

ASSESSMENT OF STATES' REVENUE RECEIPTS AND EXPENDITURES

Tax Revenues

3.1 The basic approach governing the assessment of the States' revenue receipts and expenditure has already been outlined in the preceding chapter. As indicated in our first report for 1989-90, the National Institute of Public Finance and Policy was entrusted with a study for estimating taxable capacities by the "Representative Tax System" approach. However, the complexity in the tax systems prevailing in the States and the non-availability of data on tax bases at the required level of disaggregation led them to use a mix of regression and representative tax system methods. Considering the weaknesses in the data and methodology used in the study, after holding detailed discussions with some leading economists (Annexure 1.5), we preferred to estimate taxable capacities of the States using a modified representative tax system method. Accordingly, revenue from each of the major taxes is regressed on relevant tax bases or their proxies to determine the regression average effective rates. By applying these average rates on the bases of the relevant taxes in the different States, taxable capacity was derived. To determine the average rates, however, we have employed a covariance model pooling cross-section observations over time. The analysis has been done for each of the major State taxes except agricultural taxes and miscellaneous taxes levied by the States for which no meaningful functional relationship could be established. In the case of these two taxes, no normative estimates have been made. In the case of Sales Tax, Motor Vehicles Tax and Stamp Duties and Registration Fees, the regression average effective rates were determined separately for high income, middle income and low income categories of States. For State Excise Duties, as there are only 13 States in the sample due to the prohibition policy in vogue in Gujarat, the effective rates have been determined separately for the States grouped into two categories only. The detailed methodology employed for the estimation is given in the Appendix 4. We may add that the estimates of taxable capacity on the basis of this method have been made only for the 14 Major States. The methodology used for projecting the tax revenues of the Special Category States is outlined later in the chapter.

3.2 The taxable capacity estimated for the initial year has to be projected first to the base year and then for the period of our recommendations. In the case of revenues from agricultural taxes and other miscellaneous levies, the actuals in 1986-87 were projected using the past rates of growth. In the case of other taxes, normative estimates for the initial year were projected to 1989-90 using the historical growth rates. For the period 1990-95, State tax revenues have been normatively projected to grow at 11.5 per cent keeping in view the targeted SDP growth rate of 6 per cent and allowing for a price rise of 5 per cent per annum. The rate of increase in the yield of different taxes has been derived from the above projection of aggregate tax revenues, using as a base their respective growth rates in the past which were *pro rata* adjusted.

3.3 The above exercise gives us the levels of normative tax revenues for each of the years 1990-91 to 1994-95. In order to provide adequate time for adjustment to States which were found to be under-taxing at the beginning of this period, we have taken for the year 1989-90 not the normative estimates, but the trend

level estimates for all the States and have worked out then the rate of growth of tax revenues required during the period to reach the normative levels by 1994-95. In other words, the normative approach to the assessment of tax revenues has been moderated.

3.4 The prohibition policy followed by certain States like Gujarat and Tamil Nadu is an issue which we have taken note of. We had made a limited allowance in our normative estimate on this account in 1989-90. The concerned State Governments, however, have again impressed upon us that the loss of tax revenue attributable to the prohibition policy should be totally excluded from the revenue receipts of the State Governments. This was all the more necessary as the prohibition policy emanated from the Directive Principles of State Policy as enshrined in the Constitution. The States pleaded that they should not be penalised on this account. We believe that this is a question that should be settled at the national level. The Central Government should formulate a policy in this regard and make it clear to what extent and for how long the Centre would compensate those States which lose revenue on account of prohibition, taking into account the various aspects of the matter including the possibility that the States adopting prohibition would in course of time be raising additional revenues through other taxes both because of higher productivity and higher income and also because money diverted from drinks would be spent on other taxable commodities. We find considerable merit in these submissions of the State and therefore, on reconsideration of the matter, think that States which have taken courage to clamp full or partial prohibition should not be unduly penalised. Therefore, we have not included the full taxable capacity on account of excise on liquor for the non-Special Category States which have adopted prohibition; we have taken into account only 30 per cent of the estimated revenue that would have accrued to Gujarat and Tamil Nadu, had prohibition not been in force.

3.5 The States of Nagaland and Mizoram have introduced prohibition from 1989-90. Considering the weak financial base of these two States, we have, in their case, allowed for the full loss of revenue on this account.

Non-Tax Revenue

3.6 The major sources of non-tax revenues are interest receipts and dividends, receipts from forests, mines and minerals and irrigation works and receipts from departmentally run commercial schemes like water supply schemes, milk schemes and industrial schemes.

(i) Interest Receipts

3.7 Interest receipts from institutions other than the State Electricity Boards and Road Transport Corporations have been assumed at rates rising gradually from 2 per cent in 1990-91 and reaching 6 per cent in 1994-95 on loans outstanding as on 31.3.1990. In the case of loans to agriculturists, however, only half of the normative rates has been assumed.

(ii) Dividends

3.8 The equity investment of the States in as many as 823 enterprises (other than the State Electricity Boards and State

Road Transport Corporations) aggregates to Rs. 5046.82 crore at the end of 1989-90. The successive Finance Commissions have taken the view that the large investments made in the enterprises cannot be allowed to languish without adequate return. We share their anxiety and concern. We are of the view that, with growing expenditure responsibilities and developmental commitments devolving on the State Governments, the State enterprises should not be a burden on the State exchequer any longer. Having regard to the fact that the enterprises are incurring huge losses, the Eighth Commission evolved a realistic norm assuming dividends at different rates from different categories of enterprises. Promotional enterprises were required to meet all their expenses and not to provide any return on equity considering the nature of the responsibilities assigned to them, while financial and commercial enterprises were expected to yield a return of 3 per cent and 5 per cent, respectively, on their equity capital. We stipulated the same pattern of returns as laid down by the Eighth Commission in our first report for 1989-90.

