D : THE NORMATIVE APPROACH

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New Approaches for the Ninth Finance Commission : Some Possible Options

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Introduction

The main duty of the Finance Commission under the Constitution is to make recommendations in regard to the distribution between the Union and the States of the net proceeds of certain taxes, the allocation between the States of such proceeds and the grants-in-aid of the revenues of the States which are considered to be necessary. The submissions to the Commission by the different States will focus on these substantive issues. In this paper, we are however, not discussing these substantive issues but the approach that the Ninth Commission may be called on to adopt in considering these issues in the light of certain significant changes that have been incorporated in the terms of reference of the Ninth Commission as compared to the terms of previous Commissions. A somewhat similar situation was considered by the Seventh Commission and it took the view that "the Commission's freedom to take into account other factors is not inhibited"[1]. Our submission in an earlier paper has been that with the use of the word "shall" in para 4 of the terms of reference without the qualification "among other considerations" the Ninth Commission has in fact been so inhibited. But as pointed out by the Seventh Commission "the Commission's discretion in the matter of making recommendations on these matters is not limited in the Constitution". Our submission is that what is not limited

in the Constitution can not be limited in the terms of reference. We would therefore urge that just as the Seventh Commission took the view that "the contents of paragraph 5 of the Presidential Order were not constraints on the Commission in any way", the Ninth Commission also should specifically take the view that para 4 of the terms of reference can be taken as a guideline and not as a direction and that the Commission has the power to modify the terms of this paragraph in such a manner as it may consider fit, either in its own discretion or as a result of the submission made by the various State governments.

We would suggest that the first modification that the Commission should in its own discretion make to para 4 of the terms of reference is to so interpret and, if necessary, even amend it, as to make it equitable as between the Union government on the one hand and State governments on the other. There are two important aspects in which para 4, as now worded, discriminate against State governments. First, under para 4(i), while the Commission has been asked to adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre, it has also been asked in doing so to keep in view "the special problems of each State, if any", in the case of the Centre it has been asked to keep in view, among other things, committed expenditure or liabilities. This could mean that while in the case of the States, certain items of committed expenditure could be ignored on the ground that they do not fulfill the requirements of such norms as the Commission chose to adopt, the Commission will be forced to take all committed expenditure of the Centre into account irrespective of whether it satisfies any norm not. We shall be dealing later with the problems involved in adopting the negative approach in regard to committed expenditure. But quite apart from the problems, considerations of equality of treatment between the Union government on the one hand and the State government on the other require that the Commission should adopt the same standard for both. If therefore, the committed expenditure or liabilities of the Centre are being taken into account, similar expenditure or liabilities of the States should also be taken into account.

The Commission has pointed out in a letter to the State governments that, "as things stand today the surplus on revenue account is negative". The Commission then goes on to suggest certain measures by which this situation can be remedied and mentions, by way of example, reduction in staff and cut in subsidies. Dandekar also expressed the view that "the transfer of resources from the Union to the States can not also be pushed much further without enlarging inflationary deficits in the Union accounts"[2]. While this is generally true, it has to be pointed out that at least a part of the deficit of the Union is due to its excessive expenditure on items which are really the responsibility of the States under the Constitution. In this context it becomes necessary to point out that the Commission should take into account the committed expenditure or liabilities of the Union only in regard to those subjects which fall within the purview of the Union under the Constitution. There is no reason why what really represents an encroachment by the Union upon the jurisdiction of the States as laid down in the Constitution should be perpetuated by being accepted as a committed expenditure or liability of the Union. Gulati and George have observed that "what seems to be called for is to move away from commitment to existing patterns and levels of committed expenditure at the Centre or in the States and an effort towards the effective realisation of distribution of responsibilities between the Centre and the States as originally envisaged in the Constitution"[3]. Even if this task is not done in its totality, at least in respect of the committed expenditure in the Union budget which pertains to subjects which are in the States' list, the Finance Commission should take a view that it need not accept these commitments in the same manner as it may feel called upon to accept the commitments of the Centre in regard to its legitimate field such as national security, etc. The Commission could thereby help in correcting the distortion in the distribution of expenditure between the Union and the States that has come about quite contrary to even the existing provisions in the Constitution.

