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ISSUES BEFORE THE TENTH FINANCE COMMISSION

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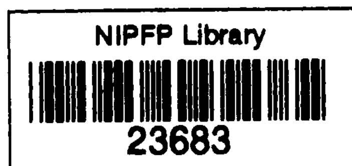

ISSUES BEFORE THE TENTH FINANCE COMMISSION*

I. INTRODUCTION

The objective of this paper is to highlight the major issues to be considered by the Tenth Finance Commission (TFC) in the light of the terms of reference given to the Commission. The paper first discusses briefly the principal theoretical issues in federal finance. In this discussion attention is concentrated on the economic case for decentralised provision of public services, the emergence of the federal finance problem in the form of vertical and horizontal fiscal gaps, different methods of effecting transfers[1] from the Centre to the States, and the criteria for determining the optimal design of federal transfers, keeping in view not only the objectives of the transfers but also the nature of response to the design on the part of the recipient units, i.e., the objectives of the transfers as well as their incentive effects.

Against this theoretical discussion, in Section III the broad trends in the Central and States finances and in the financial relations between them are reviewed. This review is intended to provide the empirical basis from which the TFC could proceed to consider its tasks. The next two Sections briefly analyse the terms of reference of the TFC and the tasks before it. The final Section discusses in some detail the major issues to be considered by the Commission and the considerations that must be borne in mind in deciding those issues.

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1. In this paper "transfers" is used to mean current transfers.

It may be pointed out that this paper does not consider the financial relations between the State governments and the local authorities and also does not review the method of assisting the States in meeting natural calamities.

II. BASIC THEORETICAL ISSUES IN FEDERAL FINANCE

1. The Emergence of Fiscal Imbalances

Apart from political considerations, from the economic point of view there are advantages to be derived from multi-level public finance. These advantages are specified in the so-called "decentralisation theorem" which states that if there are no cost differences between centralised and decentralised provision of a public good, it will be more efficient for a local government (whose jurisdiction coincides with the area of incidence of benefit from that public good) to provide that good.[2] This is because decentralised provision of public services could be (and mostly would be) more in accordance with the preference of the people. Also, equally important, if each jurisdiction collects benefit (or even non-benefit) taxes from the people resident in it to finance the cost of the public services it provides, there would be closer correspondence between the marginal benefits from the services and the marginal disutility of paying the taxes.[3] The linkage between the decision to spend and that to raise resources would help secure fiscal discipline.

The decentralisation theorem suggests that, if only the economic aspect is to be considered, ".....services which are nationwide in their benefit incidence (such as national defence) should be provided nationally. Services with local benefits (e.g. street lights) should be provided by local units, still others (such as highways) should be provided for on a regional basis .... The spatially limited nature of benefit incidence thus calls for a fiscal structure composed of multiple service units, each covering a different-sized region within which the supply of a particular service is determined and financed."[4] To this may be added the rule that while the allocative function[5] may be shared between the national and sub-central governments (with a substantial or even a

2. Oates, W.E. (1972), p.35.

3. In such a set up the only rationale for inter-governmental transfers is inter-jurisdictional spilloves. See, Breton [1975].

4. Musgrave and Musgrave (1989), p.447.

5. Relating to the provision of public services.

larger share going to the latter), the stabilisation and redistributive functions have to be assigned largely to the Central or national government. Stabilisation involves macro-economic policies and can be formulated and implemented only by the Central Government. Again, the sub-central governments cannot initiate significant redistributive measures as they have "open" economies and will be in danger of driving out capital and skilled labour from their respective jurisdictions, not to mention the fact that they cannot effectively reach assets and income located outside their borders.

Nevertheless, the expenditure responsibilities to be assigned to the State governments[6] would require a large share of revenue resources. The raising of taxes, however, has to be largely centralised for efficiency and economic reasons. Similarly, redistribution being primarily the function of the Central government, nation-wide progressive taxes have to be assigned to it. Thus it is that in all the major federations, with the exception of the United States, while important and growing expenditure responsibilities are assigned to the State governments, the major revenue handles have come to be vested with the Central Government, creating what is generally called "vertical fiscal imbalance". The emergence of this imbalance necessitates substantial transfers from the Centre to the State governments.

The case for intergovernmental transfers, however, does not rest on the vertical imbalance argument alone. In federal countries with large economic disparities among the States, the capacity to raise resources for financing public services would vary (sometimes significantly, as in India) across the States, creating what may be called horizontal fiscal imbalance.[7] This calls for horizontal transfers among the States (from the fiscally better off to the fiscally disadvantaged) or, alternatively, equalising transfers from the Centre.

2. The Vertical Fiscal Imbalance in India

The assignment of tax powers and the division of expenditure responsibilities are laid down in the Indian Constitution. On the expenditure side, because of the fairly large area of concurrence of responsibilities, the Centre has

6. From now on we substitute the term "sub-central governments" by "State governments" since we shall b dealing only with the relations between the Centre and the States.

7. Horizontal fiscal imbalance rationale for transfers is based on the argument that equal treatment of equal should not be confined to taxes, but should be extended to cover public consumption also. This implic that equally placed residents should have entitlements to equal levels of public services at a give tax-price. For details, see, Boadway and Flatters [1982].

considerable discretion in expanding or keeping limited its own expenditure functions. The establishment of the Planning Commission and its active role in public expenditure determination has also influenced the pattern of growth of expenditures by the Centre and the States. Through gradual evolution, while the major proportion amounting to over 55 per cent of the total revenue expenditure is incurred by the States, a major part of the capital expenditure of about 60 per cent of the total is incurred by the Centre.

The Constitution gave to the Central Government the power to levy the most important and productive taxes - taxes on personal non-agricultural income and corporate income, production or excise taxes on all manufactured goods other than alcohol, and customs. This seems to have been done for three reasons: the need for a financially strong Central government, efficiency in collection and the minimisation of undesirable economic effects, and the desirability of enabling the Central government to generate a surplus of revenues over its own current needs so that it can make equalising transfers to the States in need of assistance.

Some measures of the degree of centralisation of revenue collection and the size of the vertical fiscal gap for the year 1989-90 are given by the following figures:

Tax revenues collected by the Centre:	66.5 per cent of the total
Tax revenues collected by the States:	33.5 per cent of the total
Non-tax revenues collected by the Centre:	64.8 per cent of the total
Non-tax revenues collected by the States:	35.2 per cent of the total
Total revenues collected by the Centre:	66 per cent of the total
Total revenues collected by the States:	34 per cent of the total
Revenue expenditures by the Centre:	47.2 per cent of the total
Revenue expenditures by the States:	52.8 per cent of the total

It is obvious that the vertical fiscal gap need not be a fixed thing even in relative terms. Given the assignment of tax powers and the division of expenditure responsibilities under the Constitution, there emerges an implicit vertical fiscal gap. The relative size of the gap can increase if:

a. the shareable taxes of the Centre are growing relatively slowly;
b. the own revenues of the States are growing relatively slowly; and
c. the revenue expenditures of the States are growing relatively fast.

We shall discuss later the possible consequences of attempting to cover the actual gap that arises from year to year.

3. Sharing of Revenues under Multi-Level Finance

In a federal or multi-level finance system, revenue resources can be shared between the Central Government and the State governments through the division of tax powers, tax base sharing, tax proceeds sharing, and inter-governmental grants from the Centre. In assigning relative importance to each of these methods as well as in working out the pattern of each device, a compromise should be (and is usually sought to be) effected among the criteria of States' autonomy and fiscal discipline, efficiency, and inter-State equity.[8] While political judgment has to be exercised to decide the nature of the compromise, it is important to emphasise that none of them can be neglected.

It has already been indicated that if the taxing powers are sufficiently (and hence considerably) decentralised so that each jurisdiction can finance, through its own services, the entire or almost the entire cost of the services it provides, there will be the greatest degree of autonomy and also fiscal discipline will be strengthened. However, such an arrangement will violate the criteria of economic efficiency and equity. One way of increasing State autonomy to an extent without reducing efficiency is the device of tax base sharing. That is, the States are empowered to add a supplement to one or more federal taxes which would be payable by their respective residents. Correspondingly, the volume of tax sharing can be reduced. This is a useful device, but if there are wide regional disparities, the backward States will be worse off than under a regime with larger tax sharing which can be related to general indicators of fiscal need, besides collection.[9]

In any case, tax base sharing can play only a supplementary role. Given the assignment of taxes, the other two remaining means of revenue sharing, namely, tax proceeds sharing and inter-governmental grants have to play the major role.

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8. Inter-State equity is interpreted in terms of enabling each State to provide a minimum or the average standard of specified public services at a standard tax-price to be paid by its citizens or residents.

9. In India, one possible way of introducing formal tax base sharing is to persuade the States to discontinue the levy of "profession tax" and permit them to add a supplement to the personal income tax upto, say, 10 per cent of the Central tax payable.

a. Tax sharing

In some ways tax sharing is preferable to grants-in-aid: Tax devolution on the basis of a formula is a predictable source of revenue and the States would gain automatically from the buoyancy of the shared Central taxes. Moreover, if the percentages of the Central taxes are to be shared and the principles of distribution of the divisible pool among the States are fixed constitutionally, there will be certainty and avoidance of conflict and of continuous bargaining. On the other hand, grants-in-aid have the advantage that they are capable of being targetted towards fiscally disadvantaged States; another advantage from the point of view of the Central Government is that they can be made conditional regarding the nature or direction of use.

