Issues before the Thirteenth Finance Commission

M. Govinda Rao, Tapas Kumar Sen, Pratap R. Jena

Working Paper 2008-55

August 2008

National Institute of Public Finance and Policy
New Delhi
http://www.nipfp.org.in

Issues Before the Thirteenth Finance Commission

M. Govinda Rao*
Tapas Kumar Sen**
Pratap R. Jena***

Abstract

The Thirteenth Finance Commission faces challenging times. Despite improvement, the fiscal situation continues to be a matter of concern when off budget liabilities and other fiscal risks are considered. In the changing situation of increasing oil prices on the one hand and surge in capital flows on the other, calibrating the transfer system in tune with counter-cyclical fiscal policy stance is a formidable challenge.

The paper argues that irrespective of the wording of the Terms of Reference (ToR), the Commission would do well to focus on its primary task of recommending transfers to serve the objective of equity and incentives. While it is required to take into account a number of considerations, the focus should be on the transfer system. As an impartial body, the Commission should make a fair assessment of the union as well as state governments, ignoring the asymmetries in the wording of the ToR.

As regards the transfer system itself is concerned, the paper argues that although it may be difficult to make drastic changes in the relative shares of the states, the Commission should give up the gap filling approach. Instead, after recommending the tax devolution, the Commission should recommend grants to fully equalise expenditures on elementary education and basic healthcare. It is also possible to incentivise the transfer system for even those states that have a better record of providing education and healthcare to improve quality of these services. If necessary, the tax devolution percentage can be appropriately adjusted to ensure equalisation of social services.

The paper is a revised and edited version of one that was presented in the seminar on ***Issues before the Thirteenth Finance Commission*** held at the National Institute of Public Finance and Policy (NIPFP) on May 23-24, 2008.

[*] Director, National Institute of Public Finance and Policy, New Delhi (mgr@nipfp.org.in)
[**] Senior Fellow, National Institute of Public Finance and Policy, New Delhi(tapas@nipfp.org.in)
[***] Fellow, National Institute of Public Finance and Policy, New Delhi (jena@nipfp.org.in)

Issues Before the Thirteenth Finance Commission

Introduction

The appointment of the Thirteenth Finance Commission comes at a time when the fiscal situation, despite recent improvements, continues to cause concern. In addition, there are new challenges posed by emerging economic and political environment. The Commission has to formulate its recommendations to resolve fiscal imbalances in the background of continued need to exercise austerity, surging capital inflows further limiting the degrees of freedom, imperatives of enhancing public investment in physical and social infrastructure to support higher growth, increasing inter-state disparities in development, and competitive populism from coalition politics. The recommendations of the Commission will have far reaching implications for the fiscal health of the union and state governments and, more importantly, for the future of Indian federalism.

The aggregate gross fiscal deficit relative to GDP is estimated to have declined from 8.4 percent in 2003-04 to 5.5 percent in 2007-08 and the revenue deficit during the period declined from 5.9 percent to 1.3 percent. Improvement in the fiscal health was seen at both central and state levels. Buoyed by spectacular increase in income tax and service tax revenues at the central level, central fiscal deficit was compressed by 1.3 percentage points from 4.5 percent in 2003-04 to 3.2 percent in 2007-08 and revenue deficit from 3.6 percent to 1.4 percent during the same period. Aided mainly by higher tax devolution and grants from the centre, partly from increased own revenues due to the introduction of value added tax and to some extent due to lower interest payments on account of debt swap and write off schemes, the state finances too have shown a significant improvement. Aggregate states' fiscal deficit has been reduced from 4.4 percent in 2003-04 to 2.3 percent in 2007-08 and revenue deficit from 2.3 percent of GDP to a marginal surplus. However, there are significant off budget liabilities at both central and state levels which could constitute an additional five percent of GDP (India, 2008), and when these are considered the fiscal situation looks alarming.

While, in general, state finances have shown a marked improvement, the situation in some of the states still remains grim. In particular, revenue and fiscal deficits in some of the states is still a matter of concern and many of the poorer states have brought down their deficits by compressing developmental expenditures. Thus, the attempt at macroeconomic stabilisation has been at the cost of economic growth and justice, particularly in the low income states.

In addition to the above, there are significant fiscal risks which must be taken account of. These include the impact of pay revision at the central level and on the states, possibility of significant increase in food subsidy in the wake of sharp increases in the prices of foodgrains, higher than budgeted expenditures due to increases in commodity (particularly fuel) prices, sharp increase in expenditures associated with the electoral cycle at both central and state levels and the revenue cost of lowering customs tariff to contain the prices of essential consumer goods. In addition, increase in capital inflows and its sterilisation by the Reserve bank could create additional fiscal liability.

The Thirteenth Finance Commission, like its predecessors is confronted with the task of making fiscal allocations between the centre and individual states in an environment of constrained fiscal space. In addition, the Commission will have a number of additional constraints. The first is capital flows and RBI's sterilisation policy limits the ability of the centre to effectively use monetary and fiscal instruments for macroeconomic stabilisation. Even the limited flexibility in monetary policy calibration can be had only when the government restrains its own borrowing from the market. Thus, wider space for monetary policy effectiveness requires setting even lower fiscal deficit targets than that was set by the Twelfth Finance Commission.[1]

Equally concerning is the constraint posed by the fractured nature of polity. The factors such as emergence of coalition governments at the centre with regional parties as pivotal members of the coalition, regional parties in power in the states and disharmony between the ruling parties at central and state levels have significantly altered policy perspectives (Rao and Singh, 2005). First, the time horizon in policy making has shifted to the short run from more long term structural issues. This has also led to the introduction of several schemes by the central government primarily to satisfy various coalition partners. The claim to ownership of these schemes has led to bypassing the states in their implementation and flow of funds, taking away the state level supervision and accountability. Multiplicity of schemes at various levels, and poor information system has led to each agency taking a partial view of the various public services delivered. The absence of holistic perspective has led to poor planning, inefficiency and waste in implementation and lack of accountability in public service delivery.

Political economy factors have impacted on the size and distribution of the intergovernmental transfers as well. Failure to address the issue of equalisation in public services across the states in a systematic manner has led to growing regional disparities. The problem has been compounded by the disequalising regional policies (including central subsidies and tax expenditures) and various types of invisible transfers (Rao and Mandal, 2008; Rao, 1997). Among other reasons, the growing regional disparities have led to adoption of political solutions though schematic assistance and introduction of mechanisms such as backward area grants instead of tackling the fundamentals.

The Finance Commission will have to formulate its recommendations when tax reforms are still underway and the regime is still unsettled. The architecture and engineering aspects of the proposed Goods and Services Tax (GST) will impact on the nature of intergovernmental transfers not only because it will determine the revenue productivity of the tax system but also the way in which revenues accrue to the two levels of government and their distribution among the states.

India has reached a higher growth trajectory and yet, a number of states have lagged behind. Inclusive growth in a globalising environment requires, besides institutional and governance reforms, significant additional investments in physical infrastructure and human development. In a liberalised market environment, private investments will flow to states with better market institutions, physical infrastructure and human development. Not surprisingly, inter-state disparities in development have shown a significant increase since economic reforms have been initiated. This does not bode well for the future of Indian federalism. Surely, equalising incomes is not the objective of intergovernmental transfers. However, inclusive growth requires ensuring a level playing field to attract investments by offsetting fiscal disabilities of poorer states which is a legitimate objective of the transfer system which squarely is the responsibility of the Finance Commission. The past Commissions have abdicated this responsibility, but the present Commission cannot, in view of large and growing disparities. It is also important to create a proper incentive structure which will not only enable the states to provide comparable levels of public services at comparable tax rates and improve their tax effort and expenditure efficiency.

The Finance Commission will have to formulate its recommendations in the light of the above challenges. The paper is divided into five sections. Section 2 undertakes a detailed analysis of the terms of reference. Section 3 will discuss the recent fiscal trends in central and state finances to understand the background in which the Finance Commission has to formulate its recommendations. In the given environment, the approach the Finance Commission could take to deal with the primary terms of reference (ToR) is discussed in Section 4. The last section summarises the major issues before the Commission and the approaches to deal with them.

II. Terms of Reference (ToR)

There has been considerable consternation on the ToR given to the past and present Finance Commissions. Concerns about the ToR relate to the intrusion into the constitutional role of the Finance Commissions, requiring the Commission to undertake tasks not strictly within its purview, directing the Commission on the approach and methodology to be adopted and issuing guidelines for asymmetric treatment of centre and states. While the resentment on the encroachment on the role of the Commission has been a matter of debate right from the Fourth Finance Commission when the Commission was not asked to take into account the plan side of the state budgets, the debate became particularly intense after the Ninth Finance Commission.[2]

The founding fathers of the Constitution were careful to specify the tasks of the Commission to ensure that it fulfils its basic mandates specified in *Article 280* (3) of the Constitution, which are:

(a) the distribution between the union and the states of the net proceeds of taxes which are to be or may be divided between them and the allocation between the states of the respective shares of such proceeds;

(b) the principles which should govern the grants in aid of revenues of the states out of the Consolidated Fund of India;

(b and c) the measures needed to augment the Consolidated Fund of a state to supplement the resources of the *panchayats* and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state; and

(d) any other matter referred to the Commission in the interest of sound finance.

