PART I

Issues Arising from the Terms of Reference

A: INAUGURAL ADDRESS

Issues Before the Ninth Finance Commission*

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I am very grateful t the National Institute of Public Finance and Policy for giving me the opportunity of discussing with you the main issues that confront the Ninth Finance Commission. Since eight Finance Commissions have preceded this, and each Finance Commission has aroused a great deal of discussion, at least twice, first when it was appointed and later when it submitted its report; many of the main issues before the Commission have been dealt with threadbare in current economic literature. A fresh discussion of these is hardly likely to be rewarding. A more interesting approach may be to concentrate on the two major departures from the past in the terms of reference of the Ninth Finance Commission: the adoption of the normative approach and the taking into account of the entire revenue expenditure, Plan as well as non-Plan.

It must be noted that both these changes have been made in response to criticisms of past reports from responsible quarters that the recommendations were heavily based on the current receipts and expenditure accounts of the States and therefore discouraged tax efforts and resource mobilisation, and promoted extravagance .Tax sharing was used by them to ensure that as few States as possible had to be styled as weak States in need of assistance under Article 275. Given the limitations of the formula of tax-sharing, this invariably meant that the richest four States - Punjab, Haryana, Gujarat and Maharashtra - were left with large surpluses on non-Plan ac-

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* Inaugural Address at the Seminar on Issues before the Ninth Finance Commission.

count which were available to them for planned development, but the poorer States among those not benefitting from Article 275 had much less left for their urgent developmental needs. The States benefitting from Article 275 had to commence the Plan with a clean slate. (Table I). As the enormity of injustice and inequity implicit in the exercise came to be recognized, a number of sophistications were introduced. To mention only a few: Growth rates of income and expenditure of States were standardized; rules were laid down for the permitted salary revisions that should be taken into account; tax arrear reductions were assumed; norms of return on capital lent or invested were determined; need for upgradation of standards of administrative services (understood sometimes even to cover education, medical and health services) was allowed for and tax targets expected to be reached by a particular period were assumed. But, by and large, there was no effort to work out a norm of a tax structure and rate level that should be reached or a standard of State services that should be provided. On the contrary, the States in need of assistance under Article 275 were given grants just enough to cover their developmental revenue expenditure at the existing level of services and expansion thereof was left to be covered by the Planning Commission. This was condemned by many critics as a "gap-filling approach" and introduction of tax and expenditure norms was advocated. Developmental services in poor and rich States widely differ, (Table II) and any worthwhile all-India norm implies a betterment of services at least in some States, provision for which is now included in their plans. Similarly, attempts in less taxed States (Table III) to levy new taxes or increase rates of existing taxes are regarded as Additional Resource Mobilisation for the Plan. The adoption of norms, therefore, raises the question of the overlap of the spheres of jurisdiction between the Finance and the Planning Commissions. The terms of reference of the Ninth Finance Commission seem to hand over the whole question to the Ninth Finance Commission to decide.

The responsiveness of the Government of India to these two criticisms of the academic community and others interested has brought to the fore many far-reaching issues. How should the norms of tax and expenditure be arrived at? What will be the status of the norms to be laid down by the Finance Commission? If they are to be enforced in the States, what will be the machinery of enforcement? Will norms be laid down for the Centre also, and what will ensure their observance? Will there be a time-table of enforcement? If there are other authorities concerned with norms in these matters, how are their views and actions to be reconciled?

It is apparent on mature consideration that the norms laid down by the Finance Commission can only be for purposes of determining the principles and extent of devolution, and not for prescriptive purposes. There can be no insistence that these norms should be adhered to. Certain limitations follow from the quasi-judicial nature of the Finance Commission, others from its ad hoc nature. The Commission invites the views of different parties on a set of questions, listens to them, especially the Centre and State Governments, and submits its report. It does not discuss its views with concerned parties nor does it seek their acceptance by persuasion. There is no pretension of consultation. It relies for their acceptability on their nature of being an arbitration between the claims of contending parties, which have no other acceptable means of settling the issues. The Finance Commissions in general have not thought it worth their while to recommend specific grants except to a very limited extent, much less conditional ones. The returns on investment in Commercial Departments or State enterprises taken as fair have not materialized. The most important reason for the large gap between the State receipts and expenditures as worked out by the Finance Commissions on the basis of extremely limited application of norms and those assessed by the Planning Commission is that the norms are far from being realised. If there is a more extensive application of norms, the deviations might be greater. Insistence on their observance may be regarded as not only going against the spirit of healthy federalism but may lead to a break-down of the smooth process which has marked the gracious acceptance by the States of the Finance Commission's recommendations.

