# CHAPTER IV

## REASSESSMENT OF THE FORECASTS OF THE CENTRAL GOVERNMENT

4.1 Paragraph 5(i) of the President's Order enjoins that in making its recommendations, the Finance Commission shall have regard, among other considerations, to the resources of the Central Government and the demands thereon on account of the expenditure on civil administration, defence and border security, debt servicing and other committed expenditure or liabilities.

4.2 We requested the Ministry of Finance to send us forecasts of the Central Government's receipts and expenditure on revenue account and capital account for the five years ending with the financial year 1988-89. These were received on 19th August, 1983. Subsequently, the Commission held detailed discussions with the Union Finance Secretary and his colleagues regarding the premises under-lying and the assumptions made in preparing the forecasts. In respect of certain issues relating to direct taxes, the Commission had separate discussions with the Chairman of the Central Board of Direct Taxes and his colleagues. The Commission also held discussions with the Defence Secretary, the Secretary, Department of Petroleum and the Financial Commissioner, Railways, regarding the estimates of receipts and/or expenditure with which they were concerned. Further, the Secretary of the Commission held discussions with Member (Finance), Posts and Telegraphs Board. All these discussions were intended to have a fuller understanding of the important aspects of the Centre's forecasts.

4.3 It emerged from the discussions with the Ministry of Finance that the projections of tax revenues were made on the following two important assumptions: first, that the gross domestic product (GDB) would grow at the rate of 4.5 to 5 per cent per annum; and second, that the annual price rise would be around 4 per cent to 5 per cent. The projection of revenues from customs duties, it was explained, was based on the expected levels of imports and exports and the overall position regarding balance of payments. It was clarified by the Ministry that all individual heads of revenue expenditure had been projected at constant prices. However, they had made a lump-sum provision to meet the cost of fresh instalments of dearness allowance that might be sanctioned to employees during the forecast period.

4.4 As mentioned in the previous Chapter, the States' revenue and expenditure have been projected by us for the forecast period at 1983-84 prices. To be consistent, the forecasts of receipts and expenditure received from the Finance Ministry have been re-worked on the assumption of price stability. For this purpose, the rates of growth of revenue from different sources, particularly from the major taxes and duties, had to be appropriately determined.

4.5 At our instance, the National Institute of Public Finance and Policy carried out detailed exercises for projecting revenues from four important Union taxes viz. income tax, corporation tax, Union duties of excise and customs duties. The projections were worked out on the basis of partial elasticities with respect to income and price variables.

4.6 We also received from the Central Board of Direct Taxes two alternative estimates of income tax and corporation tax collections during the forecast period based on partial elasticities. One estimate assumed 4 per cent annual rate of growth in non-agricultural GDP and zero rise in wholesale price index. The other estimate incorporated in addition to a 4 per cent annual rate of growth in non-agricultural GDP, an increase of 5 per cent in the index of wholesale prices.

4.7 We also compared the actual rates of growth of revenue from the important Union taxes/duties during the period 1978-79 to 1983-84 with the rates of growth assumed by the Seventh Finance Commision and also with the rates of grwoth assumed by the Working Group set up by the Planning Commission for estimating the resources for the Sixth Plan.

### TAX REVENUES

4.8 In considering the growth of some of the important Union taxes and duties, we also took note of certain recent developments which have an important bearing on the assumptions to be made about the growth of individual taxes. For example, while the rate of growth of revenues from income tax has not been impressive in the recent year, about Rs. 1000 crores of un-accounted money was mopped up through bearer bonds. This shows that a more effective enforcement of the income tax laws would have produced a higher growth rate. Again, one of the principal reasons given by the Ministry of Finance for the decline in growth of revenue from Union excise duties in the recent past is the change in the pattern of industrial growth. It was pointed out that industrial growth in the past few years had been characterized by the relatively higher rate of growth of un-registered and small-scale units which enjoyed more liberal concessions under the scheme of excise duties. The growth of the rest of the industrial sector was slower. Further, with the exception of 1981-82 when there was a growth of 8 per cent, industrial production registered a rate of growth of only 3 to 4 per cent in other years. It was explained that both these factors appeared to be responsible for the decline in the rate of growth of revenue from Union duties of excise.