Article 280 (4) further states, "The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them".

A close reading of the Article 280 shows that:

(i) The basic mandate of the Commission is to recommend a fair distribution of resources between the centre and the states and among the states *inter-se*. Of course, the distribution of resources has to be achieved in a sustainable manner. Macroeconomic stabilisation is predominantly a central function and the constitution arms it with sufficient powers to carry it out – to control money supply as well as subnational borrowings. The responsibility of ensuring this task can not be passed on to the Finance Commission. Even if the ToR entrusts this task to the Commission, it cannot make macroeconomic stabilisation its primary task. Offsetting horizontal and vertical imbalance is the basic mandate and it is obvious that this has to be done within the overall framework of a stable economy.

(ii) Article 280 of the Constitution empowers the Commission to evolve its own approach and methodology. In fact, on the ToR issued to the Ninth Finance Commission that the Commission *shall* adopt "normative" approach, the First Report of the Ninth Finance Commission refers to the reply written by the Chairman to the Chief Minister of Kerala allaying his apprehensions that "…it was the Commission's prerogative to adopt such approach and method as it considered fit and appropriate on subjects covered by (a) and (b) of Article 280(3) of the Constitution. In view of the Presidential notification, however, he clarified that the Commission would consider *inter alia*, adopting a 'normative approach' wherever appropriate in the interest of sound finance. By doing so, the Commission would apply a uniform, just and equitable yardstick both to the Centre and the States." (India, 1989, p.3).

(iii) "Any other matter entrusted to the Commission" is not an omnibus residual provision. It has to be "in the interest of sound finance" and should relate to the issue of the basic task. Over the years, the government has developed the tendency of entrusting several issues it is unable to resolve to the Commission. Within the limited period at its disposal, the Commission cannot deal with such wide ranging matters as fiscal reform and restructuring programme, tax reforms, expenditure reforms, administrative reforms, debt relief, wage reforms, decentralisation reforms, disaster relief and environmental protection. Entrusting the Commission with too many tasks would only result in the Commission diluting its focus on the main task.

(iv) Over the years, the ToR have been framed to improperly restrict the scope of the Commission also. The most important transgression was in restricting its role to the non-plan revenue accounts of the states. The second and third Commissions were asked to take account of the plan revenue expenditures. However, in the case of the Third Commission, the government rejected the majority recommendation taking account of 75 percent of the plan expenditure and accepted the minute of dissent by the Member-Secretary that excluded the plan side altogether.[3] The Fourth Commission was not specifically asked to take account of plan expenditures and the Commission was more than willing to vacate the field when it stated, "… The terms of reference of the Fourth Finance Commission do not expressly mention plan expenditure. The Constitution does not make any distinction between plan and non-plan expenditure and it is not unconstitutional for the Finance Commission to go into the whole question of the total revenue expenditure of the States….." Nevertheless, the Commission decided that "…..it would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new Plan expenditure". The ToR of the Fifth Finance Commission specifically directed it to confine its scope to the non-plan side.[4] Subsequently, except for the Ninth and the Thirteenth Commissions, the ToR confined the role of the Commissions to assessing non-plan revenue side requirements of the states. Taking such a lopsided view of the requirements has not done any justice to the constitutional mandate of the Commission.

The issue gains importance in the wake of overlapping roles of multiple agencies making transfers. Such transfers often by-pass the states, although relating to subjects within the States' domain. Analysis shows that the proportion of transfers made through Finance Commissions' recommendations have declined over the years (*Table 1*) and more important by the formula based transfers have significantly declined relative to other types of transfers. The decline can primarily be traced to plan grants; formula based transfers for state plan schemes constitute just about 27.5 percent in 2008-09 as compared to over 80 percent a decade ago.

Table 1: Composition of Central Transfers to States

(percentages to total)

Plan Periods/ Years	**Finance Commission Transfers**			**Plan Grants**			**Other Grants**	**Total**
	Tax Devolution	**Grants**	**Total**	**State Plan Scheme**	**Central Scheme**	**Total**		
Fourth Plan	54.4	10.3	64.6	12.9	11.6	24.4	11.1	100.00
Fifth Plan (1974-79)	50.2	17.1	67.3	17.7	11.7	29.4	3.3	100.00
Sixth Plan (1980-85)	57.0	5.1	62.1	17.7	16.6	34.3	3.6	100.00
Seventh Plan (1985-90)	54.2	6.9	61.0	17.0	18.1	35.1	3.9	100.00
Annual Plan (1990-91)	52.2	10.5	62.7	17.4	16.8	34.2	3.1	100.00
Eighth Plan (1992-97)	55.6	6.2	61.8	20.4	15.4	35.8	2.5	100.00
Ninth Plan (1997-2001)	58.7	6.0	64.7	20.0	10.6	27.1	4.9	100.00
Tenth Plan (2002-2007)	53.2	8.6	61.9	20.3	11.8	32.1	6.1	100.00

Source: *Finance Accounts* of state governments**.**

The founding fathers of the Constitution, in order to ensure that the states should not be made to depend on the munificence or arbitrary will of the centre, constructed a scheme of transfers involving articles 275 and 280 (3). The wording of the Article 280 that the "President *shall* appoint a Finance Commission" and the Commission *shall* make recommendations to the President bestows on the Commission the role of a constitutional authority to deal with the task of effecting a fair distribution of resources.

As persuasively argued by K. K. Venugopal while presenting his views to the Ninth Finance Commission, both the positive interpretation of *Article 275* and analysis of the *non-obstante* clause of *Article 282* lead to the conclusion that prevailing practices with respect to central transfers to states are contrary to the constitutional provisions.[5] The positive construction of *Article 275* shows that the central government can give all types of grants – general purpose or specific purpose, plan or non-plan and revenue or capital grants. As grants under *Article 275* are awarded by the Finance Commission, it is fully competent to make recommendations on all the above. At the same time, it is not possible to visualise *Article 282* as a residuary power to the Centre to give grants. The *non-obstante* clause of the Article states, "…notwithstanding that the purpose is not one with respect to which Parliament or the legislature of the State, as the case may be, may make laws". This Article is not a miscellaneous provision but essentially meant to lift the bar for both the States and the Centre to make grants for any public purpose even on subjects beyond their legislative purview as listed in the union and state lists. Venugopal's interpretation is that *Article 282* can not be construed as residuary because it visualises that the grantors could either be the union or a state. In his view, "…to the extent that any of the terms of reference seek to deprive the Finance Commission of its powers which are constitutionally vested in it under *Article 280*, Clause 3, the terms would be invalid and unconstitutional" (NIPFP, 1993; p. 274).

Whether legitimate or otherwise, the development over the years have led to taking a segregated view of the states' requirements with the Finance Commission concerned with only maintenance expenditures, the Planning Commission dealing with spending on new services and various central ministries spending on various schemes. This has led to a number of undesirable outcomes. First, there is a disconnection between investment and maintenance expenditures, and planning for service delivery, affecting the latter adversely. Second, the multiple agencies involved pursue their own goals and this has prevented a holistic treatment of equalisation. Third, the preference to show large plan expenditures has led to significant under-provision for maintenance resulting in low productivity. Fourth, the system has opened up scope for arbitrariness and discretion as over the years, formula-based transfers have shown a steady decline. The schematic transfers have invaded even the grants under State Plan Schemes and formula based transfers within the State Plan Schemes now constitute a mere 27.5 percent.

The ToR of the Thirteenth Finance Commission fortunately does not distinguish between plan and non-plan requirements. This gives an opportunity for the Commission to take a holistic view. At least, it can look into the states' requirements in social services in a holistic manner and has the opportunity to equalise expenditures on these services.

The guidelines given to the Commissions in the ToR have always evoked considerable controversy. However, these guidelines raise two important issues. First, macroeconomic stabilisation concerns have overshadowed developmental concerns in the guidelines issued to recent Commissions. Thus, the Eleventh Finance Commission was asked to review the finances of the union and the states and suggest ways and means to restructure the public finances to restore budgetary balance and maintain macroeconomic stability" and it was asked to design a "monitorable programme of reducing deficits" after it submitted the report. The Twelfth Finance Commission was asked to recommend a fiscal restructuring plan by which both the union and state governments can phase out their revenue deficits and reduce fiscal deficits to a sustainable level. Similarly, the Thirteenth Finance Commission has been asked to, "…suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth" [6]. Although ensuring macroeconomic stability is an important objective and it is appropriate for the Finance Commissions to take sustainability into account while recommending transfers, should it be the primary focus of the Commission?

If the Finance Commission prescribes the deficits for the ensuing five years, the basic question is, how does binding the governments with cardinal numbers on the fiscal deficit enable calibration of counter-cyclical fiscal policy? If the fiscal deficit limits are determined in relation to the growth of GDP as was done by the Twelfth Finance Commission, would they remain relevant if the future growth rates of the economy were to be different from the assumed? How can these mechanically derived numbers help in taking into account other exogenous factors (such as surge in capital flows) impacting on the fiscal stance?