The Planning Commission proceeds about the business in a different manner and spirit. The Plan giving the broad objectives, the strategies and sectoral allocations is discussed at one or more NDC meetings where all the State governments are represented. The individual Plans of the States are discussed fully at meetings of the Planning Commission with the concerned States. The progress of the State with its Five Year Plan is reviewed every year at the time of the Annual Plan discussions. While there are all-India norms in matters like basic needs, it is realised that the detailed time tables for different States need variations in the light of their individual circumstances; Plan programmes like irrigation and power have different targets. The Planning Commission wields the weapon of Plan assistance which is given to the States on their Plan being accepted, but the role of Plan assistance in the formulation of State plans acceptable to the Planning Commission can be exaggerated. It is the country-wide acceptance of the Plan objectives, strategy and targets and the process of frequent discussions with the States of their plans in pursuance of common objectives that leads to agreed State Plans. Since the Finance Commission cannot by its very nature follow any such procedure, the norms it sets up can be only for the purpose of measurement. If a State raises less by way of taxes than it should according to the tax norm, it must be content with spending less; if it decides to have a higher standard of services, it must accordingly raise more. There is no question of interfering with the choices of the State's residents exercised through their chosen representatives, but the State must take the consequences of its choice. It cannot tax less than the norm, and give its citizens the benefits of services according to norm.

The logic and limitations of these permissive norms taken for the purpose of calculation in satisfying the cherished aspirations of the people must be recognized. The Constitution has made us long aspire for the countrywide acceptance of time-bound targets for ends like universal literacy, health for all, employment at a living wage, etc. These involve a simultaneous all-India pursuit of certain paths. The pressures, however, have to be slow and persistent, and have to allow for the varying circumstances and the cultural milieu of different peoples and States.

While it is clear that the normative approach the Finance Commission adopts cannot be prescriptive, one cannot be equally sure as to where exactly the norms should be laid down, and how the gap between the receipts and expenditures arrived at should be treated. Even the insistence on adoption of norms for limited purposes can sometimes compel an immediate setback. It is interesting to note that when the Fifth Finance Commission tried to broaden the adoption of norms, the States had to be rescued out of the consequences by grant of special accommodation loans to cover the non-Plan gap. If with the application of norms to the Centre there is a similar problem there, one does not know how the gap will be made good. This underlines the grave need for choosing realistic norms. If the taxable capacity of a State is determined as proportionate to State Domestic Product, a tax norm can be laid down at the percentage raised by the highest taxed States or near the lowest State, or somewhere midway between. The expenditure norm may be laid down in terms of the per capita or per unit cost of standards of essential services similarly arrived at. Much more sophisticated tax and expenditure norms are possible but may be inadvisable at this stage of our first efforts at normative approach. It may be found more practicable to divide States into groups and prescribe different norms for them.

By common consent we have the "special category States" which we exempt from the general formula of Plan assistance and treat differently. If the Finance Commissions did not follow the same procedure for tax-sharing and Article 275 grants, it was only because even in the case of other States covered under Article 275 they did not follow any general principles. The moment they adopt the normative approach they will have to recognize the distinction and treat them differently because of the nature of their terrain and the stage of their economic development. We can only hope that for all the States falling under this classification, a common treatment will be prescribed. Even in the case of Plan assistance the tendency to treat each special category State separately as a case in itself has led to some unnecessary vexation and resentment.

