CHAPTER X

CONCLUDING OBSERVATIONS

10.1 The task of a Finance Commission is a difficult one under any circumstances, as it involves judging the claims, needs and resources of the Centre and the States and on that basis working out a judicious scheme of transfers that would result in the balancing of needs and resources of the different governments. This Commission's task was rendered doubly difficult because of the grim and deteriorating fiscal scenario which we faced as we started our labours. It was a matter for concern that while the economy was doing well in many respects, the budgetary situation was far from satisfactory and was likely to hamper growth. There was a large and growing deficit on revenue account at the Centre and in the budgets of several States. In such a situation, any attempt to work out a scheme of Central transfers on the assumption that past trends would or could continue was a futile exercise. We were thus led to adopt a normative approach which had also been suggested in our terms of reference.

10.2 As this was the first time that a systematic normative approach to the assessment of revenue receipts and expenditure was being attempted, we had to develop first the basic principles of a normative approach and then work out the specific methods of assessing revenue receipts and revenue expenditure. It is in working out the methodologies of the normative assessment and applying them in practice that we had to face the greatest difficulty. Not much work had been done by Indian scholars in this area, particularly in relation to the normative assessment. We could get some guidance from studies conducted in certain other federations such as Australia and from practices in those countries. However, since the federal finance situation in our country has its own peculiar features, we had to work out for ourselves the entire methodology of normative assessment using certain relevant principles developed abroad with due adaptation.

10.3 The broad methodologies that could be applied in practice depended on the availability of data. A major source of difficulty has been in relation to obtaining relevant detailed data on a number of economic variables and other factors needed as base for making the normative assessments. Even when a methodology requiring less data was chosen, there was often difficulty in getting even such minimum data. Thus, we found that sufficient and reliable information was not available on tax bases or on the net yield of additional tax measures undertaken in various years. On the expenditure side, we could not find any authoritative or reliable studies on, for example, cost effectiveness of defence expenditure, the cost justification and distribution of benefits of subsidies of various kinds, etc. The Commission itself did not have time or resources to gather primary data or to undertake original research studies. The methodologies of normative assessments and their applications suffer from some imperfections traceable to data limitations.

10.4 It is also to be borne in mind that we were initiating a new approach with no precedence to build upon. In course of time, further experimentation should be possible and improvements in methodology could be effected. Apart from the limitations arising from the paucity of data, we also have had to make allowance for the fact that State finances were being subjected to a full-fledged normative assessment for the first time by. a Finance Commission, and, hence, we have thought fit to moderate the results of the normative assessment. As indicated in the relevant places, we have also been quite liberal in making assessments in respect of the Special Category States. Notwithstanding this liberality and the moderation of the results of normative assessment of the revenue receipts and expenditure of the non-Special Category States, we have taken care to ensure that the intended impact of normative assessment will be felt by the different States and the Centre and the signals generated by the principles underlying our scheme of Central transfers would serve to induce fiscal prudence without impinging in any way on fiscal autonomy.

10.5 The State Governments had argued before us that while it was desirable to adopt a normative approach, it was at the same time necessary to give adequate time for them to make the adjustments. The moderation of norms we have introduced is partly in response to the plea by the State Governments. The States had also urged that the normative assessment should be equally applied to the States and the Centre. We have indicated in Chapter II, the manner in which we have applied the normative approach to the assessment of Central revenues for the period 1990-95. In regard to Centre's revenue expenditure, we have sought to restrain its rate of growth. We have allowed for an overall growth in non-Plan revenue expenditure of the Centre over the base of the budget estimates of 1989-90 at only 9.7 per cent per annum in nominal terms (on the assumption of a 5 per cent rate of inflation) as against the long-term rate of growth of 17.0 per cent during the period 1974-75 to 1989-90. This represents an acceleration of the process of correction attempted in 1989-90 Budget wherein the increase in non-Plan revenue expenditure over the level in the 1988-89 revised estimates was 10.6 per cent. Of the total increase, interest payments are taken to grow at 12 per cent per annum as against 23.4 per cent in the eighties. This assumes a considerably reduced rate of growth of indebtedness which is expected to be achieved, inter alia, by taking a part of the financing of public investment out of the budget.

10.6 The rate of growth of Central Government expenditure has thus been determined normatively, keeping it well below the postulated rate of growth of revenues, as has been done in the case of the States. It could, however, be argued that the Commission should have considered the justifiable cost of providing a given standard of services in the case of the Centre too. In fact, it has been pointed out to us that the Central Government was spending large amounts of money in areas and subjects which belong properly to the jurisdiction of the State Governments under the Constitution, for example, agriculture. The strength of staff in Departments and Ministries dealing with the subjects falling largely or wholly within the jurisdiction of the States is considered by some to be unduly large. The Commission did not have the resources to undertake in depth studies in order to examine such issues. For example, while the requirements of defence will have to be assessed by military experts and the Government, it would be desirable to aim at minimisation of the cost of providing a given degree of military capability and deterrence. We had no way of judging the present level of defence expenditure on the basis of the above criterion.