Stabilisation function is predominantly in the domain of the union government and assigning primacy to this task relegating redistribution of fiscal resources as secondary could create difficulties for both development and inter-regional equity. When the Finance Commissions' transfers fail to fully offset the fiscal disabilities and for macroeconomic stability reasons uniform borrowing caps are prescribed as was done by the Twelfth Finance Commission, the regional pattern of development could be severely distorted. Uniform fiscal deficit target (linked to GSDP) constrains the poorer states' borrowing and investment. The relatively weak social and physical infrastructure limits the flow of private investments to them and accentuates inter-state disparities.

Another important issue is the asymmetric treatment of the union and the states in the guidelines issued to the Commissions (Reddy, 2007). The Thirteenth Commission has been asked to take into account the demands on the resources of the union government particularly on account of the projected 'Gross Budgetary Support' (GBS) to the central and state plans, expenditure on civil administration and defence, internal and border security, debt servicing and other committed expenditure and liabilities. However, as far as states are concerned, the ToR requires the Commission to take into account only "…the expenditure on the non-salary component of maintenance and upkeep of capital assets and non-wage related maintenance expenditure on plan schemes to be completed by March 31, 2010 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure".

Does this mean that the Commission should take the total committed expenditures and liabilities of the centre as 'non-negotiable' but only the non-salary, capital asset maintenance component of the committed expenditures of the states? Does it also mean that while the maintenance expenditures of the central government need not be scrutinised, as far as states are concerned, norms should be specified and mechanism for monitoring these maintenance expenditures should be put in place? The wording of the ToR shows a lack of sensitivity to federal values. If the Finance Commission is intended to be an impartial arbiter, it can not take these guidelines seriously. It may be futile to discuss the legitimacy or otherwise of the way in which ToR are framed; the key issue is that the Finance Commission should take a balanced view in making its assessments. This implies that the legitimate requirements of the states for meeting committed expenditures on account of both salary and non-salary components should be taken account of as much as that of the union government, and the Commission should take an even handed approach in making the assessments.[7]

Further, should the Commission take the projected GBS for central and state plans as given and take this entirely as legitimate expenditures in its assessment? Such an approach would not only be improper, but also will entail significant perverse incentives. The legitimacy and appropriateness in respect of a number of plan schemes initiated by the Union government can certainly be questioned and pre-empting expenditures on them for assessing the resources available for distribution among the states would be inappropriate. The founding fathers of the constitution have envisaged the Finance Commission to be an impartial arbiter in determining the resource allocation; it is necessary not only to be fair but also seen to be fair in its treatment of both union and state governments. Thus, it would be appropriate for the Commission to follow the mandate given to it under Article 280, ignore those parts of the ToR that seek to restrict its scope and dictate its approach and methodology and adopt those in which the union and state governments are seen to be treated in a uniform manner.

The ToR of the Finance Commission states that in formulating its recommendations the Commission should take account of a number of considerations. These include (i) analysing the impact of implementation of GST from 2010; (ii) “measures required to improve the quality of expenditures to obtain better outputs and outcomes”; (iii) management of ecology, environment and climate change consistent with sustainable development the implications of ecological management and climate change; and, (iv) measures needed to ensure commercial viability of irrigation projects and departmental and non-departmental public enterprises.

These tasks are very important, but the main question is: is the Finance Commission the right institution to resolve all these issues and to what extent it should digress into these issues within the limited time period at its disposal? Should the Commission be the body to decide on the nature of carbon taxes? Should they function as the tax reforms commission in deciding the nature of GST to be levied as also expenditure reforms commission to ensure allocative and technical efficiency in expenditure? It should be noted that the Commission is required to take account of these guidelines while making its recommendations on tax devolution and grants. The practical approach would be to take the existing knowledge and information on these considerations; it need not take them as paramount and concentrate on them at the cost of losing focus on its primary task.

III. Fiscal Consolidation: Centre and States

a. Aggregate fiscal consolidation

The fiscal situation in the country has shown a remarkable improvement in recent years. The consolidated gross fiscal deficit relative to GDP declined from 9.9 percent in 2001-02 to 6.4 percent in 2006-07 and further to 5.4 percent in 2007-08, an improvement of 4.5 percentage points (*Table 2*). It is budgeted to decline further to 4.6 percent in 2008-09. The improvement in revenue deficit is even more impressive as it declined from 7 percent of GDP in 2001-02 to 0.9 percent in 2007-08(RE) and is budgeted at 0.5 percent in 2008-09. Outstanding debt of central and state governments, however, declined only marginally from 76.4 percent in 2001-02 to 75.5 percent in 2007-08.

This turnaround in the fiscal situation has become possible due to improvements both at central and state levels. The improvement at both the levels started from the beginning of the decade, though after the fiscal restructuring plan was implemented in 2003-04, it gathered pace. The improvements conform to the fiscal responsibility legislations enacted by the centre and 26 state governments, though there are questions on the quality of adjustments, significant off-budget liabilities and impending fiscal risks. Nevertheless, it is fair to state that there has been significant improvement in reducing fiscal and revenue deficits at both central and state levels.

Table 2: Fiscal Indicators of Central and State Governments

(Percent of GDP)

	State			Centre			Consolidated		
	Revenue Deficit	Primary Deficit	Fiscal Deficit	Revenu e Deficit	Primary Deficit	Fiscal Deficit	Revenue Deficit	Primary Deficit	Fiscal Deficit
1996-97	1.18	0.85	2.72	2.39	-0.20	4.10	3.60	1.30	6.40
1997-98	1.07	0.93	2.90	3.05	0.50	4.80	4.10	2.10	7.30
1998-99	2.51	2.20	4.27	3.85	0.70	5.10	6.40	3.70	9.00
1999-00	2.78	2.39	4.72	3.49	0.75	5.40	6.30	3.80	9.50
2000-01	2.54	1.81	4.25	4.08	0.93	5.70	6.60	3.70	9.50
2001-02	2.59	1.47	4.21	4.41	1.47	6.20	6.99	3.68	9.93
2002-03	2.24	1.28	4.15	4.38	1.11	5.90	6.63	3.09	9.56
2003-04	2.21	1.49	4.45	3.56	0.00	4.50	5.76	2.05	8.48
2004-05	1.16	0.68	3.49	2.50	-0.10	4.00	3.67	1.36	7.51
2005-06	0.08	0.12	2.52	2.60	0.40	4.10	2.66	0.94	6.71
2006-07	0.03	0.40	2.77	1.90	-0.20	3.40	2.05	0.79	6.41
2007-08 (RE)	-0.47	0.11	2.29	1.35	-0.60	3.06	0.89	-0.50	5.35
2008-09 (BE)	-0.55	0.07	2.11	1.04	-1.08	2.51	0.49	-1.01	4.62

Source: *Budget Documents*, Government of India, and *Finance Accounts*, State Governments

At the central level, fiscal deficit as a ratio of GDP declined from 6.2 percent in 2001-02 to 4.5 percent in 2003-04 and further to 3.06 percent in 2007-08 (RE) and is budgeted at 2.5 percent in 2008-09. Similarly, centre's revenue deficit relative to GDP declined from 4.4 percent in 2001-02 to 1.35 percent in 2007-08 and to about one percent in 2008-09 (BE). The improvement is seen not only in the magnitude but also in the quality of deficits. The ratio of revenue deficit to fiscal deficit, which shows the extent to which borrowed funds are used to finance current spending, declined from 78 percent in 2001-02 to 47 percent in 2007-08 and is estimated to be still lower at 41 percent in 2008-09. Although there is a slippage in achieving the revenue deficit target, it must be stated that the achievement has been impressive.

Fiscal consolidation at the state level has been even more impressive. The aggregate fiscal deficit of the states relative to GDP declined from 4.2 percent in 2001-02 to 2.3 percent in 2007-08 and aggregate revenue deficit declined from 2.6 percent to a surplus of 0.5 percent of GDP during the period. Fiscal consolidation at the state level is more than the targets set in the fiscal restructuring plan of the Twelfth Finance Commission.

To what extent should these improvements be credited to the fiscal responsibility legislations? At the central level, the FRBMA was enacted in 2003 which set the targets for revenue and fiscal deficit reduction to the centre. Similarly, following the recommendation of the Twelfth Finance Commission, to gain from the benefits of debt rescheduling and write off, all the states except West Bengal and Sikkim have enacted Fiscal Responsibility Acts to phase out their revenue deficits and bring down their fiscal deficits to 3 percent of GSDP. Therefore, it is natural to conclude that legislated fiscal discipline has contributed to fiscal consolidation in India.