On grounds of certainty and the automatic growth of the shared amount according to the growth of the shared Central taxes[10], tax sharing has to be the main or major channel of transfer of current revenues from the Centre, although in Canada tax base sharing and grants are the main channels. While the sharing of taxes has to play a major role, it cannot be assigned a predominant role making grants-in-aid negligible, particularly in countries such as India with sizeable inter-State disparities in taxable capacities and in the standards of public services.

So much would generally be agreed upon. However, there are other important questions regarding the design and nature of transfers that need to be settled. These are:

i. What should be the proportion of Central revenues that should be transferred (through tax sharing and grants)?

ii. What should be the relative proportions of tax sharing and grants-in-aid?

iii. Should all Central taxes be shared?

iv. What proportion/proportions of Central taxes should be shared?

v. What should be the principle of inter-se distribution among the States of the tax share?

Taking question (iii) first, it could be stated that there would be advantages in sharing all the taxes, if the share is fixed, say, constitutionally so that it would not be subject to change except perhaps after the lapse of long periods of time.

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10. Being unconditional can also be counted as an important advantage because that is in tune with the true federal principle.

The main advantages would be, first, that the percentage share could be kept relatively low because the base will be large; consequently, the incentive for the Central Government to exploit any particular source of revenue would not be affected. Second, the States will benefit from the average buoyancy of the Central taxes and so the States' share would grow at the same rate as those taxes. The only disadvantage of the system is that if the Centre needs some extra resources to meet some unforeseen needs, it would not be able to limit the additional burden to be imposed on the people to the extra amount it needs. The Centre will not be free to raise additional resources for itself alone, whereas the States will be able to do so without losing any part of their share of Central taxes. This disadvantage, however, can be overcome by permitting the Centre to levy a surcharge on one or more of its taxes for a temporary period, the proceeds of which would be utilised by the Centre alone. In the Federal Republic of Germany, all the important federal taxes, namely, the corporate income tax, the personal income tax and the value added tax are shareable with the States, and the shares can be changed only either by changing the Constitution or by common agreement. *Per contra*, under the Indian Constitution, only the non-corporate income tax on non-agricultural incomes is compulsorily shareable, while the Union excise duty may be shared with the States. Another important difference is that the percentage share of these two taxes going to the States may be changed by the President every five years (or even earlier) after considering the recommendations of a Finance Commission also to be appointed every five years. These are two contrasting systems and the implications of the differences will be referred to later in this paper.

If the tax shares are fixed and the grants-in-aid are formula based, e.g., a given proportion of Central revenues net of tax devolution to be distributed among the "backward" States in proportion to relative deficiency in per capita taxable capacity, then there would be no need for a periodic review and assessments of the fiscal needs of the Centre and the States. Both levels of government would adjust their expenditure growth and tax effort to attain the levels of public services they would like to have, given the fixed pattern of tax sharing and the fixed proportion of Central net revenues to be given as grants. However, if a periodic review is provided for (either formally in the Constitution or informally through general agreement), then the question has to be, or could be, asked on every occasion of review, as to what proportion of Central revenues should be transferred to the States. If this is decided, the next question to be answered is: What should be the relative proportions of tax devolution and grants-in-aid? As indicated earlier, in deciding this question a balance has to be struck between States' autonomy and inter-State equity. It is important to recognise that the redistributional consequences of the two methods of transfer would be significantly different. It would

seem reasonable to argue that in a federal country with large inter-State fiscal disparities, grants-in-aid should not be relegated to a negligible or residual role.

Given the volume of tax devolution to be aimed at, what should be the proportion of the shareable taxes that should be shared? As between two taxes, one could argue, the proportion to be shared should be somewhat higher for the more income elastic tax. Apart from this, two other considerations could be kept in view: first, the proportion to be shared should not be raised so high that the Central Government will get an incentive to concentrate more on other taxes. (This possibility is already implicit in sharing only one or two taxes.) And second, the difference in the proportions should not be much, as a large difference will again tend to distort the pattern of resource mobilisation by the Centre.

If all Central taxes are to be shared then the proportion can be relatively small such as 20 or 25 per cent of the total tax revenue and this proportion should remain fixed. Otherwise, the main advantages of the system will be lost.

b. Grants-in-aid

Grants-in-aid can be either specific (conditional) with or without matching requirements or general (unconditional). The first type of grants are used to ensure minimum levels of specified public services to be provided by the States or to correct for spillovers or externalities because of which a State or States in general may not provide the optimum levels of particular services. They can also be used to impose the Central Government's preferences (e.g., grants for Centrally sponsored schemes). Unconditional grants are to be used to offset fiscal disadvantages arising from lower taxable capacity or higher unit costs (due to factors external to governments' actions). That is, equalising grants have to be general. Such general equalising grants are intended only to enable the different States to come up to a particular standard of services. Hence they least violate the federal principle.

The designing of grant schemes should take into account not only the objectives they are intended to subserve, but also the responsiveness of the recipients. This is particularly true of the transfers given to ensure minimum levels of specified services. In order to induce the deficient States to provide the services at the stipulated level, as mentioned earlier, it may be necessary to provide transfers with matching requirements by the States. There has been considerable discussion of the incentive effects of different grant designs mainly in terms of income and substitution effects and

suggestions have been made regarding the suitability of different schemes to serve various objectives.[11] The grants routed through the Planning Commission as well as the Finance Commission grants have been mainly general purpose grants. While the Planning Commission grants to the major States have been based on criteria not related to fiscal needs as such, the general purpose grants by the Finance Commission have been used to cover estimated revenue deficits, if any, remaining after devolution of taxes. Some specific grants have also been given by the Finance Commissions for upgradation of specific services in certain States where they were found to be below par. While, in conception, these were in the nature of close-ended, specific purpose non-matching grants, since there was no monitoring mechanism and the States did not have to account for how the funds were used, in fact they became additional general purpose grants.

The income and substitution effects of the grants given by the Finance and Planning Commissions in India have not been subjected to any rigorous analysis. However, it has been noted that the grants-in-aid by the Finance Commission have been reduced to a negligible proportion of the total transfers by the Commission and have not been designed to offset fiscal disadvantages.[12] Moreover, "the gap-filling" approach of the Commission has been generally criticised by economists. First, it is pointed out that such an approach has implicit in it a strong disincentive to tax effort and to economy in expenditure (Lakdawala, 1967, Sastry, 1966, Gulati, 1973, Chelliah et.al., 1981). Second, this methodology does not enable the States with lower resource bases to provide reasonable standards of services as the emphasis would be on meeting budgetary gaps arising from the existing relatively low levels of services in these States (Grewal, 1975). Third, as grants-in-aid were taken to be a residuary form of assistance, the methodology of scrutinising the budgets had relevance only to the States with post-devolution gaps in their non-Plan revenue accounts (Chelliah, et.al., 1981).

4. Design of Transfers and Incentive Effects

As already stated, if the tax shares are fixed and the grants-in-aid are formula based with the formulae not having any relation with the actual behaviour of the government, there would be no need for periodic review and assessments of the fiscal needs of the Centre and the States. Once periodic assessments are provided for, not only the volume but also the pattern of transfers might change. Hence, it will become important to take into account the incentive effects of the design of transfers. That is to

11. See Rao and Chelliah (1991) for a brief discussion and detailed references.

12. The Ninth Finance Commission made an attempt to link transfers to fiscal capacities and needs.

say, in working out the principles on the basis of which changes are brought about, the possible effects of the basis of changes on the propensity to spend and the willingness to raise resources must be kept in mind. In a truly federal system, each constituent unit must be free to decide upon its own level of public services to be provided and the level of resources it wishes to raise, given its taxing powers and the transfers it receives. If punishment or reward is introduced through the mode or design of transfers, the choices of the sub-central governments will be interfered with. That will be contrary to the federal principle. However, such interference may be politically acceptable.[13] A more serious aspect of the incentive effect is that the design of transfers may lead to competitive raising of government expenditures and inducement to raise less resources than what a government would have done but for the incentive emanating from the system of transfers (e.g., the gap-filling approach will tend to induce larger gaps).

In fact, three important consequences emerge if the tax devolution and grants-in-aid are subject to change in relation to trends in Central and State finances. First, there would be incentive effects of the design of grants and it must be the aim to minimise them or to produce only those effects (in a quasi-federation) which would, by general consent, increase the welfare of the people. The design of grants must never be such that each State would be induced to spend more in the hope that the concomitant additional tax burden can be exported to the other States via additional Central transfers.[14] Second, even though the creation or existence of the vertical fiscal gap breaks to some extent the link between the decision to spend and the decision to raise revenues, the design of transfers must ensure that such a link will be established at the margin. Third, if the periodic reviews are conducted in relation to "emerging fiscal needs", the assessment will necessarily have to be, explicitly or implicitly, on a normative basis. If the actual trends are adopted as the basis, there can be no viable solution since, in due course at any rate, the projected revenues (of the Centre and the States) cannot add up to the projected expenditures.