It has been increasingly realized that the Central budgets should, in principle, be subject to the same degree of scrutiny as the State budgets. Now that the normative approach is advocated for the States, it should also apply to the Centre. In the case of States an examination of the budgets *inter se* can greatly help the process of norm fixation, but the Central budget is a case *sui generis.* Its proper comparison is with national budgets of other countries which are very differently circumstanced, so that the comparison hardly helps. There are a few items like returns on capital lent and borrowed etc., where a treatment analogous to that of similar items in the States can help, but there are items like defence which have no parallel in State budgets. These are inherent difficulties which the Ninth Finance Commission should have been left to tackle. The Central Government has made its task more difficult by laying down that it should keep in view the special problems of each State and the special requirements of the Centre such as defence, security, debt servicing and other committed expenditure of liabilities. Was such a high-powered Commission ever likely to ignore the needs of defence and security? Was debt servicing qualitatively a different liability in the States than at the Centre? Committed expenditures or liabilities are the result of Central and State policies, which should be treated as they fall within or outside the norms. In what way are State liabilities and expenditures different from Central ones? These suspicions which, we are sure, would prove unjustified by the final outcome could have been avoided by a more careful choice of terminology.

While a Finance Commission can be expected to provide for the efficient discharge of the Central functions like defence there are others whose legitimacy will have to be critically examined in laying down norms of Central expenditure. The large sums spent by the Centre on items like agriculture and health, which are essentially State functions, for the purpose of co-ordination and research will need careful scrutiny. The expenditure on Central and Centrally sponsored schemes which are in the nature of conditional grants by the Centre to the States has assumed a dimension much beyond that sanctioned by the 1969 NDC resolution which laid down a ceiling on them of 1/7 to 1/6th of the total block Plan assistance to the States. In 1986-87, these amounted to 32 per cent of the total Plan assistance and 53 per cent of the total Plan grants to the States. They have also not been in accordance with the general principle of progressive transfers calling for an authoritative statement of the underlying first principles as well as their detailed application. The States also must be put in a position where they have to declare their stand categorically on this issue. As in the case of the States, laying down norms of Central expenditure will be only for purposes of determining devolution; they will not be prescriptive. They will take a lot of time and effort, but without such a procedure the normative approach will be one-sided and defective.

If the Central surplus so estimated equals or exceeds the sum of the States' gaps, a sigh of relief may be heaved. This does not take account of the difficulties involved in so evolving rational tax-sharing formulae that they will just fill in the gap and nothing more. If the gap still remains in the case of some States, Article 275 can be invoked if no self-denying restraints are put on its use. If a State turns out as surplus even before tax-sharing or becomes surplus after getting its share of Central taxes, that cannot be helped, but it will ensure that the States adopting norms laid down by the Finance Commission and getting Article 275 grants will all start more or less on the same equitable basis. In practice, because of various departures from the assumptions made here, the States will have large per capita surpluses and deficits, though their distribution may be very different and more rational than now. Devolution distribution will be more progressive. Hitherto, the successive distributions of Finance Commissions have been more progressive but it is a matter of gratification that they have been accepted even by the richer States. It is hoped that a further step in this direction will be accepted in the same spirit by the better-off States as the earlier ones. If, however, the Central surplus worked out according to norms is less than State deficits, the norms will have to be reworked so as to make the two equal.

The distinction between Plan and non-Plan revenue expenditure has been regarded by many as an artificial and misleading one. On the side of social services like education and health, a greater concentration on Plan expenditure has led to a wrong impression on the low importance being attached to them and a neglect of the significance of continuing current expenditure which has often escaped evaluation. It has also implied a critical neglect of maintenance, which is of as great importance as the Plan item of expansion. It must be agreed that Plan-non-Plan is only a classificatory device and putting an item in one box does not entitle it to greater consideration than all other items in the other box. At the same time, the difference between Plan and non-Plan is certainly meaningful and very different from revenue - capital. In the recent exercises of economizing, the zero budgeting technique can be applied more profitably to non-Plan expenditure as being of old vintage it is likely to have gathered much chaff. Plan expenditure items having been thought of more recently are likely to be more rational. Immediately, the more important issue is that in a Plan item often the revenue and capital components are intermixed, and one cannot be thought of without the other. Capital expenditure on a new school building and classrooms and revenue expenditure on salaries of teachers are both internal parts of the same Plan. The latter cannot be incurred without the former having been sanctioned nor the former justified before the latter is assured. The Ninth Finance Commission will have to bear in mind this practical need in fully considering the entire revenue budgets. It cannot resort to the easy device of adopting the capital Plan of the Planning Commission and add a revenue complement, as the time tables of the two bodies rule it out. Any attempt to deal with a part of the need for expansion of developmental services will lead to a dual authority and a break in the complex considerations that the Planning Commission has evolved in agreeing to the sectoral distribution of increased current expenditure. In the current situation of a resource-scarce economy the duplication will be unduly costly.