A closer analysis of fiscal trends at central and state levels reveals that there are significant off-budget liabilities and revenue and fiscal deficit reduction claimed in the budgets are exaggerated. In other words, the fiscal responsibility legislations have led the central and state governments to indulge in "creative accounting" to show lower deficits by pushing some liabilities outside the budget. Underestimation of food and fertiliser subsidy is estimated at 2 percent of GDP. The underrecovery of oil marketing companies is of even greater concern. At USD 130/barrel, the central government may have to issue oil bonds worth 2.2 percent of GDP. Along with under-budgeted (pay commission and farm loan waiver) and under budgeted (NREGA) liabilities, the total off-budget liabilities is estimated at about 5 percent of GDP. Thus, despite improvements, when off-budget liabilities are taken into account, the fiscal situation no longer looks as healthy; this shows that the fiscal responsibility legislation has tended to push some of the liabilities outside the budget.

b. Improvement in Central Finances

Can we attribute the actual improvement in the finances of central government to fiscal responsibility legislations? The Task Force on the Implementation of FRBMA worked out in detail the baseline and reform scenarios and set out the targets for revenue receipts, revenue expenditures, capital expenditures and revenue, and fiscal deficits based on the reform scenario. A comparison of the actual revenues and expenditures with the reform scenario is presented in *Table 3*. It is seen that while actual revenues were broadly in tune with the targets, the government failed to compress revenue expenditures according to the targets set and not surprisingly failed to achieve the revenue deficit targets. It is also seen that in order to achieve the fiscal deficit target, the government compressed capital expenditure from 2.4 percent of GDP in 2003-04 to 1.1 percent in 2008-09, instead of increasing it as envisaged in the reform scenario.

An analysis of the sources of fiscal improvement by the central government (*Table 4*) clarifies the picture. The gross central tax revenue relative to GDP increased by 3.3 percentage points in 2007-08 over 2003-04 and as there was a decline in non-tax revenue by 0.8 percentage point, the gross revenue increased by 2.5 points. Of this, higher tax devolution to the states claimed 0.8 percentage point and the net improvement in revenue was about 1.6 percentage points. The lower interest rates due to the debt swap scheme resulted in the lower debt service payments by about one percentage point, of which about 0.55 point was available for deficit correction after adjusting for higher non-interest expenditures. Thus, revenue deficit was compressed by 2.2 percentage points in 2007-08 over 2003-04 mainly through increasing revenues by 1.6 percentage points and reducing revenue expenditures by 0.55 point. Of the revenue deficit improvement of 2.2 percentage points, 1.2 points was used to compress the fiscal deficit.

Table 3: Targets and Achievements FRBMA

(Percent of GDP)

Fiscal Variables	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Revenue Receipts						
Projected	9.49	9.96	10.27	10.78	10.99	11.18
Actual	9.54	9.79	9.69	10.48	11.19	11.37
(Actual - Projected)	0.05	-0.17	-0.58	-0.30	0.20	0.19
Revenue Expenditure						
Projected	13.09	12.42	12.03	11.85	11.31	11.03
Actual	13.09	12.29	12.28	12.41	12.54	12.41
(Actual - Projected)	0.00	-0.13	0.25	0.56	1.23	1.38
Capital Expenditure						
Projected	2.34	2.97	2.87	2.9	3.17	3.27
Actual	2.37	2.21	1.05	1.00	1.04	1.12
(Actual - Projected)	0.03	-0.76	-1.82	-1.90	-2.13	-2.15
Total Expenditure						
Projected	15.43	15.39	14.9	14.75	14.48	14.3
Actual	17.04	15.94	14.18	14.07	15.11	14.16
(Actual - Projected)	1.61	0.55	-0.72	-0.68	0.63	-0.14
Revenue Deficit						
Projected	3.6	2.45	1.76	1.07	0.33	-0.15
Actual	3.55	2.51	2.59	1.94	1.35	1.04
(Actual - Projected)	-0.05	0.06	0.83	0.87	1.02	1.19
Fiscal Deficit						
Projected	4.77	4.43	4.03	3.56	3.13	2.8
Actual	4.46	4.02	4.11	3.44	3.06	2.51
(Actual - Projected)	-0.31	-0.41	0.08	-0.12	-0.07	-0.29

Table 4: Improvement in Central Finances

	Percent of GDP			Percentage Points	
	2001-02	**2003-04**	**2007-08 (RE)**	**Improve-ment in 2007/08 over 2001/02**	**Improve-ment in 2007/08 over 2003/04**
Gross Tax Revenue	8.20	9.20	12.47	4.27	3.28
Non-tax revenue	2.97	2.78	1.99	-0.98	-0.79
Gross revenue	11.17	11.98	14.46	3.29	2.49
Shared taxes	2.35	2.44	3.27	0.93	0.84
Grants	1.89	1.80	2.26	0.37	0.46
Net revenue	8.83	9.54	11.19	2.36	1.65
Revenue expenditure	13.22	13.09	12.54	0.68	0.55
Transfers to autonomous agencies	0.00	0.00	1.09	1.09	1.09
Net Expenditure	13.22	13.09	12.54	0.68	0.55
Net exp-grants	11.32	11.29	9.19	2.13	2.10
Interest payments	4.71	4.49	3.39	1.32	1.10
Revenue deficit	4.39	3.55	1.35	3.04	2.20
Fiscal deficit	6.18	4.46	3.22	2.96	1.24

Source: *Budget Documents* of the Central Government (relevant years), Ministry of Finance, Government of India.

Thus, the fiscal adjustment came about mainly through higher revenues. Gross tax revenue of the central government as a ratio of GDP increased from 9.2 percent in 2003-04 to 12.5 percent in 2007-08. A detailed analysis shows that this increase was mainly due to increased revenues from direct taxes (2.7 percentage points) and partly due to increase in service tax revenues (0.8 point). In fact, between 2003-04 and 2007-08, revenue from direct taxes grew at 30.7 percent per year on average. While the personal income tax revenue grew at an average rate of 29.9 percent per year, the growth in corporation tax was 31.2 percent. As for indirect taxes, revenue from service taxes increased at about 60 percent per year on average, though the growth rate of excise duties was just about 8 percent.

What contributed to such a high buoyancy of income tax revenues? Acceleration in non-agricultural GDP was important but cannot fully explain the increase in revenue productivity. This has to be attributed to improvement in tax compliance following the institution of Tax Information Network (TIN) and its implementation by National Security Depository Ltd (NSDL). According to the Report of Comptroller and Auditor General (C&AG), in 2002-03, almost 80 percent of the TDS assessee did not file returns. With the setting up of the TIN, the tax compliance has gone up significantly. In other words, the principal contributor to fiscal improvement in India is the simple reform of building a computerised information system.[8]

c. State Government Finances

Towards the end of the 1990s, the state finances deteriorated sharply. The fiscal deficits in the states increased from 2.7 percent in 1996-97 to 4.7 percent in 1999-2000, and revenue deficits increased from 0.85 percent to 2.4 percent during the period (*Table 2*). Worsening was seen not only in the volume of fiscal deficit but also the quality of deficits deteriorated as the ratio of revenue deficits increased from 26 percent to 59 percent. The states' indebtedness relative to GDP increased from 21 percent in 1995-96 to 30 percent in 2001-02. Attempts to contain deficits after the late 1990s resulted in compressing expenditures on social and physical infrastructures. The impact of these policy responses has been particularly harsh on the poorer states which are already lagging in infrastructure standards.

There are five important reasons for the declining fiscal health of the states in the late 1990s. First, central transfers declined by one percent of GDP, following the decline in central tax revenues. Second, the most important factor was the pay and pension revision of employees due to implementation of the Fifth Pay Commission. It is estimated that the burden of pay and pension revision was about two percent of GDP. Third, the pay revision at the state level came at the time when the growth rates in many states were low and states' own revenues were stagnant. Fourth, increasing government deficits and steady accumulation of debt have had adverse impact on the interest rates which caused significant increases in their borrowing costs. Many states tried to manage the hardening fiscal situation by borrowing from expensive small saving loans. Finally, the emergence of coalition politics in the centre and in the states and declining time horizon of political parties as well as politicians has led to continued proliferation of subsidies and transfers. As a result, attempt to contain fiscal deficits invariably resulted in compressing productive expenditures on infrastructure.

Since 2002-03, however, there has been a significant turnaround in state finances (Hajra, Rakhe, and Gajbhiye, 2008). Although the reform conditionalities of the Eleventh Finance Commission were ill designed (Rao, 2003), state finances started showing steady improvement, thanks to higher growth rate of the economy and larger tax devolution due to buoyancy of central taxes. By 2007-08, the states were well on course to achieve the deficit reduction targets set by the Twelfth Finance Commission (TFC). There was 3.1 percentage point reduction in the revenue deficit from 2.6 percent of GSDP in 2001-02 to a marginal surplus in 2007-08 (*Table 5*). The improvement resulted in reducing the fiscal deficit relative to GSDP from 4.2 percent to 2.3 percent during the period which meant that capital expenditures increased by about 1.2 percentage points.

As in the case of the centre, it is difficult to attribute the improvement in state finances to the fiscal restructuring plan of the Twelfth Finance Commission. The plan required the states to pass fiscal responsibility legislations to phase out their revenue deficits, and reduce fiscal deficits to 3 percent of GSDP by 2009-10. The progress in the reduction in revenue deficits was also linked to the writing off of the debt repayment to the central government. While this has provided the direction in which the adjustment should take place, there is nothing to show that the sources of improvement can be attributed to these recommendations.