Two other considerations that must be kept in mind by a social scientist studying this problem, or an impartial authority entrusted with designing a system of transfers, should be pointed out. First, the social scientist or the policymaker must be ultimately concerned with the welfare of the people at large. While there will be a

13. That is, the political decision may be in favour of quasi-federal realtions as in India. In that case, the Centre might wish to induce the States to raise more resources, even when the peoples of particular States do not wish that.

14. If all or most of the States do so, the Centre will also be induced to raise its own expenditures in relation to its revenues.

political struggle among governments for obtaining or appropriating more revenues, the concern must be not with the interests of the governments but with the interest of the people. Thus, a system of transfers, which automatically requires the Centre to make good the deficits in State budgets with each State being free to determine its own level of expenditure, would lead to a situation in which the Centre would be forced to raise the tax burden on the people or borrow from the public and the Reserve Bank of India which may be against their welfare and which on a referendum they are likely to reject. The second consideration to be borne in mind is that all changes in the design or system or volume of Central transfers will almost always have inter-State redistributional effects. For example, if Central transfers are increased, there has to be diminution of Central expenditure distributed amongst the various States and the increased transfers will not normally have fully neutralising effects because the principles of distribution of transfers will have no relation to the distribution of decreases in expenditures. The same would apply to an increase in Central taxes or increased Central borrowing accompanied by increased Central transfers. Any change in the relative proportions of tax devolution and grants-in-aid will also have redistributional effects. And so on.

One final point could be made in the context of periodic reviews and assessments of Central and State finances leading to possible changes in the system of transfers. Radical changes cannot be brought about in the system on the occasion of any one review as that would disrupt the finances of several governments. Even if it is found that the principles adopted by the earlier Finance Commissions are unsatisfactory, changes can be made to move to a more efficient and equitable system only gradually.

III. TRENDS IN INDIAN FEDERAL FINANCE

Table 1 to 12 together present the salient features of, and major trends in, Indian federal finance. The following inferences can be drawn from the information contained in the Tables:

1. As stated earlier, there is considerable decentralisation of revenue expenditure in the government sector. The share of the States in revenue expenditure has been above 50 per cent throughout the period. In recent years, the share has been around 56 per cent (Table 1) except for 1989-90. However, the share of the States in total capital expenditure has been much less than that of the Centre. Nevertheless, the States' share in aggregate expenditure (revenue and capital) has been above 50 per cent - during the Seventh Plan period it was 52 per cent (Table 2).

2. The high degree of centralisation of revenue collections can be seen from the figures presented in Table 3. It is seen that the Central Government raises around 70 per cent of the total combined revenues of the Centre and the States, two-thirds of the tax revenue and an overwhelming proportion of non-tax revenues. The relative shares of the Centre and the States have remained more or less constant over the years except for non-tax revenues where the Centre's share has been rising.

3. While the States raise only around 33 per cent of the combined tax revenues, their share of tax revenues in terms of accrual is around 50 per cent. That is, after the devolution of Central taxes, the States have for their own use more than 50 per cent of the combined tax revenues (Table 4). This share was only 45 - 46 per cent in the 60s, but it rose to 51.6 per cent in 1979-80. It was around 52 per cent between 1980-81 and 1982-83. Since then the States' share of accrual of tax revenues has been around 50 per cent. It is also worth noting that the proportion of devolution in the total taxes accruing to the States has increased from 31.6 per cent in 1983-84 to 33.3 per cent in 1989-90; it remained at more or less the same level until 1990-91.

4. As indicated earlier, the Centre raises around 70 per cent of the combined total revenues. However, as much as 62 per cent of the total accrued to the States in 1990-91. In fact, the share of the States in total revenue accruals has been almost stationary at the level of 61 - 62 per cent of the total during 80s. Thus the Centre which raises 70 per cent of the total revenues keeps for itself only about 38 per cent of that total.

5. The States' own revenue receipts finance around 56 per cent of their revenue expenditures. This proportion has significantly come down over the years : whereas it was 68 per cent in 1975-80 and 60 per cent in 1980-85, it is only 56 per cent in 1985-90 (Table 6). Similarly, the States' own total receipts finance around 55 per cent of their total expenditure.

6. During the period 1980-81 to 1989-90, the compound growth rate of tax revenues of the Centre has been higher than that of the 14 States considered (Table 8). The buoyancy of the taxes raised by the Centre at 1.17 was marginally higher than that of the taxes raised by the States taken together at 1.15 during the same period.

7. The total revenue receipts of the States grew at the rate of 15.9 per cent per annum during the period 1974-75 to 1979-80 and at 15.5 per cent (that is, at a slightly lower rate) during the period 1980-81 to 1989-90, whereas their revenue expenditure grew at 16.1 per cent and 17.6 per cent, respectively, in the two periods (Table 9). Total Central transfers to the States grew at only around 16 per cent per annum during the latter period as compared to 18 per cent in the former; on the other hand, the total revenues of the States grew at a higher rate (15.4 per cent) in the latter period than in the former period (13.9 per cent). Nevertheless, even during the latter period Central transfers to the States grew slighly faster than the States' own revenues.

8. Plan transfers and other (discretionary) transfers have increased their share of the total Central transfers during the last decade. While they constituted about 33 per cent of total transfers during the Fifth Plan period, they amounted to 38 per cent of the total transfers during the Sixth Plan period and 39 per cent during the Seventh Plan period (Table 10). Nevertheless, as far as transfers, as distinguished from loans, are concerned, the major portion flows through the recommendations of the Finance Commission. It may be noted that the plan transfers given under the Gadgil formula has remained more or less stable at around 17 per cent since the Fourth Plan. Hence the increase in the share of the non-Finance Commision transfers arises mainly due to the increase in the proportion of transfers under the Centrally sponsored schemes.

9. Generally, it is seen that per capita own revenue receipts of the States are related to per capita State Domestic Product (SDP). If only per capita SDP is taken as an indicator of revenue raising capacity of the States, equalisation of revenue capacity requires transfers to be inversely related to SDP. Table 11 shows the correlation coefficients between various types of per capita transfers and per capita SDP in respect of major States for four years: 1975-76, 1980-81, 1985-86 and 1988-89. Clearly, only in the case of shared taxes a significant negative correlation with per capita SDP is seen, that too in years subsequent to 1980-81. Of the other types of current Central transfers to States, only statutory grants for the year 1980-81 are correlated significantly with per capita SDP and the correlation coefficient is negative. None of the correlation coefficients of per capita plan grants and discretionary grants with per capita SDP are statistically significant. Obviously, because of the shared taxes, total transfers through the Finance Commission, as well as total current transfers are negatively correlated to per capita SDP, for the selected years except 1975-76.

10. However, the equalising trend in Central transfers has not been adequate to equalise per capita current expenditures in the selected States. The coefficients of variation in per capita expenditures are virtually constant at 0.25 in all the years.[15] Similarly, in the case of total expenditures (current and capital) the coefficients of variation range from 0.26 to 0.31 without showing any clear trend. It is also seen that per capita expenditures (current or total) in the States show a significant positive correlation with per capita SDP, and this has been rising over the years.

IV. THE TERMS OF REFERENCE

1. Salient Features

The terms of reference specified in the Presidential Order appointing the Finance Commissions have always been a subject matter of controversy. The guidelines given under Article 280(iii) 'in the interest of sound finance' have, over the years, attempted to restrict the scope of the task of Finance Commissions and to influence their methodology in making federal transfers (Chelliah, et.al. 1981). With development planning gaining emphasis, the Finance Commission's role was confined, according to the terms of reference, to the examination of non-plan revenue accounts of States' budgets. However, no such restriction on the scope was placed in the terms of reference given to the Ninth Finance Commission. But the guideline strongly suggesting the adoption of the "normative" approach, leading to speculation of discrimination in the treatment in its application between the Centre and the States and the possibility of further erosion of States' autonomy[16], raised unprecedented controversy. On the other hand, some argued that the emergence of the Planning Commission as an important agency to make Central transfers to the States for developmental purposes is a historical fact and that the mere Constitutional entitlement of the Finance Commission should not negate the political consensus of the National Development Council. The inference was that the Finance Commission should deal only with the non-Plan revenue side.

Perhaps in order to stay clear of the controversies, the terms of reference to the TFC virtually take us back to the traditional guidelines. The terms of reference do not make reference to any particular type of approach. The Commission may choose the approach found appropriate. However, in doing so, the Commission should, *inter-alia,*

15. In 1980-81 it was marginally lower at 0.23.

16. For details, see Vithal and Sastry (1987), Bagchi, Sen and Tulasidhar, (1988).

consider "not only balancing the receipts and expenditures on revenue account of both the States and the Central government, but also generating surpluses for capital investment and reducing fiscal deficit". The reference to fiscal deficit is an innovation. This term of reference takes cognisance of the serious fiscal imbalance prevailing in the country.

The second important feature of the terms of reference is the return of the restriction placed on the scope of the work of TFC. As was the case until the Ninth Finance Commission, the present Commission has been asked to take account of "the requirement of the States for meeting the Non-Plan revenue expenditure...." which should, *inter-alia*, include the requirements of maintenance of capital assets and committed expenditure on the Seventh Plan schemes. At the same time, requirements for upgradation of standards of administration (which is generally not included in the plan side) should also be taken into account.

