THE APPROACH OF THE COMMISSION FOR THE PERIOD 1990-95

2.1 In outlining the approach we proposed to adopt in the first report for 1989-90, we had referred to the nature of the federal finance problem*/. We had also indicated that an adequate volume of assistance in the form of federal transfers must be made available to the States in the light of the respective responsibilities assigned to them and the Union Government under the Constitution. The principles nonetheless upon which the transfers are effected must be such as to ensure that the linking of revenue and expenditure decisions and fiscal responsibility are not unduly weakened and that higher levels of expenditure than what is to be provided for on the basis of national criteria would have to be met out of the efforts of the government concerned. In this connection, we had quoted, with approval, the observation of the First Finance Commission : "The method of extending financial assistance should be such as to avoid any suggestion that the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year" (p.97). The federal transfers must, however, be adequate in the context of legitimate budgetary needs of the States while being just and fair to minimise the vertical and horizontal imbalance within the confines of available resources.

2.2 In fashioning our approach in the report for the period 1990-95, we have, in line with the above, kept in view two basic principles : (a) a fair apportionment of revenue resources between the Centre and the States, given their constitutional responsibilities and the overall limitation of resources; and (b) the manner of transfer of resources to be such as to preserve fiscal autonomy of the States and to promote fiscal responsibility on the part of both the Centre and the States. Central transfers invariably involve questions of inter-State equity and such equity can be attained in a system of federal transfers only if fiscal prudence, tax effort and growth impulses are not penalised.

2.3 Apart from these basic considerations, our approach has been influenced also by the steadily deteriorating fiscal scenario in the country. The trends in Central and State finances on revenue account (with which we are primarily concerned) are described in Appendix 3 and the figures of revenue receipts and revenue expenditures are presented in Annexure II.1; trends in revenue deficits/surpluses are given in Annexure II.2. It is noticed that at both the Central and State levels, revenue expenditures have been growing faster than revenue receipts. Over the period 1974-75 to 1986-87, while the revenue receipts of the Union Government grew at 14.4 per cent per annum, its revenue expenditures grew at 16.8 per cent; over the same period, the revenue expenditures of the States grew at 17.1 per cent, and their revenue receipts at a lower rate of 15.7 per cent. As a result of the gap between the rates of growth of receipts and expenditures, with the latter being higher, revenue deficits have emerged. The Central Government has been incurring a revenue deficit in all the years since 1979-80, and the States as a whole since 1984-85 (except for 1985-86). The revenue deficit of the Centre has been continuously increasing since 1981-82; the revenue surplus of the States as a whole started declining from the same year, and since 1986-87, the States as a whole have also been incurring a revenue deficit which is estimated to have risen to Rs. 4,451 crore in 1989-90. In that year, the revenue deficit of the Centre is budgeted at Rs. 7,012 crore. The total estimated revenue deficit of the Centre and the States in the year 1988-89 would thus be around 3.9 per cent of GDP.

2.4 The incurring of revenue deficits on a large scale year after year implies an infraction of one of the fundamental principles of sound public finance in any economy, particularly in a developing economy. A large revenue deficit implies dissaving on government account (although the amount of dissaving according to national accounting may be somewhat different from the figure of revenue deficit) and the use of the savings of the other domestic sectors or savings borrowed from abroad for financing government's consumption expenditure. In fact, an important principle of fiscal policy enunciated at the very beginning of the planning era was that there should be positive and rising savings on government account, i.e., increasing surplus in the revenue budget in order that government also could contribute to raising the rate of savings in the economy. Thus, the First Plan stated " ...... public savings, as distinguished from private savings, personal or corporate, must be developed steadily. The financing of investment through public savings would help to ensure a pattern of development in consonance with accepted social criteria" (pp. 41-42). The very principle was reiterated in the document of the Second Plan. The massive increases in taxation that have been brought about through successive Plans were intended to implement the above-mentioned principle of financing a part of public investment through the creation of revenue surpluses. However, we note that the principle has been gradually eroded by allowing revenue expenditures to grow faster than revenue receipts in spite of the steadily increasing tax ratio.