The analysis of the various sources of improvements summarised in *Table 5* shows that during the period 2001-02 to 2007-08, of the 3.1 percentage point reduction in revenue deficit relative to GDP, 2.1 points were due to increase in revenues and one point was from expenditure compression. Within revenues, 1.6 percentage points were due to higher transfers. The states' own tax revenues increased by 0.6 percentage point and this was achieved through the value added tax (VAT) reform, rationalisation of stamp duties coupled with boom in the real estate markets, and a general rise in tax collections arising from relatively higher growth of the secondary sector.

On the expenditure side, the adjustment was only one percentage point and half of this was due to lower interest payments (*Table 5*). Lower interest rates arising from the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and debt restructuring as per the recommendation of the Twelfth Finance Commission contributed to the improvement. Thus, much of the improvement in state finances has come about due to the higher transfers, but nevertheless, the improvement is likely to sustain in the medium term as revenue from central direct taxes are likely to show high buoyancy with progressive strengthening of the information system and reforms to introduce the GST.

Table 5: Improvement in State Finances Since 2001-02

	Fiscal Trends (Percent of GDP)		**Improvement in 2007-08 Over 2001-02 (Percentage Points)**
	2001-02	**2007-08 (RE)**	
Fiscal deficit	4.2	2.3	(-) 1.8
Revenue Deficit	2.6	-0.5	(-) 3.1
Revenue Receipts	11.2	13.3	(+) 2.1
Own tax Revenue	5.6	6.2	(+) 0.6
Tax Devolution	2.3	3.1	(+) 0.9
Grants	1.9	2.6	(+) 0.7
Revenue Expenditure of which:	13.8	12.9	(-) 1.0
Interest Payment	2.7	2.2	(-) 0.5

Source: Reserve Bank of India and State Budgets.

Note: RE – Revised Estimates.

Almost all the states have shown significant improvements in their fiscal health (*Table 6*). Both revenue and fiscal deficits have been reduced in every state except Kerala and Jharkhand among general category states. It is interesting to see that general category states performed better than special category states in reducing fiscal deficit, but reverse was the case in revenue deficit. Among the former, the low income states performed better in revenue deficit reduction, but the performance of high income states was better in reducing fiscal deficit. Both high income and low income categories of states brought down fiscal deficits by more than two percentage points, but the latter category states increased their capital outlay by a larger magnitude (3.3 points) than the former (1.5 points).

Table 6: Fiscal Consolidation at State Level Since 2001-02

Percent to GSDP

	Fiscal Deficit			Revenue Deficit			Capital Outlay*		
	2001-02	**2007-08 (RE)**	**Improvement (2-3)**	**2001 - 02**	**2007-08 (RE)**	**Improvements (5-6)**	**2001 -02**	**2007-08 (RE)**	**Improvement (9-8)**
I. General Category States									
High Income States									
Andhra Pradesh	4.28	3.09	1.18	1.83	-0.15	1.98	2.44	5.99	3.55
Goa	5.82	4.57	1.24	3.22	-0.02	3.24	2.60	4.59	2.00
Gujarat	5.27	1.80	3.47	5.45	-0.83	6.27	-0.18	2.63	2.81
Haryana	4.32	1.18	3.14	1.66	-1.04	2.70	2.65	2.22	-0.43
Karnataka	5.39	2.91	2.48	3.01	-1.42	4.44	2.37	4.43	2.05
Kerala	4.22	4.70	-0.47	3.37	3.16	0.21	0.86	1.54	0.68
Maharashtra	4.02	-0.10	4.12	3.02	-2.53	5.55	1.00	2.43	1.43
Punjab	6.22	3.40	2.82	4.74	0.95	3.79	1.48	2.45	0.97
Tamil Nadu	3.18	2.76	0.42	1.84	-0.34	2.18	1.34	3.10	1.76
West Bengal	7.51	4.15	3.37	5.64	2.82	2.81	1.88	1.32	-0.55
Average	**4.85**	**2.28**	**2.56**	**3.38**	**-0.33**	**3.71**	**1.47**	**2.98**	**1.51**
Low Income States									
Bihar	4.47	3.49	0.98	2.28	-3.70	5.98	2.19	7.18	5.00
Chhatisgarh	3.60	2.59	1.01	1.88	-2.63	4.51	1.73	5.22	3.49
Jharkhand	3.89	7.81	-3.91	0.87	1.86	-0.99	3.02	5.95	2.92
Madhya Pradesh	4.20	3.24	0.96	3.64	-2.41	6.05	0.56	5.65	5.09
Orissa	8.45	1.08	7.37	6.04	-1.63	7.67	2.42	2.71	0.29
Rajasthan	5.21	3.47	2.80	4.14	-0.16	4.30	2.13	3.63	1.50
U. Pradesh	6.28	3.00	2.20	3.25	-2.63	5.88	1.95	5.63	3.68
Average	**5.25**	**3.32**	**1.94**	**3.37**	**-1.86**	**5.23**	**1.88**	**5.17**	**3.29**
Average - I	**4.97**	**2.59**	**2.38**	**3.38**	**-0.79**	**4.16**	**1.60**	**3.63**	**2.04**
II. Special Category States									
Arunachal Pradesh	11.70	9.46	2.24	-2.62	-18.13	15.51	14.32	27.59	13.27
Assam	3.79	4.39	-0.60	2.30	-0.13	2.43	1.48	4.51	3.03
Himachal Pradesh	8.81	4.28	4.53	5.02	0.14	4.87	3.80	4.14	0.34
J & Kashmir	8.17	8.52	-0.35	1.85	-6.37	8.22	6.32	15.46	9.14
Manipur	10.22	1.54	8.68	4.84	-15.88	20.72	5.38	17.42	12.04
Meghalaya	4.79	1.08	3.70	0.73	-6.57	7.30	4.06	7.65	3.60
Mizoram	21.70	4.24	17.46	13.38	-11.89	25.27	8.32	16.13	7.82
Nagaland	8.09	6.97	1.12	2.46	-6.47	8.93	5.63	13.44	7.81

Table 6: Fiscal Consolidation at State Level Since 2001-02 (contd.)

Percent to GSDP

	Fiscal Deficit			Revenue Deficit			Capital Outlay*		
	2001-02	**2007-08 (RE)**	**Improvement (2-3)**	**2001 - 02**	**2007-08 (RE)**	**Improvements (5-6)**	**2001 -02**	**2007-08 (RE)**	**Improvement (9-8)**
Sikkim	5.88	11.60	-5.72	-12.58	-18.90	6.32	18.47	30.50	12.03
Tripura	8.45	4.79	3.65	-0.86	-5.94	5.08	9.30	10.73	1.43
Uttarakhand	3.83	4.78	-0.95	2.06	-3.29	5.35	1.77	8.07	6.30
Average	6.38	5.12	1.27	2.40	-3.54	5.94	3.99	8.75	4.76
All States	**5.06**	**2.74**	**2.32**	**3.32**	**-0.95**	**4.27**	**1.74**	**3.94**	**2.19**

Note: Negative sign for both fiscal deficit (col.3) and revenue deficit (cols.5 & 6) indicates surplus
GSDP figures are projected using trend growth rate on last two available years;
* Capital outlay includes net lending

Source: *Finance Accounts* and *Budget Documents* of state governments

A closer look at the data (not reported here) to examine the sources of improvement in revenue deficit in each of the states reveals that an overwhelming proportion of improvement was due to increase in own revenues and higher central transfers. The former was relatively more important in high income states while for the low income states the relative importance reversed. There was hardly any compression of revenue expenditures even as the ratio of interest payments to GSDP in 2007-08 was lower than in 2001-02. In fact, the low income states used the opportunity provided by better fiscal situation to augment both revenue and capital expenditures on social and economic services. Since 2005-06, some of the states could also avail benefits of debt rescheduling and write-off recommended by the TFC. Significant improvement in the fiscal health since 2001-02 was also seen in the case of special category states. The revenue deficit relative to GSDP was compressed by 5.9 percentage points on the strength of mainly higher central transfers.

IV. Approach of the Commission

a. Shortcomings of the prevailing approach

The primary focus of the Finance Commission should be to make recommendations to resolve vertical and horizontal fiscal imbalances. Vertical imbalance refers to the mismatch between revenue raising capacity from the sources of revenue assigned and expenditure needs for the assigned functions. Centre has comparative advantage in raising revenues and states, in expenditures. Horizontal imbalance refers to the existence of inter-state differences in revenue raising capacity and differences in the unit cost of providing public services resulting in violation of the principle of comparable public services at comparable tax rates. The constitution recognises the existence of vertical and horizontal imbalances in the assignment system and mandates the President to appoint the Finance Commission to make recommendation on tax devolution under *Article 270* and grants under *Article 275* to resolve the imbalances.