The guidelines also draw attention to laxity in fiscal management and declining productivity of capital stock in the public sector. Emphasis on the need to consider the "potential for raising additional taxes, tax efforts made by the States, the scope for better fiscal management and the need to ensure reasonable returns on departmental and non-departmental enterprises" clearly point towards the need to recommend transfers such that they do not encourage fiscal laxity or excessive expenditure. The declining productivity of capital stock, on the other hand, is considered to be mainly the consequence of inadequate provision of funds for maintenance and upkeep of capital assets and the terms of reference ask the Commission not only to evolve satisfactory norms of maintenance expenditure but also to recommend the manner of monitoring these expenditures to ensure that the funds are in fact utilised for the intended purposes.

It may also be noted that although there is no mention of "normative approach" in the terms of reference, a normative approach is implicit in the guidelines. They require the Commission to take into account the potential for raising additional taxes, consider tax efforts made by the States and to see that reasonable returns on investments are earned by the departmental and non-departmental enterprises. All this necessitates the Commission to adopt norms on the revenue side. Similarly, the consideration on the scope for better fiscal management consistent with "*efficiency and economy in expenditure*" (emphasis added), requires the Commission to adopt norms on the expenditure side. The last guideline may broadly be interpreted as requiring the estimation of the justifiable cost of providing the existing levels of services. Requirements of modernisation and upgradation in non-developmental sectors to be

separately considered by the Commission and leaving equalisation in social and economic services to the planning process, bring the terms of reference given to the TFC close to the approach adopted by the Ninth Finance Commission.[17] In this sense, adherence to the guidelines require the TFC to adopt norms for revenue raising capacity and for justifiable cost of providing public services. The only issue appears to be whether the Commission should interpret 'modernisation of administration' and 'upgrading the standards in non-developmental sectors and services' to imply upgradation in the levels of all general services in the case of fiscally disadvantaged States upto the 'average' or any other 'normative' level, or selectively provide for improvement of specific services.

Of course, it is obvious that the requirement to keep in view the need not only to balance revenues and revenue expenditures but to create a surplus for capital investment would necessitate the adoption of norms on both revenue and expenditure sides.

2. A Contradiction

A major contradiction is that while the guidelines attempt to restrict the scope of the Commission to assessing the needs of the States on non-plan revenue account, the requirement to keep in view the need to generate revenue surpluses and to reduce fiscal deficits makes it necessary for the Commission to scrutinise the total revenue and capital budgets of the Centre and the States. Strictly speaking, this would require the Commission to set targets for overall revenue surpluses to be generated and reduced fiscal deficits, and then, consistent with the targets, determine (i) the size of the Central plan and its revenue component, (ii) volume of plan assistance to the States including the assistance for Central sector and Centrally sponsored schemes; and (iii) size of individual State plans and their revenue components. Setting targets of fiscal deficits would also involve consideration of the changing role of the State vis-a-vis the market in the Indian economy. It is probably not intended that the TFC should undertake all these tasks in detail. Perhaps only close co-ordination with the Planning Commission

17. It may be noted that the Ninth Finance Commission interpreted the normative approach on the expenditure side as the requirement to take into account the "justifiable cost" of providing 'average' standards of services in the case of general services and 'existing' levels of services in the case of social and economic services, with improvement in the standards left to the Planning Commission. Of course, part of the improvement was taken care of in the plan grants recommended by the Finance Commission. But as the requirements for plan assistance were not estimated according to the shortfall in the existing levels against the normative standards, its approach could be considered *ad hoc* to some extent.

is envisaged. However, the Commission would have to consider the entire revenue account if it is to indicate a plan of phasing out revenue deficits.

3. Asymmetry

One aspect of the terms of reference that needs to be pointed out is a certain degree of asymmetry in the norms to be applied to the Centre on the one hand and the States on the other. While in the case of the States, the need to consider "the potential for raising additional taxes" and "tax efforts made by the States" has been highlighted, there is no such requirement in the case of the Centre. Similarly, only in the case of State enterprises the need to ensure reasonable return on investments has been underlined. Again, the requirement to take into account the committed liabilities is explicitly mentioned only in the case of the Centre.

There may be valid reasons for stipulating different norms for the Centre and the States. In particular, if the objective is to ensure inter-State equity and to create the right incentives at the State level, the norms stipulated for the States may be on justifiable grounds. It must also be noted that the stipulation of norms for the Centre, for the enforcement of which there is no mechanism, will not have much meaning. This does not, however, mean that the Commission should close its eyes to financial laxity indulged in by the Centre, if the Commission should arrive at such a conclusion. The Commission could give a broad interpretation to the guideline to consider, *inter alia* ".......the resources of the Central government....." and "the scope for better fiscal management consistent with efficiency and economy in expenditure" and subject the Central budget too to a close scrutiny under this term of reference. In this sense, the conditionalities implicit in the terms of reference cannot be said to be entirely one-sided.

It is important to note that, in the terms of reference, while there is explicit mention of the tax potential and tax efforts of the States and the requirement to ensure reasonable returns on investments in States' departmental and non-departmental enterprises, the guidelines do not emphasise the need to raise non-tax revenues by economic pricing of various social and economic services provided by the States and the Centre. Proper pricing of services with low externalities and which benefit relatively better off section of society is necessary for both equity and efficiency reasons. It is to be hoped that the Commission would consider making adequate cost recoveries an important aspect of "better fiscal management consistent with efficiency and economy".

The terms of reference not only suggest the considerations to be kept in mind in determining the volume and distribution of federal transfers but also suggest that the Commission should indicate concrete proposals for achieving a number of objectives. The requirement mentioned in the guidelines to suggest the manner of monitoring the expenditure of amounts meant for maintenance of capital assets and those earmarked for modernisation of administration is noteworthy. The need for ensuring reasonable returns on investments in departmental and non-departmental enterprises by the States may also require the Commission to suggest the ways of achieving such a result. This shows the recognition of the problem of inadequate provision for maintenance and the consequent decline in the productivity of capital stock. However, such stipulations for monitoring may be taken by some to make inroads into States' autonomy. These may become irritants in Centre-State relations.

4. Tasks Before the Tenth Finance Commission

The foregoing discussion brings out that the tasks before the TFC are truly formidable. As already mentioned, the Commission is required to recommend transfers to meet the needs of the States on non-Plan revenue account. However, in order to ensure surplus on revenue account, total revenue expenditure would have to be determined, or at least assumed. One method is to take the revenue component of the Eighth Plan outlay and current plan transfers from the Planning Commission. It would, however, be preferable for the Finance Commission itself to determine the feasible levels of revenue expenditure considering the States' resource position and allow the States the option of adjusting their plan and non-plan outlays within their revenue accounts.

Also, the guideline to have regard to the objective of reducing the fiscal deficit implies further enlargement in the scope of the work of the Finance Commission, for, reduction in fiscal deficit implies fall in the net borrowing of the government sector or the ratio of such borrowing to GDP. Creation of revenue surpluses, *ceteris paribus*, will automatically reduce fiscal deficit. However, given the substantially increased volume of States' loan repayment liabilities, amounting to about Rs 37,200 crore[18] during the period to be covered by the recommendations, continued emphasis on large sized plans financed mainly through borrowed funds would not help in reducing fiscal deficits on States' account. A sense of realism, therefore, is necessary in formulating State plans. Of course, generating surpluses from public enterprises, curtailing

18. Projected on the basis of the growth rate of loan repayments to the Centre in the past seven years (9.6 per cent per year).

government capital expenditure in activities having low externalities, and reducing budgetary support to public enterprises could reduce fiscal deficit to a significant extent.

As mentioned earlier, the terms of reference do not explicitly suggest the adoption of a normative approach. But quite apart from the issue of disincentives and inequity involved in the traditional gap-filling approach, generating revenue surpluses in the Centre and the States as well as reducing their fiscal deficits necessarily call for the adoption of normative yardsticks. If the Commission simply adopts the approach of projecting the revenues and expenditures of the Centre and the States on the basis of past trends with some selective norms applied, it can safely be predicted that there would be a large revenue deficit at the end of the recommendation period.

With the resource constraints becoming very severe at the State level, the problem of inadequate provision for the maintenance of capital assets[19] and the consequent declining productivity of the capital stock in the public sector, has been assuming serious proportions. Unless adequate precaution is taken, the emphasis on reducing fiscal deficit as a concomitant of the structural adjustment programme, may actually further displace these most productive items of expenditure. If this has to be prevented, conditionalities will have to be brought in, but these should apply equally to the Centre and to the States.

Another major issue that the Finance Commission would have to address, and suggest "corrective" measures is the question of States' indebtedness. States' indebtedness has reached a critical position. From just about Rs 27,729 crore forming 17 per cent of GDP in March, 1982, the States' total debt has increased to Rs 1,07,860 crore or 21 per cent of GDP by the end of March, 1991. Of this, the debt to the Centre as a proportion of GDP increased from 12 per cent in 1982 to 14 per cent in 1991. The growth of States' debt to the Centre was about 16 per cent per year on the average. Diversion of borrowed resources to meet revenue expenditures, declining productivity of capital stock, inability to make adequate recoveries from the investments made in enterprises and on social and economic services provided by the States - all these have prevented the making of adequate provision for debt servicing and repayment obligations. Emphasis on having public sector plan outlay in sizes much larger than what can be supported by budgetary savings has further helped to increase States' indebtedness. The issue has assumed critical position as, according to the present trends,

19. In the case of the States, a sharp decline in the ratio of goods and services expenditure to wages an salaries, particularly in respect of economic services clearly points towards a further deterioration in th position. See, Rao (1992) for details.

the repayment of loans to the Centre alone would amount to about Rs 37,200 crore during the period of the award of the TFC. Rescheduling or writing off of Central loans, would surely provide relief to the States, but this only transfers the burden of repayment from the individual State's taxpayers to the national taxpayers. A lasting solution to the problem has to be found only in better fiscal management and more efficient resource use by the government and public enterprises.