2.5 Another related disquieting feature of recent public finances in India is the rapidly growing public debt. A large part of investment by departmental and non-departmental enterprises financed by the government did not yield sufficient returns but in fact resulted in losses*/. In addition, the practice of the government taking over loss-making private enterprises to prevent their closure and then financing them through public borrowing, the growing revenue deficits and the non-recovery of a substantial part of loans to public enterprises and others on which even interest is often not collected have together led to an alarmingly rapid growth of public debt, especially in recent years. And in the process if the social objectives have been served at all, the cost has been highly disproportionate. Annexure II.3 shows the growth of the public debt in India. The total debt of the Central Government (internal and external) has grown from Rs. 19,193 crore on 31st March, 1971, to Rs. 2,28,241 crore on 31st March, 1989 (R.E.); it is expected to rise to Rs. 2,59,729 crore by the end of 1989-90 (B.E.). Of this, Rs. 2,31,692 crore would constitute internal debt. The indebtedness of the States has increased from only Rs. 8,749 crore as on 31st March, 1971, to Rs. 91,053 crore by 31st March, 1989 (R.E.). This total includes Rs. 55,536 crore of loans from the Centre. Excluding this, the combined indebtedness of the Centre and the States amounted to Rs. 2,63,758 crore at the end of 1988-89. Since 1984-85, the debts have been growing rapidly. In the last few years, they have been growing at the rate of Rs. 35,000 to 40,000 crore per year. The ratio of public debt to GDP which stood at 48.9 per cent on 31st March, 1981, rose to 54.9 per cent on 31st March 1985, and is estimated to have risen to 76.9 per cent on 31st March, 1989.

2.6 As a result of the growth of debt on the one hand and inadequate returns from the use of the borrowings on the other, the burden of interest payments on the budget has naturally been rising. Between 1974-75 and 1986-87, interest payments increased at 16.9 per cent per annum in the case of the States and at 20.3 per cent in the case of the Centre. (The debt of the States has been growing at 15.4 per cent per annum and that of the Centre at 18.9 per cent.) As of 1988-89, net interest payments constituted 30.4 per cent of net borrowings for the States and 37.4 per cent for the Centre. In 1989-90, the proportion of net interest

* *First Report of the Ninth Finance Commission (July 1988), Chapter II, paras 2.1 - 2.7*

* *We pointed out in the first report of the Commission that the rate of return after tax on the capital of Rs. 51,931 crore invested in Central public enterprises (covered by the Public Enterprises Survey) by the end of 1986-87 amounted only to 3.4 per cent and if the petroleum sector were excluded, the rate of return was negative. The performance of public enterprises at the State level was much worse.*

payments to net borrowings at the Centre is estimated to amount to 48.5 per cent. The vicious circle of excessive growth in revenue expenditure, meagre or negative returns from public enterprises, growing revenue deficit and large scale public borrowing resulting in a massive rise in interest burden and in turn, accentuating the revenue deficit leading to higher borrowing, must be broken. The first task must, therefore, be to restore balance in the revenue budget. The suggestion contained in one of the terms of reference given to the Commission, that the Commission should "keep in view the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment" is in line with this objective. As rightly pointed out in the Second Five Year Plan document, once expenditure is classified as revenue and capital items, revenue resources must be found to meet the recurrent needs. In our system where Finance Commissions appointed every five years recommend appropriate revenue transfers to States, large and continuing revenue deficits are indefensible either on principle or on practical grounds.

2.7 The tasks of the Commission have to be approached against the backdrop of phasing out the revenue deficits. This means that not only the growth of revenue expenditures that we postulate must be governed by the feasible rate of growth of revenues but also the manner in which Centre-State financial relations are moulded by the recommendations of the Commission should provide incentives, to the extent possible, for each government to make attempts to move towards a more healthy fiscal situation.

2.8 The problem of Central transfers to States cannot be looked upon merely as a matter of the Centre versus the States and/or largely as a question of which level gets more. Basic principles of inter-State equity, fiscal responsibility and efficiency in the use of resources are also involved. As we indicated earlier, the manner of transfer of resources should not tend to weaken fiscal responsibility and should ensure inter-State equity, i.e., the genuine basic needs of all the States should be taken into account along with differences in taxable capacity. Once assistance is granted on such a basis, it would be the responsibility of each government to balance its revenue budget.