3.9. We accept the classification of State enterprises adopted by the Seventh and the Eighth Finance Commissions. The classification of enterprises into promotional, financial and commercial ones seems proper. We also accept the logic behind the differential rates of dividends as prescribed by the Eighth Commission. Considering the higher losses being incurred by a large number of enterprises in almost all the States, it would not be realistic - much as we would like - to improve on the rates of dividends laid down by the previous Commission. Thus we treat the promotional enterprises as basic to the community and dedicated to provide service and infrastructure facilities. For this reason we are not assuming any return on their operations. Financial institutions, however, are in a separate category and we expect them to provide a minimum return of 3 per cent on the investments made in them. Commercial enterprises must generate a higher return and we assume in their case a minimum return of 5 per cent. We have, therefore, worked out dividends at zero per cent, 3 per cent and 5 per cent for promotional, financial and commercial enterprises respectively. Like our predecessors, we have assumed the same absolute amounts of return in each of the five years of the period of our report. Statewise break-up of the enterprises, the amount of investments made upto the end of 1989-90 and the amounts of dividends calculated by us in the five-year period 1990-95 are given in Annexures III.1 and III.2 respectively.

3.10 In regard to the estimation of dividends from cooperative institutions, we propose to stick to the broad methodology of the Eighth Finance Commission. That Commission recommended that cooperative banks, credit societies, sugar mills, spinning mills and other industrial cooperative institutions, should yield a minimum average return of 5 per cent. We too recommend the same as this would ensure recycling of funds and encourage their productive use. Investments in societies which are engaged in processing, warehousing, marketing and housing activities and Consumers' Societies were required to provide a minimum return of 3 per cent by the Eighth Commission. Given the nature of activities of these bodies, we consider this rate as reasonable and apply the same to these institutions. We do not assume any dividends from investments in the cooperative institutions which have been set up to promote certain socially desirable and welfare related activities arising out of State policies. Falling in this category are the societies engaged in activities such as dairy farming, fishermen's cooperatives, labour cooperatives and cooperative bodies set up as part of Tribal Areas sub-Plan programmes. The intention is that they should continue to subserve the promotional and social welfare policies of the State Governments. The resources which they may generate may be made use of for improving the quality of their services.

3.11 We have accordingly classified the societies into these three broad categories and assessed the dividends from them in 1990-91. As in the case of State public enterprises, we assume the same absolute amounts of dividends in each of the years of the

period of our report. The details are given in Annexure III.3.

(III) Revenue from Forests

3.12 Most of the State Governments pleaded before us that due to the restrictions contained in the Forest (Conservation) Act, 1980 and the guidelines issued thereunder, they would not be able to generate revenues from the forests in line with past trends.

In fact, some of them were of the view that the revenues from forests, excepting those receivable from minor forest produce, should be taken as zero over the five year period. We also had a meeting with the Union Ministry of Environment and Forests before finalising our views in this matter. With a view to conserving our precious forest resources, we have not envisaged any growth in the receipts during the period of our report excepting for the growth due to increases in prices by the postulated 5 per cent per annum. In other words, we have frozen the receipts in real terms at the 1988-89 levels.

(iv) Mines and Minerals

3.13 In the case of receipts from items other than natural gas and petroleum we have assumed 1989-90 budget estimates as the base and applied a growth rate of 8 per cent for the forecast period. In the case of receipts from natural gas and petroleum, the estimates obtained from the Ministry of Petroleum and Natural Gas have been adopted.

(v) Irrigation Receipts

3.14 The Eighth Finance Commission commented adversely on the increasing losses incurred by the irrigation projects. Though it did not assume any return on investments in those projects, it expected the State Governments to make efforts so as to ensure that the receipts covered at least the cost of maintenance. The position has since worsened. The losses of the irrigation projects which amounted to Rs. 66 crore in 1981-82 shot up to Rs. 327 crore in 1987-88. In view of this dismal performance, we feel that assuming a positive return on investments from these projects during the five-year period 1990-95 will be quite unrealistic. We have, therefore, adopted the norm of the Eighth Finance Commission, namely, that the receipts should cover at least the cost of maintenance, except in the case of hill States where a somewhat liberal norm has been adopted which is explained later in this chapter.

(vi) Minor Irrigation

3.15 We have assumed that the losses incurred in 1986-87, will be brought down gradually to one-fourth by the year 1994-95. Provision for maintenance expenditure has been made separately on the basis of norms discussed later in this chapter.

(vii) Receipts from other Departmental Schemes

3.16. The States continue to incur losses on the departmentally run water supply schemes, milk schemes and industrial schemes. The objective in this area should be to recover the full cost of these services by charging an appropriate price from the beneficiaries. It would, however, be unrealistic at this stage to make projections on the basis of this assumption considering the current operating conditions. We would, however, like these undertakings to take earnest measures to reduce the losses gradually. We have, accordingly, assumed that in the case of water supply schemes the losses should be reduced gradually by 1994-95 to one-fourth of those in 1986-87. The milk supply schemes, being of a semi-commercial nature, have been treated somewhat differently. In their case, it has been assumed that they should break even by 1994-95. In the case of industrial schemes we have assumed a positive return of 5 per cent by 1994-95.

(viii) Returns from Investments in Power Projects

3.17 The financial performance of power utilities, particularly the State Electricity Boards, has been a matter of deep concern. The poor performance stems from a wide variety of factors including poor operating efficiency, lop-sided tariff structure, disproportionately high transmission and distribution losses, and

delays in the construction and commissioning of the power projects. A number of Boards has been incurring heavy losses year after year. These utilities in which the States have invested vast resources cannot afford to continue with such losses. This affects not merely their viability but even the overall availability of resources required to fund the steadily growing Plan programmes in the Power sector.

3.18 We are aware that it is necessary to keep in view the capital intensity of the power projects and the long gestation period that their construction and commissioning involves. We have also noted that the Boards have an unfavourable capital structure without any equity component. However, we regard the Boards as commercial undertakings liable to provide a return on their investments. This is in line with the latest amendment in the Electricity (Supply) Act, 1948, which stipulates that the Board shall leave such surplus as is not less than 3 per cent or a higher percentage on its net fixed assets in service after meeting its depreciation and interest liabilities.