4.9 While determining the rates of growth of revenue from the taxes and duties of the Union Government, we have had regard to all the facts mentioned above. We have also kept in view the behaviour of several relevant macro and policy variables while finally determining the rates of growth of revenue on the assumption of price stability during the forecast period.

4.10 It may be recalled that though State Governments have presented their budgets for 1984-85, we have not used the Revised estimates for 1983-84 for the reasons given in paragraph 3.11 of the previous chapter; instead the estimates of receipts/expenditure for the base year 1983-84 were built up from the actuals of 1982-83. However, in the case of the Centre, the estimates for the base year 1983-84 have been reworked out by us using the Revised estimates for 1983-84 with suitable modifications. We made this departure as the budget documents relating to the financial year 1984-85 which contain the details of Revised estimates for 1983-84 were furnished to us and it was possible, within the time available to us, to undertake a fresh review of the resources of the Centre on the basis of the Revised estimates for 1983-84.

4.11 Briefly, the methodology and the rates of growth adopted by us are as follows:

(a) Growth rates are expected to be influenced by changes in income, prices and other factors. On the assupmptions of price stability and 5 per cent annual increase in income during the forecast period, and taking into account all other relevant factors, we have determined the annual rate of growth of income tax at 6.5 per cent, of corporation tax at 7.5 per cent (excluding the receipts from petroleum companies) and of Union duties of excise at 7 per cent (excluding the receipts from cess on crude oil).

(b) The receipts of corporation tax from petroleum companies depend upon the production of crude oil and hence they have been projected separately on the basis of the forecast given to us by the Department of Petroleum, after taking into account the deductions permissible under section 42 of the Income Tax Act for prospecting and production of mineral oils and the agreements between the Central Government and the petroleum companies.

(c) The estimates of the cess on crude oil are also based on the forecast of crude production furnished to us by that Department.

(d) As a result of the recent judgement of the Supreme Court holding that the manufacturers are liable to pay excise duty on post-manufacturing expenses, arrears of excise duty have become recoverable. Our forecast assumes the recovery of such arrears.

(e) Having regard to the likely levels of export and import during the forecast period, we have adopted 7 per cent as the rate of growth of customs duties.

(f) For estimating the proceeds in the Union territories from taxes like sales tax, motor vehicles tax, State duties of excise, etc., the rates of growth adopted by us in the adjacent States have generally been applied.

## NON-TAX REVENUES

4.12 The two important items of non-tax receipts which require special mention are interest receipts and dividends. The forecast of the interest receipts of the Centre includes recovery of interest on fresh lendings by the Central Government during the forecast period. We have re-assessed the Centre's forecast, prepared on this basis, so as to get a complete picture of their resources.

4.13 The two major items of fresh loans to the States in the forecast period, interest on which has been included in the Centre's forecast, are the loan component of Central assistance for Plans and the loans against small savings collections. In regard to loans for Plans, the forecast received from the Finance Ministry assumed an increase of 10 per cent per year. As regards the fresh loans to the State Governments against small savings collections, we have assessed the net collections of small savings during the forecast period at about Rs. 14,700 crores and we have provided for loans of about Rs. 9,800 crores to the State Governments. The estimates of interest receipts from the State Governments and the Union territories as furnished in the Finance Ministry's forecast have been accepted, except for the modifications required on account of the changes made in the estimates of loans against small savings collections referred to above.

4.14 The forecast of interest receipts from Railways and the Posts and Telegraphs furnished by the Railway Board and Posts and Telegraphs Board, based on their expectations of Plan investments, have been accepted.

4.15 Most of the loans, other than those to State Governments/Union territories, are due from the public sector undertakings of the Central Government. Consequently, we have re-assessed the interest receipts assuming an average rate of 7 per cent.