The other aspect in which para 4 deals differently with the Union government and the State governments is in regard to

para 4(ii) and 4(iii). These paras deal with resource mobilisation, financial discipline and the need for speed, efficiency and effectiveness of government functioning. The present wording is such that there is room for doubt whether these two items are to apply to both the States and the Centre. The Commission should, in fairness, interpret these two items so as to make them applicable to both the States and the Centre.

The Normative Approach

A norm can be of two types: one, a norm for measurement or judgement and the other, a prescriptive norm. A measurement norm is meant to evolve some objective criterion by which several disparate items can be measured and thereby compared. A prescriptive norm, on the other hand, is a standard which is selected as something which ought to be achieved. The subjective element would be much greater in a prescriptive norm than in a measurement norm. The problems involved in evolving either of these norms in the case of resources are much less complicated than in the case of expenditure. Methodologically, there may be quite a few technical problems in evolving norms for resource mobilisation also. But there would not be much difference of opinion or controversy about selecting a prescriptive norm for resource mobilisation. The difference between different States and considerations such as their level of development etc., would be taken into account, in any proper exercise, in the methodology for estimating their revenue potential. But, given a certain potential which would naturally differ from State to State, to expect that a certain given percentage of this potential ought to be tapped would not be too controversial. In this paper we propose to deal more with the approach to be adopted in evolving norms rather than with the actual methodology. We shall therefore not deal with norms for revenue resources but will concentrate on norms for expenditure.

The task of a Finance Commission in assessing the receipts and expenditure on revenue account generally has two aspects; one is to establish the base level and the other is to make

forecasts for the period covered by the award. Previous Commissions have generally taken the committed expenditure, subject to certain scrutiny and adjustment, as the base level. But for their forecasts for the award period they also followed a kind of normative approach. Given the present terms of reference the question would be as to how the normative approach will be applied to the committed expenditure at the base level itself. According to the wording of the terms of reference as they stand, committed expenditure of the States need not be taken into account. But we have suggested above that the Commission should, in its discretion, modify these terms of reference so as to take into account the committed expenditure or liabilities both for the States and the Centre. We are aware of the fact that taking into account committed expenditure may result in some inequity between the poorer and more backward States and the prosperous and more developed States, in that the latter have reached a higher level of committed expenditure and this higher level gets built into the forecasts, if it is accepted as the base level. Even so, there will be difficulties in finding any alternative approach that would be both reasonable and generally acceptable. We cannot have a situation where a normative approach applied to the base level will result in a State stagnating at the present level merely because its committed expenditure is already higher than the norm. Just as in the case of egalitarian policies in society, so also here, any practical approach to greater equality between different entities can be based only on differential rates of growth for the future and not either on a net negative rate of growth or even on stagnation by those who might have already reached certain higher levels. As Dandekar points out, "the indirect transfer of resources from the better placed States to the poor States has been achieved with admirable approval of even the States which lose in the process. But again this cannot be pushed much further without raising a protest from the more developed States which must be avoided"[4]. We have therefore to consider how the normative approach will be reconciled with the level of committed expenditure.

The evolution of a norm has three aspects: one, specification of the items, two, the level and three, the per unit cost. Of these three the simplest would be the per unit cost because this can be worked out by comparing the costs for the same unit in different States and taking either the average or the most efficient cost. The problems of judgement really would arise in regard to the other two aspects. If the normative approach is applied fully to the base level itself, ignoring committed expenditure, it might mean that a judgement is being made in regard to items of revenue expenditure already incurred. The committed expenditure represents the socio-economic judgement of a duly elected government; to say that some of the items already committed would not be taken into account in calculating expenditure would amount to sitting in judgement over the actions of a competent and duly elected government. In making forecasts for the award period the norms for the rate of growth of different items can be differentially set. This also would involve an act of judgement on the part of the Commission, but this is a judgement for the future and not a judgement on an action already taken by a competent authority. This judgement will be made in coming to a decision regarding devolution; in other words the Commission would in effect be saying that the devolution recommended by it is related to what it considers necessary for achieving certain norms during the forecast period. This would not prevent the duly constituted government from taking other decisions, so long as they are able to raise other resources to implement those decisions and this would then come under the item in the terms of reference which requires linking of expenditure and revenue raising decisions. We would therefore urge that for the base level, by and large, committed expenditure should be taken into account. This does not mean that no judgement will be exercised. A broad normative approach can be applied to this also, but this should be only to the extent of judging *inter se* levels of different States and not by way of exercising a value judgement on what the State governments might have done in pursuance of certain policy decisions of theirs. Whatever correction is found necessary, as a result of different States being at different levels at the base level, it

should be achieved by assuming different rates of growth during the forecast period.