2.9 To sum up, the basic objectives underlying the Commission's approach and methodology are : (a) phasing out the revenue deficit of the Centre and the States in such a manner that the deficit is reduced to zero or a relatively small figure by March 31, 1995; (b) equity in the distribution of fiscal resources both vertically and horizontally; and (c) promotion of fiscal discipline and efficiency in the utilisation of resources.

2.10 The implementation of these principles has naturally led us to the normative approach according to which "needs" and "capacities" of different governments are assessed normatively and such normative assessments are then taken as the basis for determining the volume and pattern of federal transfers. This is the first basic departure this Commission made from the practice of the previous Commissions. We indicated in the first report that in respect of the five-year period (1990-95), we shall not take for granted the base year figures either on the receipts or on the expenditure side as the "right" figures on which to proceed. We also indicated the basic considerations governing the normative approach. The relevant passage may be quoted here for convenience :

> "First, the distribution of revenues between the Centre and the States must be made in such a way that the two layers of government are enabled to fulfil their respective obligations satisfactorily as enjoined in the Constitution. The norms applied should not be discriminatory as between the Centre and the States. Second, the distribution of revenues among the States should be equitable so that every State is enabled over time to provide a specified minimum standard of basic public services. That is, the States with less capacity should be able to improve their relative standards in respect of essential services. Third, the assessment of revenues and expenditures should be done in such a manner that incentives for greater revenue effort and economy in spending are not curtailed. Fourth, the States should be free to provide more public services and defray their costs through additional levies on their respective citizens. Finally, the norms adopted should be consistent with our overall objective of balancing the revenue accounts of the Centre and the States" (paragraph 2.35).

2.11 If the Commission's labours are to result in a rapid movement towards the restoration of balance in the revenue budgets of the Centre and the States, it becomes necessary to consider the revenue budget as a whole comprising the non-Plan and Plan parts. This is the second basic departure this Commission thought fit to make. Our approach here is in keeping with the terms of reference and is in full conformity with the constitutional position regarding the scope of work of the Finance Commission. While thus determining the area of our work, we have kept in view the traditional and important role played by the Planning Commission and the arrangements that have been established, on the basis of consensus in the National Development Council, for financing the revenue and capital plans of the States in an integrated manner. We have attempted to work out an approach which, while enabling us to perform our legitimate constitutional role, would not prove detrimental to the planning process or to the role played by the Planning Commission in that process.

2.12 The normative approach must be applied as much to the assessment of Central receipts and expenditures as to that of State receipts and expenditures. Whatever norms are chosen must be applied with the same degree of rigidity in both cases. But the norms themselves cannot be uniform or identical. This is because in the distribution of transfers from the Centre among the States, questions of inter-State equity and the apportionment of burdens and benefits among the taxpayers of the different States are involved, whereas in the apportionment of revenue resources between the Centre and the States, the interests of two different groups of taxpayers are not involved. What needs to be considered is rather the question whether the relative levels of revenues raised by the Centre and the States are commensurate with the distribution of taxing powers under the Constitution and what could be the total combined tax intake that would be adequate and also acceptable to the people. On the expenditure side again, the average cannot be used as a norm for the Centre as can be done in assessing the relative needs of the States, because the services provided by the Centre are in most cases different from those provided by the States; hence, a broad judgement has to be exercised regarding the justifiability of the existing levels of Central expenditure, and the system of transfers must contain elements which would induce the Centre to exercise economy in its expenditure and to restrain its growth.

2.13 The principles and methodology of the normative assessment of tax revenues and non-Plan revenue expenditures of the State Governments are detailed in Appendices 4 and 5 respectively.

2.14 Briefly, on the revenue side, normative estimates have been derived separately for tax and non-tax revenues. In respect of taxes, a modified representative tax system approach has been applied, in order to determine what a particular State would be able to raise by way of tax revenue, had it exploited its tax bases to an average extent. Such "tax capacity" figures have been derived for a base year*/ and are then projected to the year 1989-90. As regards non-tax revenues, while actuals have been used in the case of fees and user charges, in the case of dividends and interest to be received by the government, normative rates of return have been used. Thus, total normative estimates of revenue are arrived at for the year 1989-90.