Although intuitively appealing, measurement of vertical and horizontal imbalances is beset with several difficulties (Bird, 1986) and judgements on norms are unavoidable. The analysis presented in *Table 7* shows that own revenues of the states are adequate to finance only 56 percent of their current expenditures and the remaining was financed from transfers from above and this percentage has shown a declining trend. The states' share in total expenditures increased from 52 percent in 1990-91 to 58 percent in 2005-06. However, this does not signify an increase in decentralisation for, the spending financed by specific purpose transfer on which the states' have little manoeuvrability have shown a sharp increase in recent years.

Table 7: Trends in Revenue-Expenditure Imbalance at Central and State Levels

Year	Percent of states' own revenue receipts total revenue receipts	Percent of states' revenue expenditure to total revenue expenditure	Percent of states' own revenue receipts to states' revenue Expenditure	Percent of states' expenditure* to total expenditure*
1955-56	41.2	59.0	68.9	61.7
1960-61	36.6	59.9	63.9	56.8
1970-71	35.5	60.2	60.6	53.9
1980-81	35.6	59.6	60.1	56.0
1990-91	35.2	54.6	53.1	51.7
1995-96	39.2	57.0	58.6	55.8
1999-00	38.6	56.4	49.8	56.0
2000-01	37.8	56.0	48.6	56.1
2001-02	40.2	56.9	50.0	56.3
2002-03	38.28	54.31	56.01	55.14
2003-04	37.54	56.27	53.83	57.65
2004-05	38.10	56.28	60.05	56.64
2005-06 (RE)	37.07	56.59	56.07	58.10

Current + capital expenditures. RE: Revised Estimates

Source: Public Finance Statistics, Ministry of Finance, Government of India (relevant years).

An important feature of Indian fiscal federalism is the significant inter-state differences in revenue capacity and consequently, per capita expenditures. The information on per capita revenues and expenditures of the states for 2005-06 presented in *Table 8* brings out some important features. First, there were wide inter-state variations in revenues in both per capita terms and as a percentage of Gross State Domestic Product (GSDP). These variations indicate differences both in revenue capacity and effort. Second, although fiscal dependence of the states on the centre varied inversely with per capita income, per capita expenditures in high income states were substantially higher.

There have been two important developments in the transfer scene. First, the capacity of the Finance Commission to achieve the desired degree of equalisation has been constrained by the Planning Commission and various central ministries making grants for both general and specific purposes under *Article 282*. Obviously, the Finance Commission does not have control over the distribution of these transfers, while the share of these transfers together has shown an increasing trend. Second, the transfer system as a whole has become more and more discretionary. The normal assistance to State Plans given under the *Gadgil formula* declined from 85 percent of State Plan assistance in 1991-92 to 27.5 percent in the 2008-09 budget. The consequences of these developments are: (i) the Finance Commission cannot take a holistic view of inter-state differences in public service provision; (ii) meeting the objectives of the transfers in the prevailing system is extremely difficult; and (iii) increase in the discretionary component reduces objectivity and credibility of the transfer system.

Even within its limited scope, the methodology adopted by the successive Commissions has had adverse implications on both incentives and equity. The approaches followed by the Finance Commissions broadly comprised of (i) assessment of overall budgetary requirements of the centre and states to determine the volume of resources that can be transferred during the period of their recommendation; (ii) forecasting states' own current revenues and non-plan current expenditures;(iii) determining the states' share in central tax revenues and distributing this share among the states; and (iv) filling the post-devolution projected gaps.

The criteria employed by the Finance Commissions for recommending tax devolution and the methodology employed to determine the grants have been discussed extensively in the literature. The most important are the equity and incentive implications of the transfer system which must be noted. As the Finance Commissions take the base year numbers and make projections, the expenditures of poorer states with low base year numbers continue to be assessed at low expenditures. This "tyranny of the base year" goes against the spirit of equalisation.

Table 8: Selected Fiscal Indicators of States: 2006-07

	Per Capita GSDP	Per capita Dev. Exp	Per capita Own Revenue	Per capita Transfers	Tax-GSDP Percentage
Andhra Pradesh	32533.0	4977.2	3788.0	1768.1	9.6
Bihar	10286.0	2105.3	530.9	1952.9	4.8
Chhatisgarh	26125.1	4439.6	2974.4	2279.7	9.0
Goa	95663.5	15460.0	9446.7	2886.7	8.3
Gujarat	44332.5	4558.4	4056.2	1432.1	7.5
Haryana	48213.8	5717.8	5736.0	1008.9	9.3
Jharkhand	23591.2	3992.0	1542.9	1888.3	4.5
Karnataka	36037.8	5173.7	4567.3	1733.4	11.7
Kerala	39742.1	4243.7	3841.6	1773.4	9.0
Madhya Pradesh	18984.1	2872.0	1863.2	1841.9	8.0
Maharashtra	46307.9	4587.2	4235.6	1383.3	8.2
Orissa	25997.6	2649.9	1945.3	2568.5	5.7
Punjab	43436.1	4885.9	4362.7	1612.2	8.5
Rajasthan	22210.8	3201.1	2301.3	1735.7	8.1
Tamil Nadu	37635.2	4698.3	4729.4	1454.0	11.4
Uttar Pradesh	16308.2	2368.9	1607.7	1631.9	8.1
West Bengal	30739.3	2419.5	1598.7	1550.0	4.8
General Category States	**28867.0**	**3606.4**	**2790.6**	**1691.0**	**8.3**
Arunachal Pradesh	27747.5	16941.7	2316.7	17625.0	2.1
Assam	21947.7	4579.9	1793.1	3749.5	5.6
Himachal Pradesh	43535.4	7541.5	3690.8	6996.9	5.4
Jammu & Kashmir	26334.2	8067.3	2279.1	8611.8	6.6
Manipur	27992.3	9821.7	1195.7	11795.7	1.7
Meghalaya	28342.6	7399.5	1772.5	8102.9	3.8
Mizoram	27820.5	16250.0	1820.0	18100.0	2.3
Nagaland	27740.1	9209.1	918.2	11545.5	1.9
Sikkim	34820.6	22764.5	4488.1	21177.5	6.4
Tripura	29500.1	6600.0	1247.1	8108.8	3.5
Uttarakhand	30956.0	6426.9	3203.2	4154.8	8.2
Average: Special Cat. States	**27189.0**	**6729.8**	**2197.1**	**6375.8**	**5.6**
Average: All States	**28762.5**	**1962.0**	**1421.2**	**1023.9**	**8.1**

Source: 1. Reserve Bank of India Bulletin,
2. Public Finance Statistics, Ministry of Finance, Government of India, 1994-95.

Table 9: Equalisation in Fiscal Transfer System in India – 2005-06

	Finance Commission		Plan Transfers			Total Transfers
Major states only	**Tax devolution**	**Total transfers**	**State plan schemes**	**Centrally sponsored schemes**	**Total plan transfers**	
Intercept	12.2951* (10.7236)	12.1324* (8.6215)	4.9104* (2.9939)	3.9331 (1.3682)	5.545* (2.9613)	11.1025* (8.7866)
Coefficient	-0.5535* (-4.9123)	-0.5303* (-3.8346)	0.0197 (0.1224)	0.0943 (0.3339)	0.0177 (0.0966)	-0.3973* (-3.1991)
$\bar{R}^2$	0.607	0.477	-0.07	-0.063	-0.07	0.381

Note: Estimated by employing the functional form: Ln G = $\alpha + \beta$ Ln Y+ $\in$, where G denotes different types of per capita transfers, Y represent per capita GSDP, α and β represent parameter estimates and $\in$ is the error term.

* Significant at 1 percent level.

Despite this, Finance Commission's transfers are the most equalising among the three different transfer categories (*Table 9*). The log-linear regressions of per capita transfers on per capita GSDP for the cross section of general category states (excluding the small state of Goa) in 2005-06 shows that only the Finance Commissions have a significant equalising impact with the elasticity of (-) 0.53 largely due to the progressive distribution of tax devolution recommended by the Finance Commission. Grants for State Plan as well as Centrally Sponsored Schemes have no equalisation impact whatsoever and the equalisation seen in the transfer system is mainly due to Finance Commission transfers.

Despite progressive distribution, the transfer system fails to offset the fiscal disabilities entirely and this is shown in *Figure 1*. Although transfers reduce inter-state inequalities in per capita revenue accruals and per capita expenditures, significant inequalities in revenues accruing and expenditures still persist and these are positively related to per capita GSDP.

Failure to offset the relative fiscal disabilities of the states fully is brought out in *Table 10*. Taking all-state average annual per capita expenditure as the norm, expenditure requirements are estimated for the period 2003-04 to 2005-06. Similarly, taking all-state average revenue-GSDP ratio, normative revenues are estimated. The gap between the normative expenditures and revenues are then adjusted for the transfers from the centre to the states to arrive at the residual gap. It is seen that the residual gap as a ratio of GSDP was the highest in the case of Bihar (40.6 percent) followed by Uttar Pradesh (21.7 percent) and in general, the poorer states had larger gaps. Although these estimates are not scientific, they substantiate the general point that the transfer system has failed to ensure a level playing field for the poorer states.