4.16 According to the Public Enterprises Survey for 1982-83 published by the Bureau of Public Enterprises, out of 144 running commercial and industrial undertakings (other than financial institutions, Life Insurance Corporation, General Insurance Corporation and the banks) in which the Central Government's equity investment was Rs. 13,121 crores at the end of 1982-83, a net profit of Rs. 1,517 crores was made by 82 enterprises, and the remaining companies incurred losses amounting in all to about Rs. 821 crores. Dividend amounting to Rs. 114 crores was declared by 44 companies and the Centre's share in the dividend was Rs. 110 crores. Thus, the Central Government received a return at the rate of 0.84 per cent.

4.17 In view of the nature of the Central enterprises we have thought it fit to consider them as a whole for the purpose of estimating dividends from the Central investments made in their equity. It may be recalled that in the case of States, we had taken into account the broad purposes subserved by the public sector undertakings and classified them into promotional, financial and commercial undertakings and we had assumed dividends at the rates of nil, 3 per cent and 5 per cent respecitvely from the investments in these undertakings. The Seventh Commission assumed a return of 7.5 per cent by 1983-84 to the Centre on equity investments by the Central Governments. For the financing of the Sixth Plan, the Planning Commission had assumed a return of 8 per cent on the investments of the Central Government rising to 10 per cent at the end of the Sixth Plan. Large investments have been made in the public sector undertakings in pursuance of the national economic policy, which envisages control of the commanding heights of the economy by the Government. The policy further envisages that these investments would yield reasonable surplus to the undertakings which could be ploughed back for further development or utilised to give returns to the Centre by way of dividends. There are, thus, strong grounds for expecting higher returns on these investments. However, keeping in view the losses being incurred at present as mentioned above and taking a realistic view of the matter, we have assumed an average minimum dividend of 6 per cent only during the forecast period.

4.18 The Central Government's departmental undertakings have been treated in the same manner as those of the States. In regard to the Delhi Milk Scheme, we have assumed that the existing losses would be reduced and wiped out completely, by 1986-87. However in the case of power projects like the Badarpur Thermal Station, return at the rate of 7 per cent has been assumed on the entire investment as at the end of 1983-84.

## REVENUE EXPENDITURE

4.19 Turning to the revenue expenditure, as already stated, the Finance Ministry's projections under individual major heads in their forecast were based on assumptions of price stability during the forecast period. We observe that all the important heads of expenditure have been projected at a rate of 5 per cent per annum which we consider reasonable. Their forecast also included provisions for the interim relief sanctioned from 1st June, 1983 but did not include any contingent provision to meet the liabilities that might arise on account of the recommendations of the Fourth Pay Commission which has recently been set up.

4.20 To enable the Central Government to pay dearness allowance (DA) in the event of an increase in prices, lump sum provisions had been made by them in each of the five years of the forecast period. As our reassessment is based on price stability during the forecast period, we have excluded the provisions for dearness allowance from our calculations.

4.21 It was intimated by the Ministry of Finance that the forecast of defence expenditure was based on the tentative projections made by the Defence Ministry. These projections were discussed with the Finance Secretary and his colleagues as well as with the Defence Secretary. We have reassed the defence provisions with a view to adjusting them for constant prices.

4.22 The forecast of interest payments furnished by the Ministry of Finance has been modified' by us in consequence of the changes made in the forecast of some items of capital receipts like market loans and small savings collections, to which we will refer later.

4.23 Subsidies constitute an important item of expenditure of the Central Government. The major part of the expenditure on subsidies is accounted for by three items viz. foodgrains, fertilisers and exports. The Seventh Finance Commission thought that while export subsidies might not be susceptible to reduction in view of the role they played in sustaining the national export effort, there was scope for reducing the burden of subsidies on fertilisers. They assumed a progressive decrease in the subsidy on fertilisers and reduced it to nil by 1983-84. So also, in regard to food, they assumed that the quantum of the subsidy would be reduced in 1983-84 by 25 per cent from the level existing in 1979-80. Unfortunately, these expectations of the Seventh Finance Commission have not materialised for various reasons.