If the Finance Commission in its wisdom decides to take within its fold all revenue receipts including additional resource mobilization and current expenditure, an interesting possibility will arise. The Planning Commission will be left only with the capital side. The Long Term Fiscal Policy had recognized as a harsh reality that as far as the Centre was concerned, there were hardly likely to be any non-Plan surpluses in the Seventh Plan and therefore Central Plan and Central Plan assistance had to be financed from borrowing, deficit financing and surpluses of public sector. The Finance Commission has been asked to keep in view the objective of not only undertaking balancing receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment. That does not seem to be possible; but can the job of capital balancing be more appropriately left to be dealt with in detail by a National Development Bank with quasi-commercial pretensions? An alternative line of thinking to satisfy critics, who would like to see the poorer States obtain more per capita development funds so that the development gap between them and the richer States is narrowed, would be to give capital assistance on the same line as Finance Commission's assistance on the basis of norms i.e. developmental needs and money that can be raised by themselves for development. The Gadgil formula of Plan assistance in operation now is less progressive than the Finance Commission's devolution, but it has been adopted after a long history of struggle against arbitrary ad-hoc formulae of schematic Plan assistance. The acceptability of a formula follows from its being recognized as fair by all. While an extreme equality is unlikely to be accepted as a goal by richer States which have backward areas of their own, they have already agreed to a revision of the Gadgil formula favouring the poor and may be persuaded to do more. A Finance Commission has more freedom in the matter because having submitted its report it dissolves itself. The dissatisfaction with its recommendations, the resentment against it disappear in the absence of a target. The next Finance Commission has an entirely different personnel, and grievances cannot be built up. Even then the Finar ce Commissions have been cautious and have recognized the need of wide acceptability of their recommendations. At the NDC meetings, before and after, there will be a lot of negotiations, bargaining, persuasion, pressures and counter-pressures. This makes the process slower, but the acute problems likely to arise out of the possible rejections of recommendations of the Finance Commission are avoided.

The Fifth Finance Commission which was asked to go into the question of unauthorized overdrafts of States came to the conclusion that an important reason for the States drifting into this position was the absence of a machinery to look into the non-Plan capital gaps of the States, and provide for remedial action. Ever since then, the Finance Commissions have been asked by an additional term of reference to look into this problem. As a result, they have recommended some rescheduling which has helped States avoid overdrafts. The situation calls for a more radical readjustment in the terms of various Central loans to States, but till that is possible, the present process should continue. We hope the absence of an explicit reference to suggestions regarding filling up non-Plan capital gap and a specific requirement to suggest corrective measures keeping in view the financial requirements of the Centre will not prevent the Commission from recommending debt rescheduling, if needed.

The Constitution lays down that a Finance Commission shall be appointed every five years or earlier. This has generally been taken to imply that the recommendations of the Finance Commission will hold sway for a maximum duration of five years. The Ninth Finance Commission appointed in June, 1987 has been asked to make two reports, the first covering a period of one year 1989-90 by 30th June, 1988, and the second for a period of five years commencing 1st April, 1990 by 30th June, 1989. Normally the Tenth Finance Commission will be appointed by June, 1993. The interval both between the appointments of successive Finance Commissions and the effective date of the implementation of their reports will be six years instead of five. This has been done to synchronize the end of the Ninth Finance Commission's recommendations with the completion of the Eighth Plan. But it has raised a technical anomaly. We hope a mountain will not be made out of a molehill.