2.15 As in the case of revenues, in regard to a substantial part of non-Plan revenue expenditures, the average behaviour has been taken as the norm. Thus, the normative estimates,

* *(Appendix 4)*

which may be called "the expenditure needs", in the case of general services, have been defined as the justifiable costs of providing an average standard of service. In respect of social and economic services, needs are taken to be the justifiable costs of providing the existing level of services. Here, justifiable costs are also based on the norm of an average but with due allowance for what may be called "cost disability" factors**/. In regard to expenditure on the maintenance of assets, engineering norms have been applied in a graded scale assuming that the full norms will come into operation in the last year of the report period. Certain other items of expenditure such as on elections have been computed on the basis of estimated costs; while expenditure on social welfare schemes have been fixed at certain uniform levels in order to ensure inter-State equity.

2.16 The implications of computing the budgetary positions of the State Governments on the basis of normative estimates as calculated above may be spelt out. While the actual performance of the States as a whole is kept in view (through the use of the average) the non-Plan revenue deficit or surplus of any one State computed by us is not dependent on its actual behaviour. Thus, if a State is raising revenues more than the norm, it would not be penalised; conversely, if it raises less than the norm, it would either lose or be not rewarded. Any excess revenue over and above the norm which a State raises can be used by it for purposes of its own choice thus giving the State freedom of action without affecting its entitlements to Central transfers. On the side of expenditures, since "needs" are reckoned on the basis of norms, differences in standards of services among the States attributable to differences in revenue capacities would not be frozen. On the contrary, a process of equalisation would be initiated. Again, if a State observes economy in expenditure and achieves lower costs in providing a given standard of services, it would not be penalised. On the other hand, a State which wishes to provide a standard of services higher than the norm in the case of general and administrative services would not be prevented from doing so but would have to do it on the basis of "extra" resources it raises.

2.17 It is to be emphasised that the methodology applied by the Commission implies no interference with the right of a State Government to raise resources and incur expenditures at such levels and in such manner as desired by its people and its Legislature. The norms are relevant only in arriving at the relative entitlements to Central transfers and are so designed as to ensure inter-State equity in working out such entitlements. This may be illustrated by reference to the normative rate of return applied for deriving estimates of dividends from State public enterprises. Representatives of a number of State Governments argued before us that no significant returns can be expected from Road Transport Corporations or Electricity Undertakings given their special difficulties or that it was necessary to subsidise services of such enterprises in the public interest, as was being done in several countries of the world. Apart from special difficulties for which, of course, allowances have to be made, the proposition that the actual positive or negative rates of return earned by different State Governments on their investments in State enterprises should be included in the base for judging their entitlements to Central transfers would not only tend to reward inefficiency but also imply (since actual differing rates of returns, positive or negative, will be used) that the citizens of one State using the concerned services would be subsidised by the taxpayers of all States. Thus, the question is not just whether a State Government should be heavily or partially subsidising road transport or power services; it is more a question of who should pay for the subsidies : the taxpayers of the State concerned or the national taxpayers. To take care of this problem, the Commission has, as was done by earlier Commissions, specified uniform rates of return for all the States so that to the extent that these rates of return are lower than the normally acceptable commercial rates of return, there would be scope for subsidisation by the Centre on a uniform basis. However, in order to give further time for adjustment to the States, we have stipulated that even these lower normative rates of return should be achieved to the full extent only in the last year of the reference period.

** (Appendix 5)

2.18 Although we had observed in our first report that in our approach for the period 1990-95, we intended to adopt a fully normative basis, in deference to pleas made by several State Governments that the application of norms should be spread over a period of years, we have moderated the application of norms in some ways as specified in Chapter III.

2.19 In regard to Special Category States, the Commission decided that keeping in view their relative under-development and the nature of their special problems, no systematic norms could be applied at the present stage. Therefore, the basis of projections of receipts and expenditures for these States are more or less the actuals.

2.20. It may be pointed out that since the average has been used as the norm in respect of the revenue receipts and a substantial part of the non-Plan revenue expenditures of the States, if the normative estimates are added up, we would derive a figure which would be equal to the totals of the actuals*/. Thus for the States as a whole, the base chosen is not much different from the actuals, although there would be a difference between the norm and the actual in relation to any one State. The normative estimates could not be computed for the year 1989-90 or 1988-89, for lack of the necessary data. They were worked out for an earlier base year and then projected to 1989-90 at appropriate rates of growth. In doing so, on the expenditure side, adequate provision has been added on account of revision of emoluments on par with Central Government scales.