5. Ground Realities

The task of the Finance Commission is rendered extremely difficult by the unfavourable fiscal and economic situation prevailing in the country. As already pointed out, the revenue deficit in the 14 major States in 1991-92 (RE) was estimated at about Rs 5975 crore, and this has been showing a phenomenal increase year after year. The task of phasing this out and creating a revenue surplus at the end of the award period in each of the States is surely daunting. At the same time, given the severe fiscal imbalance at the Central level and the structural adjustment reforms the country has embarked upon, it is doubtful whether the Centre would be in a position to make significantly larger volume of transfers to the States, without destabilising its own fiscal position.

The dim prospects of securing larger Central transfers underlines the imperative need for the States to undertake measures to accelerate the growth of revenues and decelerate the rate of growth of expenditures. The States' own tax revenues have grown at a reasonably fast rate in the past. Even then, there is undoubtedly untapped revenue potential contained in large-scale evasion. An appreciable increase in the rate of growth of tax revenues can be achieved only through rationalisation and better enforcement through computerisation and modernisation of procedures. Non-tax revenues (except the cess on mines and minerals) have grown at very low rates in all the States. Raising user charges to economic levels on social and economic services, particularly on those consumed by the more affluent sections, is desirable from the points of view of equity and efficiency but action on this front will crucially depend on political will. Similarly, decelerating government expenditure growth on wages and salaries, transfers and subsidies and reducing budgetary support to public enterprises calls for hard decisions. The issue of creating a proper incentive structure in the transfer scheme is therefore critical.

Another issue of concern is that, in spite of the attempts at imparting greater 'progressivity' in the transfer schemes the available evidence shows that inter-State disparities in the levels of social and economic services have not shown any perceptible decline. A principal reason for this may be seen in the unsatisfactory design

of general purpose transfers from the Centre, the overwhelming proportion of which accrues to the States on the basis of their population rather than specifically quantified revenue and cost disabilities (Rao and Aggarwal, 1990). What is of even greater concern is that the very existence of disparities in infrastructural levels creates disparities in the marginal productivity of capital, levels of private investment and therefore, levels of incomes. This would be particularly so when greater role is assigned to the market as a part of economic liberalisation. Reduction in the overall level of transfers and implementing the objective of phasing out revenue and fiscal deficits, if not carefully undertaken, will accentuate this problem.

V. ISSUES BEFORE THE COMMISSION

The Commission might wish to take into account the very changed economic and political context in which it has to perform its tasks. A major programme of restructuring the Indian economy through radical changes in economic policies has been initiated by the Government of India. It would seem that the reform programme is supported by a broad consensus among the parties and the people and would therefore continue. At the same time there has been increasing emphasis on political decentralisation and movement towards greater federalism albeit within the basic parameters of the Constitution. It would be neither desirable nor possible to ignore these changes. If planning becomes more indicative and the Planning Commission would only lay down the broad contours of development, the States would be given more power to determine their own respective plan priorities. In this context the role of the Finance Commission could be enlarged to cover the entire revenue account. Secondly, if the federal principle is to be respected more than in the past, the system of transfers to be designed by the Finance Commission should leave as much autonomy to the States as possible in determining their own levels of revenues and expenditures, given a certain pattern of Central transfers. That is to say, except to a limited extent in the national interest, the system of transfers should not aim to "force" the States to do what the Centre wants.[20]

Under the new economic policy, the market and the private sector are to play a more important role and the state is to concentrate on the social sectors, agriculture, infrastructure and the environment. Against this background the Finance Commission might have to adopt a new posture regarding the numerous public enterprises being run by the State governments and several non-strategic enterprises run

20. This would not however rule out Centrally sponsored schemes provided most of the States are in agreement with the Centre that expenditures on these schemes are desirable and are therefore willing to accept the related additional grants.

23683
11.12.92

by the Central Government. For example, disinvestment of public sector shares or closing down of non-viable government enterprises could be considered as means of reducing the public debt at both the Central and State levels.

In making its recommendations the Finance Commission has to proceed on certain assumptions regarding the actions of the Centre and the States. As we have pointed out earlier, a normative approach is inevitable. Under the normative approach, the Finance Commission would have to work out a pattern of finances that would emerge if the Centre and the State governments are required to act under reasonable restrictions imposed by the Commission. This approach is sometimes criticised by the advocates of State autonomy on the ground that the Finance Commission has no authority to require autonomous governments to behave in particular ways. Such criticism is based on a misunderstanding. The governments, Centre and State, are "sovereign" or autonomous within their own Constitutional spheres. What the Finance Commission will be doing is only to work out the entitlements to transfers of different governments on the assumptions that they conduct their finances in a particular manner. What is to be seen is whether these assumptions are reasonable and satisfy the criteria of efficiency and equity. A similar set of conditions or restrictions are imposed on the Centre, at least implicitly, when the Finance Commission decides that a certain proportion of its revenues should be made available for transfers.

1. The Major Objectives

In taking decisions on various issues that are detailed below, apart from the criteria of efficiency, autonomy and equity, the TFC has also to place before itself a certain number of objectives in line with the new economic policy and the Terms of Reference mentioned in the Presidential order. These are:

a. The government sector is to concentrate on social sectors, infrastructure, agriculture and environment. Hence, current or revenue expenditure including maintenance and capital formation in these sectors must be maintained at an adequate level. This applies to the Central and State governments but in the case of the Centre, expenditure on defence must also be included as one category in which an adequate level must be maintained. Correspondingly, expenditures on other sectors must be pruned or allowed to grow more slowly.

b. The combined fiscal deficit of the Centre and the States must be brought down to an appropriately low level by the year 2000.

c. The revenue deficit of the Centre and each of the States must be at least eliminated within the same period, even if a surplus cannot be created.

d. Disparities in the standards of essential public services among the States should be reduced.

2. The Proportion of Central Revenues to be Transferred

As shown in Table 11, Finance Commission transfers, transfers on the recommendation of the Planning Commission and other transfers constitute around 42 per cent of gross Central revenues. Should/could this proportion be increased? (A decrease is probably not to be thought of.) The revenue deficit of the Centre is large even with the present relative level of transfers to the States. In order to eliminate the deficit, net Central revenues have to grow faster and Central Government's revenue expenditure other than transfers to the States has to grow much slower than before. In this context, can transfers to States as a proportion of Central revenues be raised?

3. Tax Devolution vs Grants-in-Aid

Given the total volume of transfers contemplated[21] should the relative proportions of tax devolution and TFC grants-in-aid be changed? As indicated earlier grants-in-aid can be targetted towards particular States and are therefore more suitable for reducing horizontal fiscal imbalances. Given the total volume of transfers, if the relative importance of tax devolution is increased, either by raising the taxable share of Union excises or by re-introducing the tax on railway fares or imposing the levies mentioned under Article 269 without reducing the shares of income tax and excise, the advanced States will gain at the expense of the backward States. On the other hand, because of the ongoing process of tax reform, if the personal income tax and the extended excise tax become significantly more buoyant than in the past, it might be possible to earmark a larger proportion of the share of Union excise to be used in effect as equalising transfers.[22] This would in effect mean an increase in the proportion of grants-in-aid.

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21. TFC will have to obtain from the Central Government, or assume, the likely volume of non-Financ Commission transfers.

22. According to the Ninth Finance Commission's recommendation, out of the 45 per cent of Union excise t be shared, 7.425 per cent is to be used for transfers to fiscally disadvantaged States.

4. The Principles of Grant-in-Aid

Let us assume for the sake of argument that the proportion of grants-in-aid would be increased. The whole purpose of increasing the volume of grants-in-aid is to target the transfers towards fiscally disadvantaged States. How should this be attempted? The two criteria to be kept in mind are fiscal equity and efficiency. The bases of grant distribution could be: (a) reducing relative deficiency in revenue raising capacity (b) offsetting cost disadvantages, if any, (c) earmarking some funds for raising standards of particular services[23] and (d) rewarding tax effort. (The last two will entail some encroachment on State autonomy, but are not inconsistent with the quasi-federal structure.) Instead of using such criteria, TFC could use grants-in-aid mainly or only to cover moderated or normative gaps, as was done by the Seventh and Eighth Finance Commissions. The disadvantage, as was pointed out in Section II, is that the gaps will be filled for the backward States at low levels of standards of public services. Hence inequities would be perpetuated. Another disadvantage is that a wrong signal will be given to the States that showing a higher revenue deficit, even though the projected revenues and expenditures would be substantially moderated, would bring in some dividend. This would be especially so if the likely actuals for the base year are adopted and moderation is applied only to the growth rates.