The States have been sore on the question of operation of additional excise duties levied in lieu of sales tax on sugar, textiles and tobacco. They feel that if they had kept this right with themselves, they would have obtained more revenues. The Centre has agreed to this demand but not abided by the agreement and is not willing to go back to *status quo ante.* This matter has been debated again and again. The Central Government feels that the charge against it of increasing basic excises without increasing additional ones can be automatically met if the two were merged and the States got a fixed proportion of the total. The Finance Commission has been asked to examine its feasibility. The States have taken this proposal as the thin end of the wedge as a precursor of the adoption of the Kamalapati Tripathi Committee's recommendations in some form and an infringement of their Constitutional right to levy a sales tax. This misunderstanding could have been avoided by prior consultation and even now by a declaration that no action would be taken on this issue without a discussion at the NDC. It is hoped that the Ninth Finance Commission will take a cue on this from the Fifth Finance Commission's recommendation on a parallel issue.

There are various issues of Centre - State financial relationships where the Centre has necessarily the final voice but which vitally affect the States. Where the power to levy a tax lies with the Centre, whether to levy the tax and its structure are decided by the Centre, but these have a vital impact on the States. The Centre decides whether and at what rate to levy any of the taxes under Article 268 or 269, the proceeds of which go entirely to the States. In case of commodities where the Centre is the sole producer, it has wide discretion in whether to get more Planresources through a price rise or through an increase in Central excise rate. If it decides on the former, the States get no share in increased profits and corporation tax revenues; if the latter, the States will get 45 per cent. A convention could be established that where a public enterprise is already making a profit there will be no price increase in its product; there will only be a greater excise tax, if need be. A tax free public sector bond has an unfair advantage over a State enterprise bond, though a large part of the cost of concession in direct personal taxation is borne by the States. Decisions regarding investment of many funds which lie with the Centre can substantially affect small savings. There are many such instances where the State interests and attitudes differ widely from those of the Centre and there should be some forum for harmonization. The intermediation of the Finance Commission has been suggested for this purpose, but an inter-State Council may be much better. The Finance Commission should not be used for this purpose as its recommendations in these matters may not carry the weight they should. It is of utmost importance that only where consensus of opinion is likely to emerge, the mechanism of the Finance Commissions should be used. At the minimum, we hope that in future the Central government will take care to refer to the Finance Commission only those additional matters on which the States have agreed for a reference.

I have tried to lay before you the main issues, as I see them, which will have to be decided by the Ninth Finance Commission. With your scholarship and experience you will not only raise some more but also help in suggesting the detailed lines on which they can be tackled in the interests of the National economy.

Table 1
Per Capita Non-Plan Surpluses of States
(As Estimated by the Eighth Finance Commission)

	State	Per capita income at current prices (Rs) 1985-86	Eighth Finance Commission (1984-89) Surplus			
			Before Devolution		After Devolution	
			Amount (Rs. crores)	Per Capita (Rs.)	Amount (Rs. crores)	Per Capita (Rs.)
I.	**Major States**					
	Punjab	4,416	1,147.55	610	1,758.70	935
	Haryana	3,669	965.95	635	1,393.92	917
	Maharashtra	3,430	3,790.48	535	6,407.78	904
	West Bengal	2,813	-3,034.33	-494	-213.71	-35
	Gujarat	2,772	1,034.13	269	2,451.31	638
	Tamil Nadu	2,353	774.12	145	3,217.19	602
	Kerala	2,287	-635.43	-225	623.51	220
	Andhra Pradesh	2,184	-845.98	-141	1,908.80	319
	Karnataka	2,136	351.71	83	2,064.68	489
	Rajasthan	2,043	-1,240.63	-308	307.25(a)	76
					-9.70(b)	-2
	Assam	2,017	-1,444.46	-634	-192.79	-85
	Madhya Pradesh	1,988	-801.77	-135	1,986.34	334
	Uttar Pradesh	1,988	-2,113.59	-168	3,802.01	303
	Bihar	1,548	-3,152.50	-397	853.32	107
	Orissa	1,534(c)	-1,663.80	-566	-102.20	-35
	TOTAL for I		**-6,868.55**	**-96**	**26,256.41**	**367**
II.	**Other States**					
	Nagaland	2,931(e)	-484.04	-5,378	-158.57	-1,762
	Himachal Pradesh	2,542	-713.77	-1,487	-183.08	-381
	Manipur	2,200(c)	-422.73	-2,642	-123.55	-772
	Jammu and Kashmir	2,173	-995.39	-1,464	-257.18	-378
	Meghalaya	1,391(d)	-341.30	-2,133	-98.42	-615
	Sikkim	1,300(e)	- 92.65	-2,316	-29.13	-728
	Tripura	1,206(f)	-502.46	-2,094	-144.79	-603
	TOTAL for II		**-3,552.34**	**-1,996**	**-994.72**	**-559**
All India (I+II)		2,596	-10,420.89	-136	25,261.69	331