3.19 As mentioned earlier, we expect the State Electricity Boards, Central Sector Undertakings and State Departmental Undertakings to run on commercial principles and to yield a minimum rate of return on their capital investment. But the minimum rate of return we prescribe should not be unrealistic given the situation at the start.

3.20 While examining the finances of the Boards as they are structured today, we cannot ignore the fact that a sizeable segment of the programmes currently being undertaken by them, particularly in the rural areas, is virtually directed towards the fulfilment of certain socially desirable objectives. As such they are unlikely to generate sufficiently remunerative returns. Taking all the relevant factors into consideration, we have, firstly, for working out the return, reduced the outstanding loans as on 31.3.1990 by the amount tied up with works-in-progress (with 10 per cent of the value as on 31.3.1990 added on to the net outstanding loans in each year presuming the overall gestation period of the project to be 10 years) and by that attributable to rural electrification schemes. Secondly, we have prescribed a gradually rising rate of return starting from 3 per cent in 1990-91, increasing by 1 percentage point in each succeeding year and reaching the maximum of 7 per cent in the terminal year of the five-year period (1990-95).

3.21 Besides the State Electricity Boards, there are at present seven departmentally-run power undertakings in Arunachal Pradesh, Goa, Manipur, Mizoram, Nagaland, Sikkim and Tripura. These undertakings are still fairly small in terms of the scale of their operations. In some of the North-Eastern States, the level of indigenous generation is almost insignificant and they have to import power from the neighbouring States at a fairly high cost. The problems are further compounded by the low load scattered over a vast geographical area. We have also taken note of the inherent disabilities in the operations of electricity undertakings in the hill States. The cost of operations in the hill States is high in view of the insignificant load, difficult terrain and widely dispersed population. Considering these handicaps and taking into account the fledgling status of the operations in some of these States, we consider it appropriate not to prescribe any rate of return in their cases. This applies to the departmentally-run power undertakings in Arunachal Pradesh, Goa, Manipur, Mizoram, Nagaland, Sikkim and Tripura and the Boards in the Special Category States of Jammu and Kashmir, Himachal Pradesh, Meghalaya and Assam. Estimates of State Government loans to the State Electricity Boards outstanding at the end of 1989-90 are shown in Annexure III.4 The amounts of return worked out on the basis indicated above are shown in Annexure III.5.

Returns from Investments in Road Transport Undertakings

3.22 The State Governments have made substantial investments in Road Transport Undertakings. Most of the Undertakings in the States have been set up under the Road

Transport Corporation Act, 1950, although there are a few departmental undertakings and, as in Tamil Nadu, there are also some government companies. For our purpose we have treated all such undertakings on par.

3.23 Section 22 of the Road Transport Corporation Act stipulates that the Corporations should carry on their activities on "business principles". This requirement has not been fulfilled by most of the Corporations. We have noticed that many of them are not able to produce sufficient surpluses to provide for depreciation and pay interest and taxes. Some of the Undertakings are not in a position to cover even their working expenses. A certain measure of contribution is expected of these Undertakings for reinvestment through generation of surpluses, but this is not forthcoming at all. Barring a few exceptions such as the Andhra Pradesh State Road Transport Corporation and the Haryana Roadways which have been making sustained surpluses and the Corporations of Maharashtra, Rajasthan and Uttar Pradesh which have shown profits during 1987-88, all other Undertakings, by and large, have been showing dismal results; their total losses in 1987-88 amount to Rs. 82.65 crore. The details are brought out in Annexure III.6.

3.24 Several reasons have been adduced for the losses of these Undertakings. Our attention has been drawn, in particular, to factors like unrealistic fare structure, increased cost of inputs, growing burden of interest on loans and the compulsion of "socially oriented" concessions which the Undertakings are obliged to provide. In the hill States the Undertakings have to bear the additional burden on account of greater wear and tear to the rolling stock and higher operating costs. On the other hand, it is argued that, as a matter of policy, the fares cannot be built high enough to cover costs so that the means of transport remain cheap for the common man.

3.25 These constraints are too well-known. However, it is a recognised fact that operations of Road Transport Corporations are less complex than those of the power system. Investments in road transport have a much shorter gestation period. Moreover, there is greater scope for manoeuvre in their operations to meet temporary or even day-to-day situations. Though, sometimes, a fare hike may become unavoidable, it would be clearly incorrect to assume that improvement in the financial performance in most of the Undertakings is possible only through an upward revision of the fares. As a matter of fact, we notice that there are several avenues available for effecting structural and operational improvements in each of the Undertakings. Annexure III.7 identifies the areas of improvement and the possible means. For instance, most of the Undertakings in the States have in-house maintenance facilities at the depot, divisional or central levels. It should, therefore, be possible to control the down-time of the buses with proper and efficient monitoring of rolling stock with consequent improvement in their fleet utilisation. Similarly, the load factor/occupancy ratio could be improved by remunerative charting of bus routes and adequate scheduling of services. The staff-bus ratio also can be brought down through an appropriate deployment of staff. With suitable improvement and proper control of the physical performance of traffic operations, it is possible to secure higher earnings and reduce operating costs.

3.26 We have noted that even though most of the Undertakings are running at losses, there exist large variations in the individual performances in terms of certain identifiable parameters such as staff-bus ratio, fleet utilisation, load factor and revenue earning kilometrage per vehicle per day. While acknowledging the fact that there are constraints within which the Undertakings have to operate, we observe that, to a considerable extent, inefficient management and outmoded financial practices are responsible for their present plight. Despite exhortations of the previous Commissions and the approach adopted by the Seventh Commission which assumed a phased increase in returns on investments of the State Governments in these Undertakings, no serious effort appears to have been made to improve their operations. Since most States have no revenue surplus for capital investment, the capital contribution to the

Undertakings comes mainly out of borrowed funds which is becoming costlier year after year. We are aware of the difficulties faced by the Undertakings and also the increased cost of borrowings in recent years. Hence we recommend that the Undertakings should achieve a return of 6.5 per cent in a graduated manner. That is, we are postulating the Road Transport Undertakings in the non-hill States should give a return on the investments at the rate of at least 1 per cent in 1990-91, 2 per cent in 1991-92, 3 per cent in 1992-93, 4.5 per cent in 1993-94 and 6.5 per cent in 1994-95. The returns on the investments made by the Governments of Goa, Gujarat, Kerala and West Bengal in their Inland Water Transport Undertakings have been assessed in the same way.