One needs to reiterate that the design of transfers should be such as to preserve at the margin the link between the decisions to incur expenditures and that to raise revenues. The people of India should not be asked to pay more taxes to the Centre just because some State legislatures are voting for higher expenditures to benefit their respective residents. These higher expenditures may be for higher salary scales for their employees or larger subsidies or for more activities. In every case, given the devolution of taxes and the equalisation grants, each legislature should vote for more taxes to pay for the higher expenditures.

5. Assessment of Growth of Revenues of the Centre and the States

The first question here is whether the base year actuals should be taken or a normative estimate based on the average degree of exploitation of the potential should be chosen. The Ninth Finance Commission (NFC) took the actuals when comparing the Central revenues and the total of revenues of all the States, but used the estimate based on average use of potential in projecting the revenues of the individual States. This was

23. In this case, a monitoring mechanism would be needed.

done solely to ensure inter-State equity through making allowances for deficiency in taxable capacity. The sum of the taxable capacities would equal the actual total revenues because, the average effort was used as the standard.

However, unlike the NFC, TFC might wish to use the likely actual revenues as the base-year figures and apply normative rates of growth to the bases. Projections would have to be made separately for tax and non-tax revenues. Taking tax revenues first, the projections could be carried out in two stages. First, a set of projections could be made for Central and State tax revenues on the basis of computed income-elasticities.[24] As far as the Centre is concerned, since radical tax reforms are expected to be carried out including improvement in tax enforcement, projections based on income-elasticities would yield misleading figures. An assessment of the likely overall effect of the reforms will have to be made. There seems to be no doubt that rationalisation of the structure and improved enforcement would significantly increase revenues, though the revenue from customs might not rise.

There is often discussion of tapping the tax potential. This can, of course, be considered in terms of levying taxes which are not being levied, though mentioned in the Constitution. But far more important is the unreaped potential of the taxes that are being levied, which is enormous. It would be legitimate for the Finance Commission to assume that the actual buoyancy of Central taxes (except customs) could be (and would be) higher than the elasticity based on past data.

Similarly, the States could be required to raise the buoyancy of their taxes by rationalising them and improving enforcement. In doing so the TFC would be even-handed in its treatment of the Centre and the States.[25] It would be entirely justifiable to expect the States to undertake tax reforms and to improve enforcement. It is a common knowledge that a significant part of the taxes due is not being collected. There is large-scale evasion, and not an inconsiderable proportion of the taxes due is illegally going into the hands of the tax collectors.

If the levy of new taxes is contemplated, then it may be pertinent to suggest that they should fit into the overall rational pattern or system of taxation that is being envisaged for the country.

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24. Income elasticities would be computed after "cleaning" the time series to remove the effects of discretionary tax changes.

25. The small-sized special category States probably do not have much tax potential.

The Tax Reforms Committee in its Final Report (Part I) has suggested two additional sources of revenue, as part of the overall rational pattern, which would also improve the equity of the system. The first is the taxation of the agricultural income (in excess of Rs.25,000) of those who are liable to pay tax on non-agricultural income. The second is the extension of the MODVAT to the wholesale stage. This tax would capture vaiue added at the wholesale stage and would, further, serve to cut down undervaluation at the manufacturing stage.[26] The VAT collected at the wholesale stage is to be passed on entirely to the States. TFC might wish to discuss these proposals with the State govenments.

In the final analysis, the TFC will have to make a judgment as to how much more taxation the people of India can be asked to bear. The rich, of course, should pay a higher proportion of their incomes as taxes, but the major part of the tax revenue will have to come from the majority of the people.

As far as non-tax revenues are concerned, the earlier Commissions have adopted certain norms which could be examined. Apart from rates of return on investment, it would be necessary to evolve norms for user charges particularly for services with low externalities (as argued earlier).

6. Assessments of the Growth of Revenue Expenditures

Here again the first question to ask is: Should the likely actuals or normative estimates be taken for the base year in the case of the States? The normative estimates would be arrived at by comparing the expenditures of the different States, that is, by taking the average as the norm. In the case of the Centre, a similar normative estimate cannot be arrived at. However, some part of Central Government's revenue expenditure could be considered excessive or unnecessary or far beyond the normative growth set by the Ninth Finance Commission and be excluded from the base year figure.

If the actuals for the States are taken for the base year, as pointed out earlier, the disparities in the standards of public services among the States would tend to get perpetuated, unless substantially differential rates of growth of expenditure are adopted as norms for the reference period. Then the question arises: How or on the basis of what principles should the differential rates be determined? It should also be pointed

26. The power of the States to levy their own sales taxes will remain undiminished and unaltered.

out that adopting the likely actuals for the base year would give a wrong signal to the different State governments that no matter how fast their revenue expenditure grows during the five-year period between two Finance Commissions, each successive Finance Commission would sanctify the actual rate of growth by adopting the actuals as the base for its own projections. Higher growth of revenue expenditure than allowed for by the Finance Commission becomes possible through the use of borrowed funds for financing revenue deficit. This in turn creates the problem of excessive indebtedness for all those State governments which deploy borrowed funds in the above manner, but they can hope to avoid paying the price for it if the Finance Commission either writes off the debt or reschedules repayments.[27] Another implication of taking the actual levels of revenue expenditures for the base year is that the present Finance Commission would be simply ignoring the standards laid down by the earlier Commission. Should each Commission simply ignore the results of the hard work put in by the previous Commission? Of course, minor deviations or justified deviations could be ignored; but it is for the TFC to consider if everything said by the NFC in terms of rate of growth and norms should be taken to be null and void for purposes of its own work. Lastly, if the likely actuals for revenue expenditures of the Centre and the States are taken for the base year, the TFC will have only two options: either leave revenue deficits for the Centre and for several State governments or fully cover the revenue deficits of all the States to leave the Centre with a huge revenue deficit.

The next major question relates to the rates of growth to be adopted for different items of expenditure. Some of the earlier Commissions stipulated what they consider to be reasonable rates of growth keeping in mind past trends. By contrast, the Ninth Finance Commission estimated the non-plan expenditure needs of the States on a normative basis. Accordingly, the needs of general administrative services were assessed on the basis of the justifiable cost of providing the average standards of these services. Spending on social and economic services were assessed on the basis of the justifiable cost of providing the standards of services already attained in the States. The improvement in the standards of social and economic services in the backward States were to be achieved through plan spending. The assessments of justifiable costs were made on the basis of the estimated cost functions in the case of regular and recurring items of expenditure and on the basis of engineering norms in the case of physical assets. These expenditure needs estimated for the base year were then projected by applying normative growth rates consistent with the overall plan of reducing revenue deficits. In

27. It is important to note that rescheduling and writing off of debt provides an escape route for the States if they operate beyond prudent norms just as unlimited access to RBI credit provides an escape route for the Central Government.

any case, rates of growth allowed for must be consistent with the objective of eliminating revenue deficits by the end of the recommendation period. In the next section we give alternative routes for achieving this objective.

7. Phasing out Revenue Deficits: Alternatives

As mentioned earlier, the rates of growth of revenues and expenditures assumed in the Commission's assessment must be consistent with the objective of eliminating revenue deficits by the end of the recommendation period. We have worked out the acceleration in revenues and deceleration in revenue expenditures required to achieve this objective at the Centre, and in the fourteen major States. If the existing trend in expenditure growth continues, the revenues of the States would have to increase at 18 per cent per annum or by almost 2.5 percentage points higher than the prevailing growth rate. Alternatively, their expenditure growth would have to be decelerated to 13.7 per cent if revenues grow only as fast as in the past. The problem is particularly severe in States like Uttar Pradesh, Bihar and Punjab where revenues would have to increase by more than 19 per cent per year, or growth of expenditure would have to be restricted to 11 to 13 per cent per year. The issue is still more serious in the case of the Centre. The increase in revenues required to phase out the revenue deficit at the Centre is over 20 per cent if the expenditure continues to grow as in the past. Alternatively, given the current revenue trends, the expenditure growth should have to be reduced to 13.5 per cent or by almost 4 percentage points lower than the prevailing growth rate.

8. Reduction in States' Fiscal Deficit - Some Alternatives

As pointed out earlier, the reduction in revenue deficit, *ceteris paribus,* automatically reduces the fiscal deficits of the States. However, given that repayment of Central loans during the period to be covered by the recommendation would be substantial, reasonable levels of plan spending on social and economic infrastructure would surely necessitate the States to resort to very high levels of fiscal deficit. Of course, the States should take cognisance of the changing role of the government in the developmental process and limit their activities only to these services having a high degree of externalities. Yet, unless they get substantial relief on their loan repayments to the Centre, the task of reducing fiscal deficits would be extremely difficult.

The Commission can, as in the past reschedule or write off a part of the States' indebtedness to the Centre. But as pointed out earlier, this would only transfer the burden of repayment to the national taxpayer, and in the event of benefit accruing to all the States equally, on the future generation. Further, the guidelines indicate that the

Commission should suggest corrective measures, and rescheduling or writing off of debt without going into the basic causes of the malady cannot provide any 'corrective'.

The States, however, can be encouraged to vacate from activities where they do not have any comparative advantage. Disinvestment of equity in public enterprises, in non-core areas as well as sale of non-viable loss making enterprises (including the land owned by such enterprises) should provide ample funds. After providing for adequate compensation to displaced employees, if any, the rest of the money should be used to repay Central loans. TFC should consider whether the rescheduling of repayment of Central loans it contemplates should not be linked in some way to the extent of disinvestment. Another possibility is that the TFC could suggest additional rescheduling during the period to be linked to the extent of reduction in revenue deficit.