10.7 Most of the data we collected have been computerised and will be passed on to the Ministry of Finance. In the very difficult task we were assigned to carry on, and in the context of the disconcerting fiscal scenario we felt hamstrung by non-availabilty of ready, adequate and reliable data. We, therefore, recommend that between the end of the life of one Finance Commission and the appointment of the next Finance Commission, in the interregnum, active and imaginative studies and projects on different topics relevant for the working of the Finance Commission be undertaken by the Finance Ministry to facilitate the work of the incoming Finance Commission. We strongly suggest that the present Division in the Finance Ministry which looks after the work of the Finance Commission, in the interregnum, be entrusted with this task. The Division, however, needs to be substantially strengthened and should function under a separate Senior Joint Secretary assisted by adequate number of officials and technical staff trained to collect and analyse the data and material, necessary for the Finance Commission. It may also be worthwhile examining constituting an Advisory Committee headed by a person well conversant with the intricacies of the public finances in India, which should guide this particular Division in its work and functions. One of our Members, Shri Justice A.S. Qureshi, however, in his dissenting note has suggested a different approach on this point. He opines, that Clause 1 of Article 280 of the Constitution envisages a permanent Finance Commission to be reconstituted every five years.

10.8 We would like to refer here to a complaint made by several State Governments, that while the Finance Commission wishes to impose, and might succeed in imposing, fiscal discipline on the State Governments, a similar dicipline could not be imposed on the Central Government. The Central Government, they argued, has access to credit from the Reserve Bank of India (on which limitations could be placed only out of Central Government's own volition), which meant not only that the Centre could incur expenditure in excess of whatever norms were prescribed, but also that an inflationary rise in prices was generated which threw the budgets of the States out of equilibrium.

10.9 The approach adopted by this Commission would result in a degree of discipline being imposed on the budgetary operations of the State Governments in the following manner. First, the volume of Central transfers has been determined on the basis of a normative assessment of revenue receipts and revenue expenditure and this places a limit on possible increases in expenditure without additional resources being mobilised. Second, this Commission has not attempted to fully close the non-Plan capital gaps of the States and as such the States would have to observe extreme caution in incurring additional debt, especially for financing revenue expenditure. Third, the overdraft facility with Reserve Bank of India to the State Governments has already been strictly limited. As against this, the fact that the Union Government has virtually unlimited "overdraft facility" with Reserve Bank of India means that it can incur additional debt to finance expenditures in excess of norms without raising additional revenue resources of its own. We have earlier urged that the Central and State Governments should be treated in a similar manner with regard to fiscal discipline. We recommend that a convention should, therefore, be developed limiting the extent of deficit financing by Central Government, in any given year, to an amount to be determined in consultation with the Governor of the Reserve Bank of India on the basis of certain objective economic criteria to be clearly laid down in advance. We would urge that suitable guidelines and criteria for determining the permissible amount of net RBI credit to Government be devised jointly by the Union Ministry of Finance and the Reserve Bank of India. It will also be necessary to predetermine the permissible peak level of RBI credit to Central Government at any point of time, in the course of the year.

10.10 In our first report, we had stated that in the report for the period 1990-95, we shall indicate in some detail the changes in fiscal policy and practices needed to bring about a situation of balance in the revenue budgets. Fiscal experts are agreed that the sine qua non for controlling the growth of revenue expenditure is the avoidance of inflation. This in turn requires strict limits to be placed on deficit financing in the sense of net RBI credit to the Central Government. Therefore, the first basic change in fiscal policy required is that the extent of deficit financing permissible in an year should be first determined in the manner we have suggested in paragraph 10.9 above. If under certain extraordinary circumstances the agreed upon limits of credit from RBI are to be exceeded, the matter should be discussed in Parliament and its approval obtained.

10.11 Second, the criterion of efficiency must be given a much larger weight in the pursuit of fiscal policy. Accessibility to funds without conditions or definite limits based on economic principles which we have referred to earlier in our report leads to erosion of responsibility and efficiency. It is, therefore, necessary to link performance with accessibility to funds.

10.12 Third, we suggest certain specific steps for bringing down the rate of growth of revenue expenditure in the immediate future:

(a) As the budgets are over-burdened and resources are scarce, government would have to shed some activities. This calls for the application of zero-based budgeting. Each Ministry/Department at the Centre and State be asked to order its activities according to its own scheme of priorities keeping in view certain guidelines to be issued by the respective Cabinets. Five per cent of each Department's work (measured in terms of share of revenue expenditure) which is of the lowest priority according to its own evaluation should be given up. The surplus staff created by this procedure would be kept available for re-location in other areas where activities might have to be expanded.