3.27 As regards Hill States and hill areas of the non-Hill States, we have to keep in view the difficult operating conditions leading to higher operating costs. We, therefore, recommend that the Road Transport Undertakings in these States and those catering to the hill areas in other States should at least provide for depreciation in full, after meeting their working expenses.

3.28 The returns on investments assessed on the above basis for the period 1990-91 to 1994-95 are shown in Annexures III.8 and III.9.

Grants-in-aid from the Centre

3.29 The Central Government gives grants-in-aid to the States for meeting expenditure on a number of non-Plan heads. We have assumed that all these grants would continue to flow to the States on the existing basis. Accordingly, in our assessment of the revenues of the States we have taken credit for these grants-in-aid by providing for expenditures corresponding to them. However, the grants which are given for meeting expenditure of a capital nature such as on border and strategic roads have been omitted by us.

Special Category States

3.30 The States of Arunachal Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura and also Assam form a distinct group requiring somewhat different treatment from what we have accorded to the non-Special Category States. This applies to the state of Goa as well. Keeping in view the special features of the Special Category States and the historical background in which these States came to be constituted, we have adopted a liberal approach in assessing their receipts as well as expenditures. We have firmed up their estimates of receipts and expenditures for the base year 1989-90 by taking into consideration the budget estimates or the latest estimates received from these States. In some cases the intended purpose was served better by taking the actuals of the latest year for which they were available and projecting to the base year 1989-90 by adopting the State-specific past growth rate. Having provided adequately for the base year 1989-90, the projection of revenue receipts and expenditures for the forecast period has been done at the rate of 11.5 per cent and 7 per cent per annum, respectively. Wherever norms have been applied, they are on a more liberal basis than for the non-Special Category States. However the need for over-all fiscal discipline on the part of the Special Category States is as necessary as in the case of other States. The States must take effective corrective measures to reverse the current trend of growing deficits. There is urgent need to augment the revenue receipts and cut down the disproportionately high growth in expenditure. Keeping them in view, on the base arrived at for 1989-90 revenues have been projected to increase at 11.5 per cent per annum during the period 1990-95.

Non-Plan Revenue Expenditures

3.31 We have estimated the non-Plan revenue expenditures on the basis of a normative assessment of "needs". Such an approach is expected to help whether States provide

their people with a certain minimum standards of services.

3.32 The estimation of normative non-Plan revenue expenditures for the period 1990-91 to 1994-95 involves two distinct steps. The first is the estimation of expenditure needs of the States in a base year and, second, making projections for the period 1990-91 to 1994-95. The estimation of expenditure needs was found to be extremely difficult as it involved the quantification of the units of public service provided and the unit cost of providing them. The non-excludability and non-marketability of public goods makes it difficult both to assess the demand for these goods and to measure the standards of public services supplied. The output of public services is, therefore, generally attempted to be measured by taking input proxies which have gone into their provision.

3.33 For the purpose of assessing non-Plan expenditure needs of the States on a normative basis, we have classified the expenditures into three categories:

- (i) those items of expenditure which depend upon either the stock of monetary liabilities, such as interest payments, or the stock of physical assets such as maintenance expenditures on roads, buildings and irrigation works;
- (ii) those items of regular and recurring expenditure whose levels of service can be measured by making statistical analysis of the revenue expenditures; and
- (iii) those items of revenue expenditures which can be reckoned neither on the basis of statistical analysis nor on the basis of engineering norms.

3.34 We have to mention that we were considerably handicapped in our work on account of paucity of data on a wide variety of subjects despite our persistent efforts to obtain the same. We, therefore, had to rely upon the use second-best, alternative techniques for our analysis. These are discussed below:

Category (i)

3.35 The major items of expenditure falling in this category are interest payments and maintenance of capital assets.

Interest payments

3.36 Interest payments by the State governments have been computed in two stages. In the first stage, interest payments due in 1990-91 with respect to the borrowings upto the end of 1989-90 have been worked out with reference to the actual terms thereof. Thereafter, in the second stage, we have inducted a normative element in respect of interest payments for the period 1991-92 to 1994-95. In the past, borrowings have been resorted to by the States in a liberal manner and, at times, on quite stringent terms to meet their immediate requirements disregarding their long-term effects. Against this background, we consider it appropriate to apply a growth rate of 12 per cent only on the estimated interest payments in 1990-91 for the next four years, i.e. 1991-95. This would cover the liability on account of the fresh loans during the five year 1990-95. While deciding the normative growth rate of interest payment, we have been guided by the consideration that in our scheme of dispensation the States are better placed in meeting their expenditure requirements. What is, however, more important is that we expect the States to exercise much greater restraint in the future in the matter of borrowings. The States themselves should raise adequate revenue resources so as to finance at least their current requirements in full measure.

Maintenance of Capital Assets

3.37 The provisions made by us for the maintenance of capital assets like irrigation works, buildings, roads, etc. are based on engineering norms obtained from the concerned Central organisations. These provisions are restricted to assets

created upto 1989-90 as the assets created thereafter would, under the present system, be maintained on Plan account. As indicated earlier, the norms have been applied in a graduated manner.

(i) Major and Medium Irrigation Works

3.38 For the maintenance of irrigation works, the Eighth Finance Commission adopted a norm of Rs.100 per hectare for the utilised potential (including special repairs and regular establishment) and Rs.30 per hectare for the unutilised potential, with an increase of 30 per cent thereon for hill States.