2.21 For the purpose of assessing Central revenue receipts and non-Plan revenue expenditures, we have taken 1989-90 budget estimates as the base, except for estimates of dividend and interest income for which normative rates of returns have been used, as in the case of the States. Since the sum total of the normative estimates for the States tends to equal the "actuals", there has been broad similarity in our treatment of the Centre and the States. The difference is that for the Centre, instead of taking the 1986-87 actuals and projecting them to 1989-90 at trend rates of growth or adjusted trend rates of growth, we have adopted the 1989-90 budget estimates as the base. We find that the Centre's non-Plan revenue expenditure (excluding interest payments) in 1989-90 would be higher than the budget estimates if we proceeded from 1986-87 actuals. This is obviously bacause of the restraint shown by the Centre in formulating the budget estimates of 1989-90. We are of the view that this was a step in the right direction and that we should build our projections on that lower base only.

2.22 We had indicated that for judging the relative tax performance of the Centre and the States, we have to consider the relative levels of revenue raised in the light of the constitutional division of tax powers. The major productive sources of revenue have been assigned to the Centre and hence the Central Government has the responsibility for raising the major part of the tax revenues. We find that, in recent years, the Centre has been raising 66-67 per cent of the combined tax revenues of the Centre and the States, i.e., around 2/3rds, with the total tax revenue/GDP ratio being near 17.5 per cent. While there is no way of definitively determining whether this magnitude of the relative share of taxes raised indicates an adequate relative use of tax powers, it is seen that the Centre is raising much the larger part of tax revenues.

2.23 For our present purpose, we are proceeding on the basis of the broad approach to fiscal policy being evolved by the Planning Commission in relation to the Eighth Plan. With an average GDP growth rate of 6 per cent per annum, the Planning Commission is envisaging a significant increase in the tax ratio to be brought about mainly through tax rationalisation and better enforcement. In view of this, we are assuming that revenues will, and can be made to, grow faster than GDP. Allowing for a 5 per

* *Except for stochastic errors.*

cent increase in prices per annum (in conformity with the present thinking in the Planning Commission), we assume GDP to be growing at 11 per cent per annum in nominal terms. On this assumption, we postulate an increase in the tax revenues of the States as a whole at 11.5 per cent per annum in nominal terms and that of the tax revenues of the Centre, at 12.8 per cent per annum. A higher rate of increase has been postulated for the Centre, because over the period 1974-75 to 1986-87, the share of taxes raised by the Centre in the combined tax revenues of the Centre and the States has fallen slightly. These rates of growth of revenue subsume a certain amount of additional tax effort. This has been done because we are including a minimum level of revenue Plan expenditure and to derive a balance on revenue account. Non-tax revenues of the Centre and the States have been projected using similar methods; while normative rates of return have been used in respect of income from investments, reasonable rates of growth (5-6 per cent per annum) have been applied to the base year figures of fees and other user charges.

2.24 In view of the large revenue deficit in the base year, the above-mentioned orders of increase in revenues would imply strict control of the growth of revenue expenditure, particularly non-Plan revenue expenditure, if the revenue deficit is to be phased out according to our scheme. Accordingly, we are postulating an annual average increase of 7 per cent in non-Plan revenue expenditure in nominal terms. Since full neutralisation of price rise is not granted in the revision of dearness allowance and the prices of goods bought by the government do not generally rise as fast as the wholesale price index which includes the prices of capital goods and intermediates with higher deflators, a 7 per cent increase in nominal terms should allow for a 3 per cent increase in expenditure in real terms. Increases in interest payments, however, have been allowed on the basis of likely actuals on the assumption of a slower rate of growth of public debt than in the past.

