two years of the forecast period. Annexure 6.11 indicates the expenditure relating to transfer of committed liabilities in the forecast period.

Summary of Assessment

6.49 The result of this detailed exercise, indicating our assessment of the revenue, expenditure and pre-devolution non-plan revenue deficit of each state for each year of the award period, is furnished in annexure 6.12. Table 6.2 indicates the summary of the results for all states combined.

Table 6.2

Pre-devolution Non-Plan Revenue Account of Aggregate States, 2005-10

(Rs. crore/per cent)

	Item (1)	States' Projections (2)	Our Projections (3)	Difference (3-2) (4)
i.	Own Revenue Receipts	1391002 *(6.3)*	1653661 *(7.5)*	262659 (1.2)
ii.	Non-Plan Revenue Expenditure	2315499 *(10.5)*	1879298 *(8.5)*	-436201 (-2.0)
iii.	Pre-devolution gap (i - ii)	-924497 *(-4.2)*	-225637 *(-1.0)*	698860 *(3.2)*

Figures in parentheses are percentage of GDP.

As compared to the states' projections of own revenue receipts at 6.3 per cent of GDP, the assessment by this Commission has placed it at 7.5 per cent, an increase of 1.2 percentage points. The reduction in NPRE, however, has been somewhat larger at 2.0 percentage points. The compression of the pre-devolution gap from 4.2 per cent of GDP to 1.0 per cent has resulted from the normative assessment of revenues and expenditure.

Salient features of normative assessment

6.50 Own Tax Revenues: In conformity with the plan for restructuring state finances, the tax-GDP ratio, considering all states, has been raised by a little less than 0.9 percentage point over the forecast period. This has been achieved by a two-step process. In the first instance, the tax-GSDP ratio of those states, for which this ratio is lower than their respective group average, has been partially corrected in the base year. In the second step relating to projection for the forecast period, differential buoyancies have been assigned to the states in a manner so that the objective of overall improvement in the tax-GDP ratio is achieved.

6.51 Own Non-Tax Revenues: Wherever possible, the projection of own non-tax revenues have been linked to associated costs. Thus, the projections of interest receipts and dividends are based on recovering some part of the borrowing costs. Similarly, cost recovery norms have been used for projecting irrigation receipts by making these recover a substantial part of maintenance expenditure. For projecting user charges under general, social and economic services, the growth rates employed have been fixed at a higher level than the growth rates used for projecting their corresponding expenditure. Thus, the principle of cost recovery adopted for projecting own non-tax revenues has resulted in reducing the subsidies implicit in the budgetary provisions.

6.52 Non-Plan Revenue Expenditure: Our approach has been to attempt compression of the growth rate of NPRE in general, while encouraging higher growth in expenditure in areas relating to education, health, maintenance of roads and maintenance of buildings. This has been captured in the following manner:

(i) Interest payments: The overall objective has been to bring down the burden on this count, and not provide fully for interest payments arising from large scale borrowings by some of the states in the past while computing the deficit grant. For this purpose, corrections in the base year have been made for those states whose ratio of interest payments to total revenue receipts is higher than the average. Further, for projections in the forecast period, an average growth rate of 7.5 per cent has been adopted, as against the average growth rate of 18.2 per cent during 1993-2003.

(ii) Pension payments: In determining pension payments, keeping in view the inability of the states in influencing this expenditure stream in the medium term, budget estimates for 2004-05 have been adopted as the base year figure, and a growth rate of 10 per cent adopted in the forecast period, broadly in line with recent growth rate.

(iii) Education and health sectors: Our objective has been to encourage higher expenditure in these sectors. In the projections here, we have assigned the normal growth rate of 6 per cent and 5 per cent in the salary component of education and health sectors respectively, but a much larger growth rate of 30 per cent in the non-salary components. The revenue deficit grants have been worked out accordingly. Being conscious of the fact that application of liberal norms for education and health expenditure does not guarantee that larger funds would flow to these sectors, we have given additional grants-in-aid separately for these two sectors in line with the equalisation principle to some of the states, as discussed in chapter 10.

(iv) Maintenance of irrigation works: The projections have been worked out largely on the basis of norms obtained from Ministry of Water Resources. The expenditure norms adopted by us in the base year are Rs.600 per hectare for utilised potential and Rs.300 per hectare for unutilised potential of major and medium irrigation schemes. A norm of Rs.300 per hectare has been adopted for minor irrigation schemes. The projections have been worked out on the basis of an annual growth rate of 5 per cent.

(v) Maintenance of roads and bridges: The approach followed by us is similar to that for health and education sectors. We have encouraged larger expenditure for maintenance of roads and bridges by providing separate additional grants as discussed in chapter 10. For computation of revenue deficit grant, however, we have decided to adopt the normal expenditure figures, with a 5 per cent growth rate in the forecast period.

(vi) Other general, other social and other economic services: These items were considered appropriate for expenditure compression in terms of growth rate, particularly their salary part. Thus, in the base year, we took the lower of the TGR-based estimates and the budget estimates. For purposes of projection, the salary component was held constant in real terms by assigning an average nominal growth rate of only 5 per cent. The non-salary part is to grow normatively at 7 per cent for other general services, and 10 per cent for the remaining two services.

(vii) Compensation and assignment to local bodies: We have encouraged the expenditure on local bodies in two ways. Firstly, we have excluded local body grants given on central finance commission's recommendations from the receipt side of the states, but we have not excluded an equal amount from the expenditure side. This would result in a higher normative revenue deficit for the states. Secondly, we have assumed a larger annual growth rate of 12.5 per cent during the projection period on expenditure relating to compensation and assignment to local bodies.

(viii) Transfer of committed plan liabilities: 30 per cent of the plan revenue expenditure in 2006-07 for general category states, and 10 per cent in the case of special category states, has been transferred to the non-plan revenue expenditure side in 2007-08, which would help the states in taking up new plan schemes.

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