3.39 The Ministry of Water Resources recommended to us a basic norm of Rs.180 per hectare for the maintenance of the utilised potential. In addition, it recommended Rs.65 per hectare for regular establishment and Rs.36 per hectare for special repairs (with Rs.25 per hectare extra for areas having drainage problems). With this, the total cost comes to Rs.281 per hectare. The Ministry suggested that the maintenance expenditure should be updated annually for escalation in cost. As regards the unutilised potential, the norm suggested by the Ministry is Rs.60 per hectare.

3.40 The norms suggested by the Ministry for the utilised potential are found to be on the very high side, being nearly three times the norms adopted by the last Commission. Taking into account escalation in the cost of labour and material, a norm of Rs.180 per hectare appears reasonable to us in the case of utilised potential. As for the unutilised potential, we have accepted the rate of Rs.60 per hectare recommended by the Ministry. We have also provided for a price increase at the rate of 5 per cent per annum. Having regard to the low level of current maintenance expenditure, the normative expenditure level has been projected to be reached in a graduated manner by the end of the period.

3.41 On the basis of the data obtained from the Planning Commission, we worked out for each State the extent of utilisation of the irrigation potential likely to be created upto 1989-90. Annexure-III-10 gives the irrigation potential and its utilisation in 1987-88 and 1989-90 (Estimated).

3.42 We find that the extent of utilisation of the potential is extremely poor in some States. We share the concern of the last Commission in this matter and urge the States to bring the utilised potential into use as expeditiously as possible. For this purpose, we have divided the States into three categories, viz. (i) the States where the extent of unutilised potential is less than 10 per cent (Andhra Pradesh, Karnataka, Kerala, Orissa, Punjab, Tamil Nadu and West Bengal); (ii) the States where the unutilised potential varies from 10 to 25 per cent (Bihar, Haryana, Madhya Pradesh, Rajasthan, Uttar Pradesh, Jammu and Kashmir and Manipur); and (iii) the States in which the extent of non-utilisation is over 25 per cent (Assam, Goa, Gujarat, Himachal Pradesh, Maharashtra). We have, in our assessment assumed that in the case of States falling in category (i), the potential estimated to be created at the end of 1989-90 will be fully utilised by the end of 1994-95, and that in the case of States falling in categories (ii) and (iii) the unutilised potential would be reduced to 5 per cent and 10 per cent, respectively, by the end of 1994-95.

3.43 As stated earlier, we have assumed gross receipts from the major and medium irrigation works to be equal to the maintenance expenditure provided by us on the basis of norms in respect of the utilised potential only. However, in regard to the hill States, though the norm for maintenance expenditure has been raised by 30 per cent, the receipts in their case have been limited to cover the normal expenditure only. No receipts have been assumed in the case of unutilised potential. Annexure III.11 shows the gross receipts, working expenses and net returns in the case of each State as assessed by us over the period 1990-95.

3.44 While providing for maintenance of major and medium irrigation projects, we felt that Loktak lake in Manipur which is the largest natural lake in eastern India requires additional funds over and above the level of expenditure already provided by us. We

have, therefore, provided an additional sum of Rs.15 crore for the maintenance and preservation of the Loktak lake.

(ii) Flood Control Works

3.45 On the basis of data on length, height and age of the embankments and the discharge capacity of the drainage channels which it could obtain, the Ministry of Water Resources, gave us at our request, suggestions regarding the level of maintenance expenditure required in the year 1989-90 in accordance with the norms recommended by the Expert Committee appointed by the Ministry. However, as the Ministry could not get the data from all the States and the data received were also not up to the mark, we decided to have a parallel exercise conducted in order to work out the maintenance expenditure in respect of flood control works on the lines attempted by the Eighth Finance Commission. For this purpose, we derived the expenditure in the base year 1989-90 by applying a growth rate of 10 per cent to the actual non-Plan expenditure on this account for the year 1987-88. Having done that, we made a comparison of the two sets of figures for 1989-90 and adopted the higher of the two. The projections for the next five years have been done on the basis of a growth rate of 7 per cent per annum and are shown in Annexure III.12.

3.46 The recurrence of floods in North Bihar creates havoc to the State's economy and this was brought to our notice quite tellingly during our field visit. The State Government has already prepared a long term Plan involving construction of a reservoir in the catchment areas of the river in Nepal. As a medium term solution, the State Government suggested the strengthening and controlling of embankments. The long term project for the drainage scheme prepared by the State Government is already with the Planning Commission. The project merits the support of the Planning Commission. We have made adequate provision for the maintenance of the flood control works in North Bihar.

(iii) Minor Irrigation

3.47 We could not adopt a normative approach in making provision for the maintenance of minor irrigation for want of the requisite data. We, therefore, worked out the estimated requirements for 1989-90 by applying a growth rate of 10 per cent to the actual non-Plan expenditure for the year 1986-87. The level of expenditure for 1989-90 so derived was further stepped up at the rate of 7 per cent per annum for the period of our report.

(iv) Maintenance of Roads

3.48 Provision was made by the Eighth Finance Commission for the maintenance of State highways and other roads, on the basis of the norms recommended by the Expert Committee (1968) and the Malhotra Committee (1978) respectively. In May, 1988 the Ministry of Surface Transport appointed a Study Group to update the norms recommended by those two committees. Based on the prices of chips and other materials used for the maintenance of roads, this Group divided the country into six zones and recommended separate maintenance norms for each zone. These norms as set out in Annexure III-13 were approved by the Transport Development Council.

3.49 We obtained from the State Governments information as to the length of State highways, major district roads and other roads. The data received was updated to 1989-90 by following the State-specific trend registered during 1982-86. Applying the norms of the Study Group to the road length in different States, we derived estimates of maintenance expenditure in respect of roads.

3.50 Since the norms recommended by the Study Group were at 1987-88 prices, the provisions for maintenance based thereon were augmented appropriately to make allowance for the subsequent price increases. The cost of establishment and tools and plants has been added to the above estimates at the rate of 16 per cent and 4 per cent of the expenditure, respectively, in each year.