4.24 Our view in regard to food subsidy is that it would be unrealistic to assume any reduction in the level of this subsidy during the forecast period. Factors such as growth of population, larger procurement and off-take of foodgrains, increases in prices of foodgrains and of storage charges etc. are the important factors which effect the quantum of subsidy. All these factors are likely to necessitate a higher subsidy. We have, however, projected the amount of subsidy shown in Revised estimates for 1983-84 at the rate of 2 per cent per annum to provide only for the likely increase on account of the increase in population. So far as other factors are concerned we expect the Central Government and the Food Corporation of India to meet the additional burdens by increases in the issue prices and/or by reduction in the costs of handling foodgrains. On this basis, we have made a provision of Rs.4,433 crores for subsidy on food as against a provision of Rs.4,884 crores made in the Ministry's forecast.

4.25 We notice that the subsidy on indigenous fertilisers has risen steeply in recent years. This seems to be for two reasons. Firstly, efforts are being made, as a matter of policy, to substitute imports by indigenous production of fertilisers. The domestic costs of production are higher than the international prices. The subsidy is calculated on the basis of retention prices fixed for the various manufacturing units. Larger amounts of subsidy have become payable as a greater portion of the demand is being met by indigenous production of fertilisers. Secondly, in order to encourage the farmers to increase the consumption of fertilisers, the issue prices had also to be subsidised. These considerations are unlikely to change in the near future and, therefore, it is unlikely that there will be any significant reduction in the levels of subsidy during the forecast period. We have projected increases in the quantum of subsidy so as to take into account the likely increase in production in the forecast period. We have, however, not made provision for increase in the quantum of subsidy on account of further increase in the production costs of fertilisers. We expect that the latter increases would be suitably absorbed in the issue prices of fertilisers. Accordingly, we have reduced the provision of Rs.10,197 crores made by the Ministry to Rs.6,581 crores.

4.26 The need to step up exports still continuous and there is a rationale for the export subsidy which is being given at present. Taking note of the present overall economic policy, we have made provisions for the subsidy in the forecast period at the level obtaining in Revised estimates for 1983-84.

4.27 A major item of expenditure is the transfer to the Oil Industry Development Board of the cess raised by the Central Government on the production of crude oil. The law under which the cess is levied earmarks it for the development of the oil industry. The receipts from cess are estimated at Rs.854 crores in Revised estimates for 1983-84. Though no transfer is envisaged in Revised estimates for 1983-84, the Finance Ministry has indicated that the entire amount of receipts will be transferred to the Oil Industry Development Board in the forecast period. These funds are required by the Board for lending to the various nationalised petroleum companies. The expenditure of the Board is in the nature of Plan expenditure. Consequently, in estimating the revenue surplus of the Central Government, we have not made any provision for such transfers.

# COMMITTED LIABILITY

4.28 The forecast of the Central Government did not include provisions for maintenance of the Plan schemes completed by the end of 1983-84. We have, however, made provisions for this in the year 1984-85 as well in subsequent years after obtaining relevant information from the Ministry of Finance. So far as Sixth Plan schemes completed during 1984-85 are concerned, we have not made provision for their committed liability in the first four years of the Seventh Plan, namely, 1985-86 to 1988-89. This procedure has been adopted in accordance with the recommendation of the majority of the Commission for reasons similar to those stated in paragraph 3.127 of Chapter III.

4.29 Shri Justice T.P.S Chawla and Shri G.C. Baveja are of the view that this Commission should follow the practice adopted by the Planning Commission for making provision for maintenance of Plan schemes. They are, therefore, in favour of making provision for maintenance of all the Sixth Plan schemes, including those likely to be completed in the year 1984-85, in the forecast period commencing from first year of the Seventh Plan, i.e. 1985-86. For the same reason, they are against making provision in the year 1984-85 for maintenance of Sixth Plan schemes completed by 1983-84, since this would appropriately form part of the Plan expenditure and not non-Plan expenditure.

## CAPITAL ACCOUNT

4.30 As indicated earlier, we have modified the Centre's estimates in respect of market loans and net small savings collections as a result of which additional receipts of about Rs. 11,000 crores would accrue in the forecast period. These changes are based on the trends of the major determinants of market loans and small savaings collections in the recent past. The Centre's forecast did not provide for repayment of small savings loans by the State Governments. We have revised the forecast in this respect by including, according to the normal terms and conditions of these loans, such repayments amounting to Rs.960 crores during the period 1984-85 to 1988-89. On the expenditure side, we have made additional provision for loans to the States against their share in small savings collections.