2.25 As indicated earlier in paragraph 2.11, the Commission has assessed, on the expenditure side, the entire requirements of revenue account, Plan and non-Plan. The manner in which estimates of revenue Plan expenditures have been derived is indicated in Chapter VII. Under our approach, once the revenue expenditures, non-Plan and Plan, of the State Governments and the Centre are normatively determined and given the total revenues that could justifiably be expected to be raised by them during the report period, federal transfers should be such as to ensure that each government can undertake the expenditures normatively determined for it, if it fulfils the norms for raising revenues. It follows that the volume and criteria of the distribution of Central shareable taxes and of grants-in-aid must be such as to subserve this basic objective. Most of the earlier Finance Commissions confined the scope of their work to non-Plan revenue expenditures and receipts excluding the effects of additional resource mobilisation effort. They did not, therefore, concern themselves with what levels of revenue Plan expenditures the different States could have or how such expenditures would be financed; they were content with ensuring that each State Government would at least cover its estimated non-Plan revenue expenditures. With this approach, our predecessors developed criteria for the distribution of shareable taxes which were quite independent of their assessment of the budgetary needs of the States. It is rather through the raising of the volume of devolution than through a tailored distribution of shared taxes that they attempted to cover the pre-devolution revenue gaps of the States. This and the fact that the predominant criterion of devolution of the Eighth Finance Commission, for example, was population*/ and the general grants-in-aid of revenue were just sufficient to close the revenue gaps remaining after devolution, meant that the Finance Commission's recommendations left the different State Governments with varying levels of per capita non-Plan revenue surpluses ranging from fairly large figures to zero. Under our approach, the volume as well as distribution of Central transfers must be aligned to the need to enable the States to incur, at least to a significant extent, the expenditures normatively determined for them. Also, it would seem proper that there should be a degree of equalisation in the capacity of the different State Governments to undertake revenue Plan expenditures.

2.26 The volume of Central transfers has to be determined on the one hand by the estimated needs of the States and on the other by the estimated needs of the Central Government; and the total expenditures to be provided on revenue account (for the Centre and the States together) would depend on the total revenues they could be expected to raise and the pace at which the revenue deficit is to be phased out. In arriving at the final estimates of feasible levels of Central Government expenditures, we have kept in view an important condition, namely, that the total transfers from the Centre to the States under our recommendations should not be less than what they are now as a percentage of estimated Central revenues. The fiscal situation at the Centre being what it is, they cannot be substantially higher. If the total volume of transfers is thus determined, larger transfers to deficit States (taking non-Plan and Plan expenditures together) through grants-in-aid would necessarily mean a reduction in the relative weight of formula-based devolution as compared to the past. While we consider that the move towards equalisation that we are recommending is in the right direction, we are conscious that too radical a departure would not be feasible. We are, therefore, recommending only a moderate step in this direction to begin with. In course of time, a greater degree of equalisation could be attempted.

2.27 We have retained the level of devolution prescribed by the Eighth Finance Commission, that is, 85 per cent of Income Tax and 45 per cent of Union Excise Duties (basic plus special). The share of Income Tax is to be distributed among all the States according to the criteria evolved by us. A portion of the shareable Union Excise Duties (16.5 per cent), however, is to be linked to our normative assessment of non-Plan budgetary needs; the rest will be distributed according to the formula applicable to all the States. The normative gaps on non-Plan revenue account remaining after devolution are filled by grants-in-aid under Article 275.

2.28 Our normative assessment of revenue expenditures on economic and social services revealed that a number of States were providing standards of services below the average. In order to bring about a degree of equalisation in standards of these services, we are recommending development grants to the States whose non-plan revenue surpluses are found inadequate according to a formula evolved by us**/. These development grants are being recommended under Article 275 and will be in addition to those that a State will get for Plan purposes under the modified Gadgil formula. The use of the development grants recommended by us will be determined in consultation with the Planning Commission.

2.29 Thus, subject to the overall constraint of resources, we have endeavoured to bring about a greater degree of inter-State equity through the partial linking of the distribution of Union excise duties to normative assessment and through the recommendation of development grants to help weaker States afford a higher level of development expenditure.

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*/ *Although on the face of it, it would seem that the Eighth Finance Commission had accorded 75 per cent weight to per capita SDP, in fact, since population was used as a scale factor in relation to SDP, the total direct and indirect weight given to population in the distribution of shared taxes (other than 10 per cent of income tax distributed according to collection) works out on the average to 83 per cent. This figure has been derived on the basis of the average of differences between the share of a State on the basis of population criterion alone and its share on the basis of the combined criteria used by the Eighth Finance Commission, in relation to the non-Special Category States.*

**/ *(Chapter VII).*