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3.51 The estimates of provisions for maintenance of roads worked out in the manner described above came out to be much higher than the present levels. Such higher levels cannot, in any case, be reached in a short span of time. Hence, we restricted the provisions for 1994-95 to a maximum of 220 per cent of the amounts allowed by the Eighth Finance Commission for 1988-89. As these provisions were at 1989-90 prices, we made an allowance of 5 per cent per annum to account for the effect of price rise during the next five year period. The provision thus worked out for 1994-95 has been assumed to be reached in graduated steps, keeping in view the current level of expenditure. Annexure III.14 shows the provisions allowed to each State for the maintenance of roads over the period 1990-95. These include the provision for maintenance of the roads of local bodies as well.

(v) Maintenance of Buildings

3.52. We obtained from the State Governments data on the plinth area of buildings at the end of March, 1989 by three broad age groups viz., 0 to 20 years, 20 to 40 years and over 40 years. The data were scaled upto March, 1990 by applying the trends witnessed in the preceding years. As the Central Public Works Department maintains the Central Government buildings throughout the country, we thought it proper to make provisions for the maintenance of State Government buildings also on the basis of the same norms as are followed by the CPWD with suitable allowance for price increases. These norms are shown at Annexures III-15A and III-15B.

3.53 The norms for the hill States have been adjusted upward to the extent of 50 per cent for residential buildings and 25 per cent for non-residential buildings. Additional provisions of 16 per cent and 4 per cent of the expenditure worked out on the basis of norms have been allowed for establishment charges and tools and plant, respectively.

3.54 We found that the annual provision worked out in the above-mentioned manner came out to be either very low or very high in some States. We, therefore, decided to moderate it so as to ensure that no State would be provided in 1994-95 less than 180 per cent and more than 220 per cent of the annual provision made for this purpose by the Eighth Finance Commission. On this a price increase at the rate of 5 per cent per annum has also been allowed. However, in view of the low level of current maintenance expenditure, the normative expenditure has been allowed to increase in a graduated manner during the forecast period. The provisions made on this basis for the five years 1990-95 are given in Annexure III.16.

Monitoring of the Maintenance Expenditure

3.55 We find that successive Finance Commissions have made provision for maintenance expenditure based on certain engineering norms, but the expenditure incurred in actual practice by the States has been far too low relative to the norms as well as the requirements for the maintenance of the assets even on a minimum basis. There appears to be a strong preference for the creation of additional assets with little attention being paid to the maintenance of assets already created. In the process, the quality of the assets and their useful life span decline steeply. The neglect of maintenance is an unhealthy practice and must be discouraged. The amount required for the maintenance of the existing assets should be the first charge on the resources of the States. We would even suggest that the Planning Commission should be given a special responsibility for ensuring that the maintenance of the existing assets in the States is in no way compromised. At the time of assessing the resources for the State Plan, the Planning Commission should take special care to ensure that the maintenance expenditures are fully provided for.

Category (ii)

3.56 In the case of items of expenditure falling under this

category, we could estimate cost functions using regression analysis. The detailed methodology for assessing the expenditure needs using this analysis is given in Appendix 5.

3.57 In order to estimate the non-Plan revenue expenditure "needs", we have attempted to estimate the cost functions of non-Plan expenditures classified into suitable categories under general, social and economic services. Expenditure "needs" under general services have been defined as the justifiable costs of providing the average standards of services. In the case of social and economic services, however, the justifiable costs of providing the existing standards of services have been taken to represent "needs". The "needs" so estimated give us the normative assessments.

3.58 Since expenditure needs have been derived on the basis of the estimated cost functions, expenditure variations among the States are attributable to differences in the quantity of public service provided and in the costs of providing them. Here, we have tried to separate the cost factors within the control of the State Governments and those beyond their control.

3.59 After estimating the effects of various quantity and cost variables on the expenditures of the States, we made normative estimates of the expenditures for the year 1986-87. As stated above for general services, the estimates represent expenditures that would be required to provide the average standards of services aid for social and economic services, they show the requirements of providing the existing standards of services on the basis of the quantified behavioural relationship.

Provision for parity of pay scales.

3.60 We may mention here that the expenditure estimates derived on the basis mentioned above take into account the salary revisions done by the States only upto 1986-87. Many State Governments undertook salary revisions for their employees subsequently following the implementation of the recommendations of the Fourth Central Pay Commission by the Government of India. Almost all the State Governments and a number of employees' associations in different States made strong representations to us emphasising the need to bring about parity in the pay scales of State Government and Union Government employees.

3.61 Parity in pay scales is a subject of considerable discussion and debate. Pay parity, however, should not be viewed in total isolation. The frequency and the periodicity of pay revision must also be kept in view. It is necessary to mention here that although the scales of pay in some States are lower than the comparable Central scales, the total emoluments of a comparable State employee could be higher than his counter-part in the Central Government due to the frequent revision of scales in the former. The emoluments that an employee gets is a function not merely of scales of pay but also the frequency of pay revision, the weightage and fixation benefits given to the employee at the time of each pay revision, the existence of automatic grade promotion, revision of other allowances consequent on the revision of pay and proportions of promotions post to the feeder posts. We have made provision for parity only in terms of basic pay. This has been done by taking into account the difference in the scales of pay prevailing at the Union and the State Governments levels for representative categories of employees. We made a comparison of basic pay of selected categories of employees in different States with that under the Union Government by notionally adjusting them to the CPI level of 608 to which the pay scales of the Central Government employees, as revised by the Fourth Central Pay Commission, are related. Wherever these notionally adjusted amounts were lower than the basic pay under the Central Government, additional provisions have been made in the manner as explained in Annexure III.17.

3.62 The estimated expenditure on pay parity was then adjusted to conform to our normative expenditure estimates. For this purpose, we first segregated the non-Plan component by proportionately adjusting the total provision on the basis of the

expenditure and normative expenditure in each of the major States in 1986-87.