Ranked by per capita State Income:

(a) For 1984-85
(b) For 1985-89
(c) Relates to 1984-85
(d) Relates to 1982-83
(e) Relates to 1983-84
(f) Relates to 1980-81

Sources: 1. Central Statistical Organisation, **Estimates of State Domestic Product: 1970-71 - 1985-86,** New Delhi, June, 1984.

2. Report of the Eighth Finance Commission: 1984.

Table 2
Per Capita Development Expenditure : 1985-86 (RE)
(Revenue and Capital Accounts Combined)

	States	Development Expenditure Rs. crores	Per capita (Rs.)
I.	**Major States**		
	Punjab	1,054	579
	Haryana	802	553
	Gujarat	1,965	531
	Maharashtra	3,333	487
	Andhra Pradesh	2,596	449
	Kerala	1,225	447
	Karnataka	1,690	417
	Assam	883	405
	Madhya Pradesh	2,121	373
	Tamil Nadu	1,916	371
	Orissa	1,025	361
	Rajasthan	1,345	352
	West Bengal	1,821	308
	Bihar	1,965	258
	Uttar Pradesh	3,108	258
	TOTAL for I	**26,849**	**375**
II.	**Other States**		
	Sikkim	86	2,150
	Nagaland	175	1,944
	Manipur	164	1,025
	Meghalaya	146	973
	Jammu & Kashmir	620	954
	Tripura	210	913
	Himachal Pradesh	388	843
	TOTAL for II	**1,789**	**1,005**
	TOTAL for (I+II)	28,366	386

Ranked by last column.
Source: Reserve Bank of India Bulletin, Bombay, November 1986.

Table 3
Tax Revenues as Percentage of State Income: 1985-86 (RE)

		Per capita State income at current prices (Rs.) 1985-86	State's own tax revenue 1985-86 (RE)		Per capita revenue
			(Rs.) crores	as % of per capita State income	
I	**Major States**				
	Karnataka	2,136	1,101.22	12.7	272
	Tamil Nadu	2,353	1,520.11	12.5	294
	Andhra Pradesh	2,184	1,451.60	11.5	251
	Kerala	2,287	695.60	11.1	254
	Gujarat	2,772	1,051.99	10.3	284
	Maharashtra	3,430	2,292.23	9.8	335
	Haryana	3,669	499.22	9.4	344
	Punjab	4,416	646.50	7.6	335
	Madhya Pradesh	1,988	837.87	7.4	147
	Rajasthan	2,043	564.64	7.2	148
	Orissa	1,534(a)	296.04	6.8	104
	West Bengal	2,813	1,085.38	6.5	184
	Uttar Pradesh	1,988	1,269.84	5.3	105
	Bihar	1,548	573.82	4.8	75
	Assam	2,017	194.99	4.4	89
	TOTAL for I		**14,081.05**	**196**	
II.	**Other States**				
	Sikkim	1,300(c)	4.64	116	8.9
	Jammu and Kashmir	2,173	103.45	159	7.3
	Meghalaya	1,391(b)	12.05	88	6.3
	Himachal Pradesh	2,542	70.53	153	6.0
	Nagaland	2,931(c)	9.48	105	3.6
	Tripura	1,206(d)	8.45	37	3.1
	Manipur	2,200(a)	7.33	46	2.1
	TOTAL for II		**215.93**		**121**
All-India (I =II)		2,596	14,296.98	7.5	195

Ranked by last column:

(a) Relates to 1984-85 (c) Relates to 1983-84

(b) Relates to 1982-83 (d) Relates to 1980-81

Sources: 1. Central Statistical Organisation, **Estimates of State Domestic Product**: 1970-71 - 1985-86, New Delhi, June, 1987.

2. **Reserve Bank of India Bulletin**, Bombay, November 1987.