4.31 Annexure IV-I presents a summary of the results of our reassessment of the Centre's forecast. As a result of our reassessment, the surplus on Revenue Account of the Central Government will increase by Rs. 18,671 crores and that on Capital Account by Rs. 11,736 crores, resulting in an overall surplus of Rs. 96,319 crores during the forecast period as against Rs. 65,912 crores assessed by the Ministry of Finance.

4.32 Shri A.R. Shirali has some reservations on the above reassessment. These are reflected in his Note of Dissent which is appended.

## CHAPTER V

## INCOME TAX

5.1 Under Article 280(3) of the Constitution, it is the duty of the Finance Commission to make recommendations to the President, inter alia, as to the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds. Article 270(2) of the Constitution specifically provides that such percentage, as may be prescribed, of the net proceeds in any financial year of taxes on income, other than agricultural income, except in so far as these proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which the tax is leviable in that year. Sub-clause 4(a) of Article 270 specifically excludes corporation tax from the definition of 'taxes on income'. Article 271, permits levy of a surcharge on taxes and duties for the purposes of the Union and the whole proceeds of such surcharge form part of the Consolidated Fund of India.

5.2 The share out of the net proceeds of income tax assigned by the First Finance Commission to the States was fixed at 55 per cent. This was raised to 60 per cent, 66 2/3 per cent and 75 per cent by the Second, Third and Fourth Finance Commissions respectively. The Fifth Finance Commission did not increase the States' share further and retained it at 75 per cent, inter alia, on the ground that the proceeds of the income tax distributable among the States during the period covered by the Commission's recommendations would also be inclusive of advance tax collections which, till then, were not shared with the States.

5.3 The Sixth Finance Commission increased the States' share in income tax to 80 per cent having regard to various considerations. Their approach was conditioned by the desire to ensure that there was no decrease in the distributable income tax pool on account of the disappearance of the arrear element of the advance tax collections which existed in the previous period. The Seventh Finance Commission was impressed by the grievance of the States that the Centre was using the power to levy surcharge as a normal revenue measure, instead of restricting its use to meet extraordinary or emergent needs and, hence, increased the States' share to 85 per cent of the net proceeds.

5.4 In their Memoranda submitted to us, eight States viz. Assam, Bihar, Gujarat, Jammu & Kashmir, Karnataka, Nagaland, Orissa and Tamil Nadu have pleaded for an increase in the States' share in income tax from 85 per cent to 90 per cent. Punjab has proposed enhancement of the States' share to 90 per cent of the net proceeds of income tax, inclusive of surcharge. Four States, viz. Madhya Pradesh, Maharashtra, Rajasthan and Uttar Pradesh have proposed that it should be 95 per cent. Another four States viz. Andhra Pradesh, Haryana, Tripura and West Bengal have proposed that it be hundred per cent.

But Andhra Pradesh has, alternatively, said that if surcharge on income tax is merged in the divisible pool, such percentage share may be kept at 90 per cent of the enlarged divisible pool. Further, both Andhra Pradesh and Haryana have suggested that if surcharge and corporation tax are both included in the divisible pool, the share of the States in the combined receipts may be reduced to 50 per cent. Four States viz. Himachal Pradesh, Kerala, Manipur and Sikkim have not proposed any change in the existing share of 85 per cent.

Meghalaya is the only State which has suggested a reduction in the share of the States to 80 per cent, or even 75 per cent, for the reason that surcharge on income tax has been brought down from 15 per cent as at the time of the last Commission's report to $12\frac{1}{2}$ per cent as at present.

5.5 The States, by and large, have advanced two main arguments for increasing their share in the divisible pool of income tax. Firstly, they say that surcharge and corporation tax should be made a part of the divisible pool or, alternatively, whilst determining the share of the States, regard be had to the fact that they are not part of the pool. Secondly, they say that the share of the divisible pool should be enhanced because their needs have increased over the years.