3.63 The expenditure needs thus estimated for 1986-87 were required to be projected to the period of our recommendations. This has been done in two stages. In the first phase the normative expenditures have been projected to the base year 1989-90 by applying the average historical growth rates for all States adjusted partially for periodic revision in the salaries by the States. It should be noted that unlike in the case of the Central Government where the salary revision subsequent to the recommendation of the Fourth Pay Commission was done after thirteen years, in a majority of States, the scales have been revised more frequently contributing to the growth of expenditure by a substantial margin.

3.64 As the provision for parity in the pay scales has been made separately, the rate of growth of expenditures had to be adjusted to exclude partially the effect of periodic revision of pay scales in the States. We, therefore, applied the growth rate of 13 per cent per year on the normative expenditures estimated for 1986-87 (historical growth-rate being 14.5 per cent), to estimate the expenditures in 1989-90. The salary revision as computed by us was added to this provision.

3.65 The normative estimates of expenditure arrived at for 1989-90 thus constitute the expenditures at justifiable costs. At the same time in the case of general administrative services, the cost of providing the average standards of services has been taken into account. We must state in this connection that the overall effect of expenditure assessment has been to reckon the non-Plan expenditures of less developed States at a level higher than their actual level. Thus, the overall effect of the application of the norms has been equitable, as may be seen from the details given in Appendix 5.

3.66 In the second stage, the normative estimate of expenditure arrived at for the base year was projected to the period 1990-91 to 1994-95. In making projections, we have been guided by the consideration of phasing out revenue deficits by the terminal year of the period of our Report. This would require restricting the rate of growth in non-Plan expenditure so that the imbalance between the growth of revenues and expenditures is eliminated. Achieving overall balance in the revenue account is possible only when we succeed in limiting the rate of growth of expenditures. This means that the State Governments can ill afford to increase their expenditures substantially in real terms.

3.67 Considering these factors, we have provided for only moderate increases in real expenditures. Given the overall assumption of 5 per cent increase in prices, provision for increase in prices alone would result in the growth of expenditures by 4 per cent, as the major component of expenditures, i.e., wages and salaries, was found to increase by 0.75 per cent for every one per cent increase in prices in the past. In addition, we have assumed that the expenditures should increase at a rate marginally higher than the increase in population, considering that the public services, by and large, are meant to serve the entire population. Therefore, we have assumed 3 per cent growth of expenditure in real terms. Thus, we have projected the non-Plan expenditure for the period 1990-91 to 1994-95 assuming a growth rate of 7 per cent per annum.

3.68 It is necessary to mention here that achieving the normative levels of expenditure right from the first year of our recommendation may not be feasible. In the case of those States for which normative levels were reckoned lower than the level of their actual expenditures, severe hardship would result if the normative levels were to be assumed from the first year itself. Similarly, in the case of the States whose actual expenditures fell short of the normative levels, it might not be realistic to assume that within a year the normative levels would be achieved. We have, therefore, phased out the expenditures so as to reach the normative levels by 1994-95. For this purpose, we have restricted the difference between actuals and normative estimates by one-

half in 1989-90. Taking these as the base year estimates, we have phased the expenditure growth to reach the targeted level in 1994-95.

3.69 While finalising the level of non-Plan revenue expenditure, we have not made any exclusive allocation for upgradation of such administrative services as Training, Jails, Judiciary, Police and Revenue Administration. We do realise the essentiality of these services and the need for their improvement and upgradation. We have, however, not recommended any specific grants-in-aid for such upgradation, because the need for upgrading these services in States where they are below average level has been taken care of in the norms which we have adopted. Our experience is that these sectors are generally starved of funds in a zeal to conserve resources for the Plan. It is desirable, no doubt, to make economy in non-Plan expenditure and to make resources available for financing a larger Plan. We feel, however, that it would not be advisable to do so at the cost of the efficiency of the basic administrative services. The requirements of these services should be met in adequate measure. We, therefore, suggest that a Committee may be constituted in each State under the Chairmanship of the Chief Secretary to ensure that the legitimate requirements of these basic services are adequately met.

Category (III)

3.70 The notable items of expenditure which fall in this category are elections, pensions and retirement benefits and social security and welfare.

Elections

3.71 Provision has been made for expenditure on regular election machinery. We have also provided fully for the conduct of State assembly elections wherever it will become due during the report period. This has been done on the basis of the information obtained from the Office of the Election Commission. Full allowance has been made to accommodate the additional cost arising from the enlargement of the electorate following the recent lowering of the voting age.

Pension and Retirement Benefits

3.72 In the case of pensions, no data are available about the number of pensioners in different pension ranges. Most of the States have already revised their scales of pay and the impact of the revision on pension and other retirement benefits would be reflected in the pension figures in the budget estimates for 1989-90. We have, therefore, projected the provisions in the budget estimates for 1989-90 by applying a growth rate of 7 per cent to work out the estimates for each year of the report period. The impact on account of revision of pay scales subsequent to the presentation of the budget has also been taken care of.

Social Security and Welfare

3.73 Provision for old-age pension has been made by allowing a pension of Rs.100/- per month to 0.2 per cent of the population of each State as per the 1981 Census. In the case of Special Nutrition Programme and food subsidy in States like Andhra Pradesh, Gujarat, Kerala and Tamil Nadu, the expenditure as provided in budget estimates for 1989-90 has been adopted as the base and projected at the rate of 7 per cent per annum. The expenditures on other programmes have been worked out by taking the actuals of 1986-87 and projecting the same at the annual rate of 10 per cent till 1989-90 and 7 per cent over the subsequent period of our Report.

Other Expenditures

3.74 Some of the north-eastern States represented to us that for want of funds they had not been able to build accommodation for housing their capital. They requested us to consider giving grants for construction of secretariat, high court building, government residential buildings and similar other facilities. We urge the Government of India to consider the entire matter and provide appropriate assistance.

3.75 To commemorate the memory of the entry of the INA and Netaji Subash Chandra Bose on the Indian soil, the citizens of Moirang (Manipur) erected a memorial in 1956. The memorial consists of a modest museum-cum-library, a life size statue of Netaji and a pillar in honour of Indian National Army. This memorial is managed by the Government of Manipur. The Commission feels that this national heritage needs to be conserved, improved and fostered as befitting the memory of Netaji and INA. The Commission would suggest that the Government of India undertake the expenditure in this regard which may amount to Rs. 10 crore. We are confident that our assessment of non-Plan revenue expenditure of the Centre can easily accommodate a provision of Rs. 10 crore in this regard.