(b) There has been a fairly fast growth of employment in the government sector, particularly at the State level. Between 1979-80 and 1988-89, employment in the government sector, taking all States together, grew at the rate of 3.6 per cent (for the major States alone, the corresponding figure is 3.3 per cent). The result has been burgeoning increase in the salary bills. Therefore, it is essential to prevent the growth of government sector employment. There should be no increase in employment in the government sector (Centre and States) during the Eighth Plan period and the revenue Plan expenditure of the Eighth Plan should consist only of expenditure on materials except in relation to additional schools and hospitals to be started under the Plan. If expenditure on additional staff is incurred in respect of such Plan schemes, that must be adjusted within the non-Plan budget.

(c) Special efforts must be made to plug leakages in the Departments incurring heavy expenditure on materials such as P.W.D., Water Supply, Medical and Public Health. Considerable money could also be saved through economy in inventories and stores.

(d) The phasing out of the revenue deficit would reduce the rate of growth of public debt and, hence, the rate of growth of interest payments. In addition, some other measures are needed to slow down the growth of public debt. One is to reduce budgetary support to public enterprises, i.e., financing of public enterprises should be taken out of the budget as far as possible. Budget support would, of course, have to be extended to key infrastructure sectors like the railways; but even in such cases, part of the financing could be met through borrowing from the market with some interest subsidy from the budget. Methods of financing of the investment by other public enterprises through funds obtained outside the budget would have to be worked out. Public enterprises which are performing efficiently and are showing satisfactory financial results can be allowed by the Controller of Capital Issues to issue debentures as is done in respect of private enterprises. It would be desirable if Corporations in large cities are allowed to borrow funds against debentures with appropriate interest subsidy, to undertake slum clearance and other developmental activities. Another way of reducing the load on the public sector is to share with the private sector the task of expanding capacity in some areas such as power.

(e) In Chapter II, we referred to the low rates of return being obtained from public enterprises as a whole (excluding the petroleum sector) and to the fact that several of them are making losses. At the State level, most public enterprises including State Electricity Boards and State Road Transport Corporations are suffering losses. There is little justification for continuing to own and operate enterprises outside the core sector* which are continually making losses and which, according to reasonable expectations, cannot be revived and turned around. At present, these enterprises are being sustained largely through loans from the budget and, to some extent, through grants. Major budgetary savings can be effected if a way can be found to cut out such loan or grant subsidy. Those enterprises which can be rehabilitated with a reasonable infusion of funds should be brought back to health with the help of public financing institutions or the private sector; others would have to be merged with larger enterprises or closed down with adequate care taken to safeguard the interest of displaced labour. (We understand that part of the staff displaced could be absorbed in large number of vacancies normally arising in the government itself).

10.13 Subsidies are an item of expenditure in the Central Government Budget that has been rising rapidly. The rate of growth witnessed in recent years is not sustainable. Food, fertilizer and export subsidies account for by far the major proportion of total subsidies in the Central Budget. Food subsidies might have to be targeted in future towards the poor only, and with only a moderate rate of inflation, it would be possible to adjust issue prices when procurement prices are raised. We feel that not only the manner of determining and granting fertilizer subsidy, but the entire philosophy and approach would have to be re-examined, as otherwise with increasing fertilizer production on the basis of higher and higher costs due to increased capital costs, fertilizer subsidy would grow unbearably large in the not so distant future. Export subsidies are, of course, necessary but the increase in the quantum of subsidy could be reduced if the competitiveness of Indian exports could be ensured in other ways.

10.14 We urge that the above suggestions for policy changes we have made be given the utmost consideration by the Central and State Governments so that fiscal equilibrium is restored at least by the end of the period of our report.

10.15 Before concluding this report, it is pertinent to point out that the methodology of normative assesment which we have applied to the revenues and expenditures of the State Governments affects only inter-State transfers and has no role in determining the total volume of transfers from the Centre to the States as a whole. The methodology is so designed as to favour the States with lower revenue capacities and lower than average standard of services at justifiable costs. This is the major departure made by this Commission. As far as the projections for the 5-year period 1990-95 are concerned, we have followed almost the same approach as the earlier Commissions; that is, normative rates of growth of revenues and expenditures have been applied to base year figures and the base year figures are closely related to the actuals for the Centre as well as for the States taken as a whole.

10.16 The annexures included in this report contain only such summary tables as are essential for explaining our recommendations. A supplementary volume containing the detailed explanations will be submitted in a few days time.

* The core sector for this purpose may be defined to consist of coal, steel, power, petroleum, railways, telecommunications and some strategic non-ferrous metals. Loss making enterprises in this sector cannot be closed down, but should be brought back to health on the basis of a time bound programme.