The inability to offset fiscal disabilities has caused significant inter-state differences in spending on basic public services. The analysis of expenditures presented in *Table 11* shows that inter-state differences in per capita expenditures are not only high in all cases, but have actually increased in education and health expenditures as measured by the coefficients of variation. It is also seen that the correlation of per capita expenditures on education, health, total social services, and economic services as well as aggregate expenditures with per capita NSDP is high and significant. Together with increasing coefficients of variation, these results show that per capita expenditures are higher in high income states and differences in per capita expenditures between low income and high income states have steadily increased over the years.

Figure 1 : Extent of Equalisation in Central transfers to States

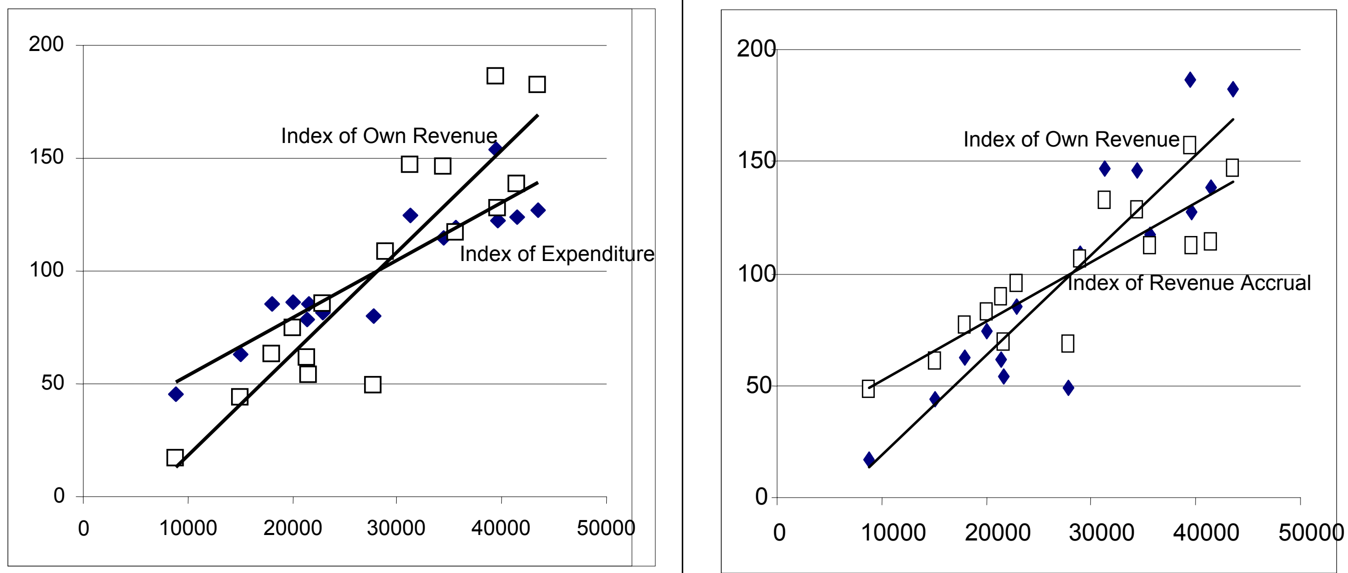

Table 10: Normative Resource Gap of Major States with Averages as Norms

State	Per capita Total Expend-iture (Average 2003-06) (Rs.)	Own Revenue/ GSDP (%) (Average 2003-06)	Normative Own Revenue (Rs. crore)	Normative Total Expenditure (Rs. crore)	Normat-ive Gap/ GSDP (%)	Normat-ive Gap After Actual Transfers / GSDP (%)
Andhra Pradesh	4750.59	9.58	19213.56	43121.88	11.25	6.68
Bihar	1874.66	5.01	6645.07	48088.49	56.40	40.55
Chhatisgarh	5979.75	9.74	4151.71	7539.78	7.38	1.15
Goa	16747.17	14.74	1000.31	776.06	-2.03	-4.24
Gujarat	5322.18	8.67	17210.37	29180.55	6.29	3.83
Haryana	5216.41	10.10	8515.47	12317.08	4.04	2.35
Jharkhand	2903.07	6.65	4893.05	15547.51	19.69	13.50
Karnataka	9780.22	11.86	13500.25	15249.16	1.17	-3.09
Kerala	5353.85	9.01	9708.75	17831.92	7.57	4.08
Madhya Pradesh	3683.61	9.73	9840.75	35105.30	23.22	16.23
Maharashtra	5525.56	8.76	34629.43	55635.14	5.49	3.67
Orissa	3457.69	7.74	6372.31	20789.68	20.46	11.51
Punjab	5982.12	9.61	8953.33	13878.23	4.97	2.86
Rajasthan	3910.06	9.22	10584.59	32908.22	19.07	12.94
Tamil Nadu	5100.07	10.86	18093.45	34939.13	8.42	4.99
Uttar Pradesh	3087.61	7.42	22713.53	96777.29	29.49	21.72
West Bengal	3540.72	5.05	19103.77	45507.19	12.50	8.05

Inequalities in expenditures on social and economic services cause inequalities in these services. Thus, the children in states with low literacy rates have poor access to school education and people in states with low health status have low levels of expenditures on medical and public health. Similarly the states with low infrastructure levels spend less on infrastructure. This pattern of spending increases inequalities in social and physical infrastructure and reinforce inequalities in development. Thus inability to place the poorer states on a level playing field in regard to infrastructure provision combined with poor development of market institutions in these states has contributed to growing inter-state inequalities in levels of living.

Not surprisingly, inter-state disparities among the general category states are not only high, but have shown an increasing trend (Rao, 2008). In 1980-81, the per capita SDP in the richest state, Punjab (Rs 2674) was about 2.9 times that of the poorest, Bihar (Rs 919). In 2006-07, this difference increased to 4.8 times with per capita SDPs of Haryana, the highest income state at Rs. 48214 and Bihar at Rs. 10286 (*Table 9*). It is also seen that per capita income levels have tended to diverge sharply after market-based reforms were initiated. (Rao *et al*, 1999). With economic liberalisation, the states with better access to factor and product markets and better transport infrastructure and connectivity, were able to take greater advantage of the opportunities as compared to those with poor transport infrastructure and low levels of market development.

The second major shortcoming of Finance Commission transfers is the inherent adverse incentives it entails which has been described as "fiscal dentistry" (Rao and Singh, 2005). Projection of revenues and expenditures, even when sprinkled with some norms, provides disincentive to tax effort and incentive to expenditure profligacy. Not surprisingly, the incentive is to have larger "cavities" and until the Finance Commission moves away from this approach, the perverse incentive will continue.

Table 11: Inter-State Differences in Per Capita Expenditures on Public Services

Expenditure Head	1995-96	2000-01	2001-02	2002-03	2003-04
1. Education					
a. Mean (Rs)	285.79	532.06	522.69	531.31	550.18
b. Coefficient of variation	0.35	0.45	0.40	0.47	0.48
c. Corr. coeff with per capita NSDP	0.616	0.644	0.619	0.699	0.513
2. Medical and Public Health					
a. Mean	88.33	146.42	146.93	148.42	154.99
b. Coefficient of variation	0.27	0.45	0.36	0.34	0.35
c. Corr. coeff with per capita NSDP	0.687	0.765	0.793	0.811	0.528
3. Social Services					
a. Mean	575.48	1030.51	1033.23	1060.39	1136.11
b. Coefficient of variation	0.40	0.42	0.32	0.33	0.37
c. Corr. coeff with per capita NSDP	0.841	0.763	0.812	0.852	0.716
4. Economic Services					
a. Mean	514.74	827.85	821.69	854.21	1128.96
b. Coefficient of variation	0.38	0.58	0.49	0.42	0.34
c. Corr. coeff with per capita NSDP	0.824	0.765	0.671	0.740	0.662
5. Development Expenditure					
a. Mean	1090.23	1858.36	1854.92	1914.61	2265.07
b. Coefficient of variation	0.33	0.47	0.37	0.36	0.30
c. Corr. coeff with per capita NSDP	0.872	0.794	0.791	0.828	0.865
6. Total Expenditure					
a. Mean	1690.37	3059.30	3180.46	3348.41	3858.04
b. Coefficient of variation	0.37	0.45	0.34	0.36	0.31
c. Corr. coeff with per capita NSDP	0.885	0.842	0.917	0.905	0.839

Source: Estimated from expenditure data derived from *Finance Accounts* of states, Comptroller and Auditor General, Government of India.

b. Possible Approaches

The Thirteenth Finance Commission has the opportunity to change the approach and make a significant contribution in the design of the transfer system to make it more equitable and incentive compatible. It is important to design the transfers that would help to improve fiscal discipline at the margin, and should at least ensure that the states have resources to equalise basic services. However, any approach that is adopted by the Finance Commission should be simple and by and large acceptable to the centre and states. Unfortunately, the Commission is not writing on a clean slate and therefore, it is important to ensure that the transition is smooth and does not destabilise the budgets of individual state governments.