3.76 It was represented to us by the Government of Manipur inter alia that a time bound comprehensive and integrated project be taken up to solve the problem of jhoom cultivation. The estimate given to us for undertaking this programme was Rs. 45 crore at the rate of Rs. 28,000 per family. This problem, in fact, is not peculiar to Manipur alone as it obtains in all the north-eastern States. We understand that schemes to tackle this problem are being taken up as part of the Plan exercise. In view of the imperative necessity to meet this problem, we expect that Planning Commission and the State Governments together would draw up and implement a comprehensive Plan.

3.77 The Government of Sikkim approached us with a proposal for assistance for construction of an airstrip, which, according to them, was vital for the State in view of its strategic location, difficult terrain and frequent landslides disrupting communication link with the rest of the country. We are convinced of the genuineness of the State Government's demand. While proceeding to Gangtök, we ourselves got stranded because of a massive landslide on the way. We would, strongly urge the Government of India to take up the construction of an airstrip in the State.

Committed Liability

3.78 In the assessment of non-Plan revenue expenditure of States, we have not provided for committed liability of the Seventh Plan Schemes. This departure from the practice adopted so far is intended to correct what we consider to be an unsatisfactory way of providing for this liability. As repeatedly stated by the previous Finance Commissions, it is extremely difficult to assess correctly the committed liability. So the previous Commissions adopted on overall percentage of the revenue expenditure of the base year State Plan as a reasonable estimate of committed liability. As those Commissions dealt only with non-Plan revenue account, they had to assess the committed liability in some manner and they followed a method reasonable and feasible in that situation. However, the Ninth Commission is in a better position in the sense that our terms of reference imply assessment of the entire revenue account including Plan expenditure. Therefore, we have examined whether there is a better way to tackle the issue of committed liability. The result of our analysis in this regard is the finding that to deal with committed liability in an isolated manner without a linkage to new Plan revenue expenditure can be misleading. What is worse is that such an exercise could lead to wasteful expenditure. A substantial part of the Plan revenue expenditure is on staff and allied items. The expenditure in the last year of a Plan is the cumulative expenditure built up over the five years of that Plan. If all that staff and allied expenditure are transferred to non-Plan side when the new Plan starts, the expenditure for the same item (many of such schemes continue from Plan to Plan with or without some alterations) should, in the first year, be substantially less than that of the final year of the previous Plan. But in actual practice, in most cases, the first year's Plan is higher than the Plan outlay of the previous year and each Union Ministry or State Government Department insists on getting a corresponding increase in their shares of that outlay also. In any case, the system in its totality does not have the resources to

transfer a substantial part of the revenue expenditure of the terminal year of a Plan to the non-Plan side and provide, in addition, a higher amount for the revenue expenditure of the first year of the new Plan. This is particularly true of programmes under Education, Family Welfare, Extension Schemes in Agriculture, etc.

3.79 From this analysis, we have come to the view that what is required is to provide funds for normal gradual increase in the revenue expenditure of the last year of a Plan into the next Plan also. How much of that provision should be actually transferred to non-Plan and how much should be retained as part of Plan should be decided by the States and Centre (for Central Plan) in consultation with the Planning Commission. This should be based on a close scrutiny of the schemes with substantial revenue expenditure component and not on the basis of a rough overall percentage. In a fiscal exercise like ours, that type of detailed analysis is not possible nor is it necessary provided we ensure adequate provision for total revenue expenditure.

3.80 Consistent with this perception, we have not provided separately for committed liability, but we are providing (as explained in Chapter VII) for reasonable growth in Plan expenditure of both the States and Centre over the corresponding outlays, from the first year of the Eighth Plan onwards.

3.81 Before we conclude this Chapter, we would like to mention that the Commission's Secretariat had prepared two alternative sets of exercises to project the tax revenues and non-Plan revenue expenditures over the period covered in our second report. The details of the first exercise are available in Appendices 4 and 5 of the report. A separate exercise was also done to estimate the tax revenues and the non-Plan expenditures of each State in the traditional manner. For this exercise, the data for the base year (1989-90) was firmed up by applying to the actuals of 1986-87, duly cleaned for non-recurring and abnormal items, the State-specific long term rates of growth and keeping fully in view the budget and the latest estimates for the year 1989-90 as received from the States. The latest developments which came to our notice following our meeting with the State Governments were also taken into consideration in finalising the base for 1989-90. The projection for the five-year period of our report was worked out by giving the tax revenues (excepting Land Revenue) in the base year (1989-90) an annual growth rate of 11.5 per cent. The non-Plan revenue expenditure of the base year was stepped up by projecting it at an annual rate of 7 per cent, except in the case of Compensation and Assignment to local Bodies which was increased by 9 per cent. The final figures of receipts and expenditure resulting from both the sets of exercises for each State are set out in Annexure III.18.

3.82 The approach as detailed in Appendices 4 and 5 has been attempted by the Finance Commission for the first time. The inherent logic of this approach is inescapable. Finance Commissions in the future may bring about further sophistication and refinement in this exercise. As this exercise is unique and is being attempted for the first time by the Finance Commission, we have made certain adjustments in the final estimates resulting from this exercise. It would be seen that the estimates flowing from this exercise either show higher surpluses or lower deficit than those resulting from the alternative more traditional exercise in the case of 10 of the 14 major States, excluding Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. These differences arise because of deviations of the trends from the norms adopted by us. As a matter of abundant caution and as a measure of concession to the States, we have reduced by 50 per cent the net improvement in the budget position shown by the normative exercise. (Annexure III.19).

3.83 Shri Justice A.S. Qureshi is of the view that the methodology adopted for applying the normative approach is not satisfactory. He has explained his view in the Note of Dissent.