VI. CONCLUDING REMARKS

The terms of reference given to the Tenth Finance Commission do not seem to bear the imprint of the structural reform programme undertaken by the Central Government. There is of course reference to have regard to "the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Central Government, but also generating surpluses for capital investment and reducing fiscal deficit"; but the traditional emphasis on tax effort and tax potential without any reference to tax reform or rationalisation at the State level and the absence of any reference to one of the aims of the structural adjustment programme, namely, reducing the role of the government and the area of public enterprises clearly shows that the Finance Commission's terms of reference have been drawn up outside the framework of the structural reform programme.

It is a matter of common agreement among fiscal economists that the structure of State taxes in the main is quite irrational from the economic point of view, apart from the sizeable inter-State exportation of taxes. The administration of the State taxes, particularly that of the sales taxes, is in general in an abysmal condition with complicated procedures, out-dated methods and harassment co-existing with large-scale evasion. The state of affairs in regard to the Central taxes has been described in detail in the Report of the Tax Reforms Committee. In this context, the Tenth Finance Commission should seriously ponder how the tax potential is to be realised and what kind of tax effort should be encouraged. Higher revenues could be realised without hurting trade and industry and without causing a taxpayer revolt if enforcement is

strengthened, corruption is reduced and compliance is enhanced through the introduction of moderate rates on broad bases in a simplified system.

Higher tax revenues have to come out of the interaction between a reformed, more strictly enforced, tax system and the growth of the economy. Such a fruitful interaction can be brought about. However, the acceptability of a certain level of tax revenues in relation to the level of income or GDP depends not only on the level of the standard of living of the people but also on their perception of the way in which the governments are using the money collected in taxes. Today, there is a wide-spread feeling - and knowledge - that government leaders and government servants are using revenues in many unproductive ways and often for their own benefit rather than for the benefit of the people at large. The terms of reference rightly refer to the need to consider "the scope for better fiscal management consistent with efficiency and economy in expenditure". Budgetary equilibrium should be sought to be achieved more through the pruning of government expenditures than through the raising of higher tax revenues, though there is ample justification for increasing user charges for several services rendered. In fact, ultimately, in accordance with democratic principles, it is the people who must decide how much taxes they should pay and for what kinds of services. They cannot of course work out the details, but political leaders should clearly tell the people of their respective constituencies their (the leaders') ideas on taxation and expenditure and get a broad mandate from them. The Planning Commission has fully reversed - if not subverted - this democratic process. It sets up a target of tax/GDP ratio to be reached by the end of every five-year plan, on the premise that the Planning Commission knows best how the total resources should be deployed. In theory, of course, the Planning Commission can argue that it only states that a certain tax/GDP ratio is needed if the nation wants a plan of a particular size; in practice, however, since that Commission lobbys for as large a plan as it can get, it is virtually deciding the volume of taxes that the people should pay. This reversal of the political process in relation to the public economics has led to distortions and undesirable results. The governments accept the targets of additional resource mobilisation (ARM) in return for large plan sizes, but since the leaders have not received a clear mandate from the people, at election time or through discussions in the legislatures, for higher taxes, the State governments try to export their taxes or ask the Centre to levy more taxes or further distort their tax systems.

Be it noted that the ARM stipulations of the Planning Commission come after the Finance Commission has completed its task of projecting revenues "at the existing levels of taxation" (and presumably at existing levels of enforcement). At least that was so, until the Ninth Finance Commission. However, that Commission as well as the Tenth Finance Commission have been asked to the need to consider ".....targets set

for additional resource mobilisation for the Plan and the potential for raising additional taxes." This means that Tenth Finance Commission would have to stipulate ARM on its own part! It is to be hoped that the Finance Commission would take a comprehensive view and suggest what should be the total tax ratio at the end of its recommendation period. The Planning Commission would have to operate within this target. For fixing this tax ratio target, the Finance Commission can have extended discussions with the Central and State Governments. The target can then be apportioned between the Centre and the States on the existing pattern (66 per cent Centre and 34 per cent States). The target for the States can be apportioned among the States according to unused relative taxable capacity.

Earlier in the paper we had referred to a transfer system of fixed tax shares and formulae-based grants. In practice, it would seem that we have arrived at a situation of fixed tax shares. This is because it is going to be very difficult - indeed it may be harmful to the nation - to reduce the proportion of total revenues (of the Centre and the States) left in the hands of the Centre for its use, below the existing level of 38 per cent. If that be so, to raise the tax share within the overall proportion of 38 per cent, would mean a fall in the proportion of grants-in-aid. This would certainly go against the interests of the fiscally needy States and benefit the fiscally better off States. In effect, therefore, the Finance Commission would have to operate within the proportions already arrived at in terms of tax shares and the proportion of tax devolution to grants-in-aid. If this becomes clear then the State Governments would realise that any increase in their expenditures would have to be met out of taxes on their own respective residents.

Table 1

Revenue Expenditure of the Centre and the States and their Share in Aggregate Revenue Expenditure

(Rs. crore)

Year	Aggregate Revenue Expenditure	Revenue Expenditure of the Centre	Revenue Expenditure of the States	(2/1) (per cent)	(3/1) (per cent)
	(1)	(2)	(3)	(4)	(5)
1975-76	11847	5325	6522	45.0	55.1
1980-81	23711	9475	14136	40.4	59.6
1985-86	56031	24669	31362	44.0	56.0
1989-90	107704	50873	56831	47.2	52.8
1990-91(R.E.)	126051	56028	70024	44.4	55.6
1991-92(B.E.)	138736	59377	79359	42.8	57.2

Note: (i) States include Union Territories.

(ii) All the basic figures exclude intergovernmental transactions. Revenue expenditure by the States and Union Territories include interest payments to the Central government, which are netted out in the revenue expenditure of the Centre.

Source: *Indian Economic Statistics (Public Finance).*

Table 2

Revenue, Capital and Total Expenditure by the States and the Union Territories

(Rs. crore)

Plan	Revenue Expenditures			Capital Expenditures			Total Expenditures		
	States and UTs	Aggregate	(3/2) (per cent)	States and UTs	Aggregate	(6/5) (per cent)	States and UTs	Aggregate	(9/8) (per cent)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Fifth Plan (1974-79)	37933	67056	56.6	13456	29164	46.1	51389	96225	53.4
Annual Plan (1979-80)	11512	28356	40.6	4538	8318	54.6	16050	36674	43.8
Sixth Plan (1980-85)	99492	171494	58.0	30951	68251	45.3	130443	239745	54.4
Seventh Plan (1985-90)	216950	391790	55.4	49451	120644	41.0	266401	512434	52.0

Source: *Indian Economic Statistics (Public Finance).*

Table 3

Share of the Central Government in the Revenue Receipts Collected

(per cent)

Year	Gross Tax Revenue of the Centre/ Aggregate Tax Revenue	Nontax Revenue of the Centre/ Aggregate Nontax Revenue @	Gross Total Revenue of the Centre/ Aggregate Revenue Receipts
1975-76	68.0	58.9	66.5
1980-81	66.4	58.3	64.6
1985-86	66.3	62.1	66.0
1989-90	66.5	64.8	66.0

@ Both numerator and denominator exclude interest received by the Centre from the States. The denominator excludes grants received by the States from the Centre as well.

Source: *Indian Economic Statistics (Public Finance).*

Table 4

The Share of States in the Total Tax Revenues of of the Centre and States

(Rs. Lakh)

Year	Taxes Levied by the States	Devo-lution of Taxes	Taxes Accruing to States	Total Taxes (Centre and States)	Taxes Accruing to States as Per Cent of Total Taxes
1975-76	357294	159912	517206	1118173	46.25
1976-77	406079	167983	574062	1233196	46.55
1977-78	437780	180563	618443	1323718	46.72
1978-79	500269	195272	695541	1552756	44.79
1979-80	570943	340779	911772	1768308	51.56
1980-81	666417	378903	1045320	1984375	52.68
1981-82	829491	425820	1255311	2414241	52.00
1982-83	954590	463262	1417852	2724157	52.10
1983-84	1080342	500718	1581060	3152545	50.15
1984-85	1234283	585343	1819626	3581342	50.81
1985-86	1459652	725974	2185626	4326671	50.52
1986-87	1670075	835974	2506049	4953922	50.58
1987-88	1930996	972942	2903938	5697560	50.97
1988-89	2245091	1073658	3318749	6692494	49.59
1989-90	2605649	1309736	3915385	7769236	50.40
1990-91 (R.E.)	3038643	1449878	4488521	8930266	50.25
1991-92 (B.E.)	3457692	1586571	5044263	10289643	49.02

Note: States include Union Territories.

Source: *Indian Economic Statistics (Public Finance)*.