One possible approach is to take tax revenues at a ratio of GSDP and expenditures at average per capita while making the assessments as shown in the illustration in *Table 10*. However, it is not correct to assume that the relationship between tax revenues and GSDP is linear. Furthermore, taxable capacity is determined by not just GSDP, but a number of capacity factors. Similarly, estimation of expenditure needs involves, besides population, the demographic composition of population, its density, and various environmental factors. The attempt by the Ninth Finance Commission to estimate fiscal capacities and needs of the states was criticised on the grounds that it was too complicated. In any case, adoption of such an approach would involve significant change in the inter-state distribution of transfers. It is doubtful whether the Commission can make such a drastic departure.

One feasible approach the Commission could adopt is to continue with the tax devolution as in the past and equalise social services such as basic education and healthcare completely. In fact, the Twelfth Finance Commission attempted to equalise the expenditures on basic education and healthcare but found that it did not have the requisite resources and ended up recommending grants to equalise 10 percent equalisation in basic education and 30 percent equalisation in health expenditures.

It is possible to estimate the expenditure needs of basic social services in a more scientific manner based on the physical norms relating to these services. In the case of health expenditures for example, it is possible to estimate the required number of health centres and sub-centres, hospital beds, medical and paramedical personnel, and work out the costs. A recent study by Rao and Choudhury (2008) provides a detailed methodology for estimating expenditure needs in respect of health expenditures. Similarly in the case of education expenditure, requirements in each state can be estimated separately for primary, secondary, vocational, and higher education.

Once the expenditure need is estimated, the Commission can work out the expenditures presently incurred from all sources – plan and non-plan. Besides the expenditures incurred in the state budgets, there are central government expenditures incurred for various schemes (National Rural Health Mission, *Sarva Shiksha Abhiyan* etc.) and after taking into account their inter-state distribution, the Commission can estimate the additional expenditure required for equalisation. The equalisation grants in respect of these could be designed in an incentive compatible manner to ensure minimum standards of social services are provided in the states. Full equalisation of expenditures on basic social services can be done if the grants are given to equalise these basic services instead of filling the gaps. Once social services are equalised, the state governments can borrow from the market to ensure minimum standards of economic services.

The approach outlined above has several advantages. First, it will take a holistic view of the requirements in social services without making a distinction between plan and non-plan or revenue and capital. Second, it will avoid the perverse incentives from the gap filling approach. Third, it is possible to design the grants to ensure that the states do not substitute their own expenditures on these services. Fourth, this will facilitate human development in poorer states by improving the standards of public services in them and contribute to increase in productivity.

V. Summing Up

The Thirteenth Finance Commission faces challenging times. Despite substantial improvement, the fiscal situation continues to be a matter of concern when off-budget liabilities and other fiscal risks are considered. In addition, the surge in capital flows and sterilisation of foreign exchange inflows by the Reserve Bank of India leaves very little room for manoeuvrability to pursue independent monetary policy.

While macroeconomic stability is an extremely important objective, it is necessary to consider whether the Finance Commission should take this as a primary task. Surely, the Commission will have to consider the ability and flexibility of the central government in the macroeconomic management of the economy in formulating its recommendations on tax devolution and grants. It should also consider building in appropriate incentive structure in its recommendations to provide incentive to the states for better fiscal management and penalise those that indulge in laxity. All sustainability calculations involve judgements and the nature of the GDP growth projected. However, to bind the central and state governments to the projected values can make calibration of counter-cyclical fiscal policies difficult.

Concern has been expressed on the wording used in the ToRs of the Commission. The first issue pertains to the primacy of the task of the Commission itself. While many of the guidelines are important and should be taken into consideration while formulating its recommendations for tax devolutions and grants, they should not by themselves, become the primary objective. More importantly, the Commission is an independent constitutional authority vested with the task of dividing the fiscal resources as an impartial arbiter and therefore, has to take into consideration the revenue potential of the centre and the states on the one hand and genuine expenditure needs of the centre and the states on the other, irrespective of the wording of the ToR.

The Thirteenth Finance Commission has the opportunity to assess the requirements of the states in a holistic manner without making a distinction between plan and non-plan sides. In particular, it is opportune to take comprehensive requirements in social sectors such as basic education and healthcare to ensure comparable standards of services in these services across the country. The requirement to spend more on public education and healthcare in poorer states is all the more important due to the small presence of the private sector, particularly in the rural areas in these states.

It will be very difficult to change the shares of the states drastically in its recommendations. However, it can make a paradigm shift to change the structure of incentives and accountability as an inherent part of the transfer system. Thus rather than continuing with the “gap-filling” approach, the Commission can fully equalise expenditures on at least basic healthcare and education. It is possible to design the transfer system to build in the incentives even to the states which have a better record of providing education and health to improve their services further from quantity to quality. If necessary, the tax devolution percentage can be appropriately adjusted to ensure equalisation of social services.

References

Bird, Richard, M.1986. "On Measuring Fiscal Centralization and Fiscal Balance in Federal States", *Government and Policy: Environment and Planning*, 4(4):389-404.

GoI, 1965. Report of the Finance Commission (Fourth), Ministry of Finance, Government of India.

--------, 1969. Report of the Finance Commission (Fifth), Ministry of Finance, Government of India.

---------, 1989. The First Report of the Ninth Finance Commission, Ministry of Finance, Government of India.

---------, 2008. Economic Outlook for 2008/09, Economic Advisory Council to the Prime Minister, New Delhi.

Hajra, Kumudini, P.B. Rekhe, and Dhirendra Gajbhiye, 2008. Issues Before the Thirteenth Finance Commission", *Economic and Political Weekly,* 43(12-13): 89-96. (March-April).

NIPFP, 1993. *The Ninth Finance Commission: Issues and Recommendations.* New Delhi: National Institute of Public Finance and Policy.

Rao, M. Govinda 1997. "Invisible Transfers in Indian Federalism, *Public Finance/Finances Publiques*, 52(3): 299-316.

Rao, M. Govinda and Mita Choudhury, 2008. Inter-State Equalisation of Health Expenditures in Indian Union, National Institute of Public Finance and Policy, New Delhi (*mimeo*).

Rao M. Govinda and Nirvikar Singh, 2005. *Political Economy of Federalism in India.* New Delhi: Oxford University Press.

Rao, M. Govinda and R. Kavita Rao, 2006. "Trends and Issues in Tax Policy and Reform in India", *India Policy Forum, 2005/06*, pp. 55-122.

Rao. M. Govinda and Subrata Mandal, 2008. "Resource Endowment, Fiscal Flows and Regional Equity in Indian Federalism" in (*eds.*) M. Govinda Rao and Anwar Shah, *Fiscal Management Challenges of Indian States and Regional Equity in India,* New Delhi: Oxford University Press (forthcoming).

Rao, Kavita, R. 2008. Goods and Services Tax For India, Paper Presented at the Fifth Meeting of the Asian Tax Forum, New Delhi.

Reddy, G. R. 2007. "Imbalance in Agenda of Finance Commission", *Economic and Political Weekly*, 42(51): 8-10. (December).

Virmani, Arvind 2007. “Macroeconomic Management of the Indian Economy: Capital Flows, Interest Rates and Inflation”, Working Paper No.2/2007, – Department of Economic Affairs, Ministry of Finance, Government of India.

Vithal, B. P. R. and M. L. Shastry, 1987. “Terms of Reference of the Ninth Finance Commission: Some Preliminary Comments”, *Economic and Political Weekly*, July 25.

Endnotes

[1] Virmani (2007) argues that the fiscal deficit targets for 2013 should be set at 3 percent of GDP (1.5 percent each for the centre and states) as against 6 percent set for 2009 by the Twelfth Finance Commission.

[2] Some of the Finance Commissions themselves resented the restrictions imposed upon them from their constitutional mandate. For example, responding to the restriction placed on the Fifth Finance Commission to confine itself to non-plan side of the states' budgets, it stated, "As the language of the *Article 275* stands, there is nothing to exclude from its purview, grants for meeting revenue expenditures on plan schemes nor is there is explicit bar against grants for capital purposes". However, it did not do so , "….as it would blur the entire division of functions between the Commission and the Planning Commission" (India, 1969, p.12)

[3] This is one of those rare cases where the Government did not accept the majority recommendation of the Commission.

[4] See footnote 2 above.

[5] The Ninth Finance Commission sought the opinions of N. A. Palkhiwala, K. K. Venugopal, and A. G. Noorani on the specific issue of the interpretation of *Articles 275, 280* and *282* of the constitution. The views of Noorani and Venugopal are available in the "Round Table Discussion" summarised in The *Ninth Finance Commission: Issues and Recommendations* (NIPFP 1993: 207-235).

[6] In this context it is necessary to point out the unusual procedure of requesting the Finance Commission "…to revisit the roadmap for fiscal adjustment and suggest a suitably revised roadmap" in the Budget Speech 2008-09 (p. 22) of the Union Finance Minister.

[7] Even when the approach is even-handed, the deviation of the actual estimates from those projected by the Commission can have different impact on the union and state governments. Therefore, Guhan in a lighter vein used to say that the Finance Commissions can only bark at the centre, but they bite the states!

[8] For details on this *see*, Rao and Rao (2006), pp. 104-05.