Chapter 15

Concluding Observations

15.1 The Commission has recommended a scheme of fiscal transfers that can serve the objectives of equity and efficiency within a framework of fiscal consolidation. The effort needed to achieve fiscal consolidation should be seen as the joint responsibility of the central and state governments. For achieving vertical and horizontal balance, consistent with the responsibilities of the two levels of governments in respect of providing public and merit goods and services, both the centre and the states need to raise the levels of revenues relative to their respective revenue bases, and exercise restraint in undertaking unwarranted expenditure commitments.

15.2 The finances of the central and state governments, individually and in the aggregate, have evinced large and persistent imbalances in the period preceding the Commission's award period. Four factors have accounted for the continuing deterioration: fall in centre's tax-GDP ratio compared to the peak levels achieved in the late eighties, substantial increase in the level of salary and pension payments, particularly for the states, in the wake of the recommendations of the Fifth Central Pay Commission, high levels of nominal interest rates in the late nineties combined with the subsequent fall in inflation rates, and the low growth rates in the first three years of the new decade. While these reasons account for the acuteness of the ailment, there are also underlying structural reasons for the persistence of fiscal deterioration because of the tax structure and expenditure pattern.

15.3 In the scheme of fiscal transfers, the correction of vertical imbalance is, to some extent, based on judgment. An assessment has to be made of the gap between resources and responsibilities at the two levels of government. Taking into account a variety of factors including the historical trends, we have recommended an increase in the share of states in the divisible pool of taxes to 30.5 per cent from the current level of 29.5 per cent. We believe that this increase can be accommodated by the central government by pruning their activities that fall in the domain of the states. We have raised the indicative limit of overall transfers out of the gross revenue receipts of the centre from 37.5 per cent to 38 per cent.

15.4 In the context of horizontal imbalance, we feel that the equalization approach to transfers is appropriate as it is consistent with both equity and efficiency.

It has not, however, been possible to implement this approach fully, as the extent of disparities in the per capita fiscal capacities of the states is too large and some of the better-off states are also in serious fiscal imbalance. In the devolution scheme recommended by us, we have endeavored to strike a balance among different criteria reflecting deficiency in fiscal capacities, cost disabilities, and fiscal efficiency. Apart from following a normative approach in assessing own resources and expenditures of the states with a view to estimating the resource gap, we have focused on education and health as the two critical merit services, where highest priority must be accorded in reducing disparities in the level of service provision, and have recommended conditional grants, within the framework of the equalization approach. We have also increased the proportion of grants to tax-devolution in the scheme of transfers. It is therefore necessary that in judging the transfer to a state, both tax devolution and grants should be taken into account. The coefficient of correlation between comparable GSDP per capita (average of 1999-00 to 2001-02) and the recommended per capita transfers, comprising tax devolution and all the grants, among the general category states excluding Goa, is estimated at -0.89, which emphasises the redistributive character of the transfers.

15.5 We have laid emphasis on strengthening the local bodies in keeping with the constitutional mandate for effective and autonomous local self-governance, recognizing that local bodies must be supported by a scheme of transfers that encourages decentralization and own effort for raising revenues. The recommended transfers for the local bodies constitute about 1.24 per cent of the shareable taxes and 0.9 per cent of centre's gross revenue receipts.

15.6 We have recognized that the debt burden of the states is currently heavy. We have provided a scheme of debt relief, which is in two parts. First, there is the relief that comes from consolidating the past debt and rescheduling it, along with interest rate reduction. The second part consists of a debt write-off, which is linked to the reduction in the absolute levels of revenue deficits. Both reliefs will be available, only if states enact appropriate legislations to bring down the revenue deficit to zero by 2008-09 and commit to reducing the fiscal deficit in a phased manner. With the relief that we have recommended, it should be possible for states to pursue their developmental goals with fiscal prudence.

15.7 We have argued that important institutional changes are required to tackle some of the structural problems in managing government finances. One central change relates to the regime of government borrowing. We have recommended that states, like the centre, must decide their annual borrowing programme, within the framework of their respective fiscal responsibility legislations. There is also a need to let the states access the market directly for their borrowing requirements. The overall limit to their annual borrowing from all sources should be supervised by an independent body like a Loan Council with representatives from the Ministry of Finance, Planning Commission, Reserve Bank of India, and the state governments. This Council may, at the beginning of each year, announce borrowing limits for each state, taking into account the sustainability considerations into account. Our suggestion

for de-linking grants and loans in plan assistance, as these need to be determined on different principles, is part of the reform of the borrowing regime.

15.8 In our plan for restructuring government finances, we expect a positive growth dividend, as revenue deficits relative to GDP progressively fall, implying a fall in government dis-savings, and an increase in the overall savings relative to GDP. A higher tax-GDP ratio combined with higher growth on a sustained basis, and fall in interest payments, create the necessary space for increasing government capital expenditure, and productivity enhancing non-interest, non-salary revenue expenditure. The virtuous cycle of reforms, robust government finances, and an equalizing system of fiscal transfers, should help establish a sound federal fiscal system in India.

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