Table 5

Revenue Accruals of the Union Government and the State Governments

(Rs. crore)

Year	Revenue Receipts of Centre and States	Revenue Accruals of States	Revenue Accruals of Centre	Percent Revenue Accruals to States	Percent Revenue Accruals to Centre
1974-75	11048	6004	5044	54.34	45.66
1975-76	13687	7475	6212	54.61	45.39
1976-77	15258	8652	6606	56.70	43.30
1977-78	16435	9401	7034	57.20	42.80
1978-79	18775	11008	7767	58.63	41.37
1979-80	21211	13060	8151	61.57	38.43
1980-81	23835	15036	8799	63.08	36.92
1981-82	28881	17504	11377	60.61	39.39
1982-83	33086	20243	12843	61.18	38.82
1983-84	36959	22908	14051	61.98	38.02
1984-85	42933	26220	16713	61.07	38.93
1985-86	51011	31906	19105	62.55	37.45
1986-87	58434	35981	22453	61.58	38.42
1987-88	66838	42167	24671	63.09	36.91
1988-89	77512	47767	29745	61.63	38.37
1989-90	92283	53324	38959	57.78	42.22
1990-91(RE)	103085	64642	38443	62.71	37.29
1991-92(BE)	119737	74213	45524	61.98	38.02

Note: States include Union Territories.

Source: *Indian Economic Statistics (Public Finance).*

Table 6

Indicators of Vertical Imbalance in Indian Federal Finance

(per cent)

Average for the period	States' Own revenue Receipts / States Revenue Expenditure	States' Own Total Receipts / States' Total Expenditure
1970-75	58.62	56.23
1975-80	68.00	57.49
1980-85	60.21	53.08
1985-90	55.95	55.18

Source: *Indian Economic Statistics (Public Finance).*

Table 7

Share of Tax Devolution in the Gross Tax Receipts of the Centre

(Rs.crore)

Year	Devolution of Taxes	Gross Tax Revenue	(2/3) (per cent)
(1)	(2)	(3)	(4)
1975-76	1599	7609	21.0
1980-81	3789	13180	28.7
1985-86	7260	28670	25.3
1989-90	13097	51636	25.4
1990-91 (R.E.)	14499	58917	24.6
1991-92 (B.E.)	15866	68320	23.2

Source: *Indian Economic Statistics (Public Finance).*

Table 8

Compound Growth Rate of Tax Revenues of Selected States and the Centre (1980-81 to 1989-90)

(per cent per annum)

	State/Centre	Total Tax Revenue	Own Tax Revenue
1.	Andhra Pradesh	16.04	17.01
2.	Bihar	14.75	14.28
3.	Gujarat	14.51	15.97
4.	Haryana	14.74	15.84
5.	Karnataka	15.61	16.42
6.	Kerala	15.00	15.83
7.	Maharashtra	14.82	15.72
8.	Madhya Pradesh	15.49	16.26
9.	Orissa	15.70	16.58
10.	Punjab	13.09	13.72
11.	Rajasthan	15.96	16.89
12.	Tamil Nadu	14.11	14.50
13.	Uttar Pradesh	15.32	15.02
14.	West Bengal	15.42	16.58
15.	Centre	16.27	16.75

Note: For the Centre, total tax revenue refers to gross tax revenue and own tax revenue refers to the tax revenue net of States' share.

Table 9

Growth of State Revenue and Expenditures

(Per cent per annum)

	1974-75 to 1979-80	1980-81 to 1989-90	1974-75 to 1989-90
(1)	(2)	(3)	(4)
I. Revenue Receipts			
a. Own Tax Revenue	14.4	16.1	15.6
b. Own Non-Tax Revenue	11.9	12.5	12.3
c. Own Total Revenue	13.9	15.4	15.0
d. Central Transfers to States	18.4	15.8	16.5
Total - Revenue Receipts	**15.9**	**15.5**	**15.6**
II. Total Revenue Expenditure	16.1	17.6	17.2
III. Total Capital Outlay	20.1	11.1	13.5
IV. Total Expenditure	17.5	15.8	16.2

Note : Sub period growth rates have been computed by using kinked exponential model.

Source : Computed on the basis of data taken from *Indian Economic Statistics (Public Finance)*.

Table 10

Current Transfers from the Centre to the States

(Rs. crore)

Five-year Plan Periods	Finance Commision Transfers			Plan Grants			Other Grants	Total Current Transfers
	Shares of Taxes	Grants-in-aid	Total	State Plan	Central Cent-rally Sponso-red	Total		
Fourth Plan	4562	859	5421	1077	969	2046	926	8393
(1969-74)	(54.2)	(10.2)	(64.6)	(12.8)	(11.5)	(24.4)	(11.0)	(100)
Fifth Plan	826	2823	11090	2907	1932	4839	539	16468
(1974-79)	(50.2)	(17.1)	(67.3)	(17.7)	(11.7)	(29.4)	(3.3)	(100)
Annual Plan	3406	276	3682	970	834	1804	215	5701
(1979-80)	(59.7)	(4.8)	(64.6)	(17.0)	(14.6)	(31.6)	(3.8)	(100)
Sixth Plan	23728	2139	25867	7382	6900	14282	1505	41654
(1980-85)	(57.0)	(5.1)	(62.1)	(17.7)	(16.6)	(34.3)	(3.6)	(100)
Seventh Plan	49463	6273	55736	15523	16510	32033	3545	91314
(1985-90)	(54.2)	(6.9)	(61.0)	(17.0)	(18.1)	(35.1)	(3.9)	(100)

Note: Values within parentheses are percentages to total current transfers.

Source: *Indian Economic Statistics (Public Finance).*

Table 11

Share of Revenue Transfers in the Revenue Receipts of the Centre

(Rs. crore)

Year	Revenue Transfers	Revenue Receipts@	(2/3) (per cent)
(1)	(2)	(3)	(4)
1975-76	2888	9100	31.7
1980-81	6588	15386	42.8
1985-86	14558	33662	43.2
1989-90	21945	60905	36.0
1990-91(RE)	27708	66152	41.9
1991-92(BE)	31483	76492	41.2

@ Including States' share of Centrally levied taxes, but excluding interest received from the States.

Source: *Indian Economic Statistics (Public Finance).*

Table 12

Correlation of per capita Central Transfers with per capita SDP of Major States

	Shared Taxes	Non Plan Grants		State Plan	Central Plan and Centrally Sponsored	Finance Commission Transfers	Plan Transfers	Total Transfers
		Finance Commission	Others					
1975-76	-0.0179	-0.2524	0.0467	-0.2137	0.4417	-0.2705	0.2113	-0.1047
	(-0.06)	(-0.90)	(0.16)	(-0.76)	(1.71)	(-0.97)	(0.75)	(-0.36)
1980-81	-0.7855	-0.5440	-0.1615	-0.3734	-0.2215	-0.8399	-0.3020	-0.4687
	(-4.40)*	(-2.25)*	(-0.57)	(-1.39)	(-0.79)	(-5.36)*	(-1.10)	(-1.84)*
1985-86	-0.8558	0.0480	0.0634	0.2501	0.2062	-0.6855	0.2897	-0.5249
	(-5.73)*	(0.17)	(0.22)	(0.89)	(0.73)	(-3.26)*	(1.05)	(-2.14)*
1988-89	-0.8831	0.0928	0.3008	-0.3975	-0.1706	-0.8795	-0.3212	-0.5527
	(-6.52)*	(0.32)	(1.09)	(-1.50)	(-0.60)	(-6.40)*	(-1.17)	(-2.30)*

Note: t-values in parentheses; * indicates that the statistic is significant at 5 per cent level of significance.

Table 13

Growth of Revenue and Expenditure Required to Phase Out Revenue Deficits

(Rs. crore)

	1991-92(RE)		Growth Rates (1980-81 to 1990-91)		1999-2000 (Trend Projection)		Required Growth of Revenue at Trend Expenditure Growth	Required Growth of Expenditure at Trend Revenue Growth
	Revenue Receipts	Revenue Expenditure	Revenue Receipts (per cent)	Revenue Expenditure (per cent)	Revenue Receipts	Revenue Expenditure	(per cent)	(per cent)
Andhra Pradesh	6073	6300	15.7	16.9	19501	21972	17.4	15.2
Bihar	4854	5739	15.9	16.5	15803	19472	19.0	13.5
Gujarat	5023	5308	14.1	17.3	14430	19024	18.1	13.3
Haryana	2282	2312	14.1	16.6	6554	7896	16.8	13.9
Karnataka	4875	4801	15.0	14.1	14912	13793	13.9	15.2
Kerala	2767	3225	13.3	15.5	7513	10214	17.7	11.2
Madhya Pradesh	5367	5526	15.1	17.2	16532	19672	17.6	14.7
Maharashtra	9542	9866	15.1	16.2	29393	32794	16.7	14.6
Orissa	2559	2791	13.6	14.8	7099	8419	16.1	12.4
Punjab	3737	4331	13.3	16.8	10147	15001	19.0	11.2
Rajasthan	4041	4214	16.0	17.4	13247	15203	18.0	15.4
Tamil Nadu	5880	6493	14.2	16.9	17009	22644	18.4	12.8
Uttar Pradesh	8814*	10114*	15.2	18.3	27340	38799	20.4	13.2
West Bengal	4800	5570	14.7	15.4	14381	17519	17.6	12.6
Major States	70614	76590	14.9	16.6	213861	262422	17.8	13.7
Central Govt 1992-93(BE)	76205	89570	16.2@	17.4@	217807	274542	20.1	13.5

Note : * Budget Estimates. @ Relates to the period 1981-82 to 1992-93(BE)

Source : 1. Budget Documents of Central and State Governments.
2. *Indian Economic Statistics (Public Finance).*

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