This approach would assume that resources have been found for the base level of expenditure including existing devolutions, i.e., there is no deficit on revenue account. To the extent there is a deficit a correction can be made either in the expenditure or the revenue assumed. In other words, the Commission would be accepting that it is the prerogative of the State government to determine its own pattern of expenditure to the extent that resources have been found but not where such expenditure is in excess of resources. In matching expenditure and resources also a judgement would be involved, but that would be a legitimate exercise of discretion. To this base level the norms evolved by the Commission would be applied to see whether an individual State is above the norm or below it. This factor would then be taken into account in deciding future devolutions. In this the Commission would also have a make a judgement about the period of time in which they would expect the imbalances in the base level to be corrected. In other words the correction of the imbalances between States at the base level would be the chief determinant of the decisions regarding future devolutions and grants-in-aid. This would involve assuming lower rates of growth for some items for some States which might have already reached higher levels but it would not mean that any item of committed expenditure is altogether left out of consideration. To put it somewhat loosely, this would mean that the Commission would encourage some States in some aspects and dampen some others in other aspects, but would not act in such a way as to give the impression that it is putting the stamp of approval or disapproval on specific acts or schemes of States or that it is negating the specific actions of any particular State. The norms chosen by the Commission should be taken only as the criteria selected by it for determining the *inter se* distribution of resources between States and not as a judgement on the decisions of State governments in regard to various items of revenue expenditure.

In regard to norms different views have been expressed. Thimmaiah has taken the view that "it would be better to cover all items of expenditure under the revenue account leaving out only the uncommon items"[5]. On the other hand Lakdawala took the view at a seminar in Hyderabad, that the norms should be aggregate norms which are generally acceptable and not norms for individual items[6]. Where norms are selected for purposes of *inter-se* judgement only, they can be norms for broad categories because they are meant only as tools for helping to arrive at a just and rational decision regarding the transfer of resources. But if the norms are taken as what we have called prescriptive norms then this would create a problem. It is easy to select norms for any expenditure item and work out the unit cost on the basis of previous experience or even on a normative basis. But the achievement of the norm does not depend merely on the expenditure of the unit cost. There are many steps in between which cannot obviously be spelt out in a norm. For instance, for primary education the norm can be based on the number of teachers required or on the number of children in the relevant age-group etc. But the achievement of any target of education requires several detailed decisions. Obviously the Finance Commission cannot go into such details without becoming a Planning Commission. For the same reason, the condition stipulated in para 4 (iii) is also almost impossible to fulfil. Here again the process of financial transfers can merely ensure a certain administrative framework which is considered necessary for fulfilling a particular task. It is not possible to say whether, having set up such a machinery, it would function with "speed, efficiency and effectiveness". Even after adequate money is provided for the minimum machinery considered necessary, there are so many other factors involved in speed, efficiency and effectiveness that it is not clear how the Finance Commission will be able to ensure these. Obviously, the terms of reference envisage that the Finance Commission will function not merely as the Planning Commission for the revenue plan but also as a programme evaluation organisation.

Even if the norms evolved are made conditional, there are practical difficulties in ensuring that the conditions are observed. In the past the grants for upgradation of levels of administration had been made conditional in this manner, but the experience of both the achievement and the monitoring in this regard has not been happy. It cannot be said that the difference in levels of different States in regard to items for which specific grants had been given has been reduced. If now we take up not merely certain selected items but the entire revenue expenditure, the monitoring will become a monitoring of the entire budget of the State. There is no machinery which can undertake such a monitoring. The Finance Commission is itself not a continuing body. If this task is left to the Union Finance Ministry we would be giving the Union government a power and a role in regard to State budgets which the Constitution itself has not given it. In practical terms also the task will be so complex that it will degenerate into a token exercise except in cases where, for political reasons, the Union government would like to use this as a means of exercising control over some State government. Now that the distinction between Plan and non-Plan has been removed, it can be argued that the monitoring in regard to certain Plan targets at least can be done by the Planning Commission. But this raises issues regarding the respective roles of the two Commissions which are discussed later.

The task before the Commission is to decide the devolution of certain taxes as well as grants-in-aid of revenue. To do this a certain judgement is necessary on the part of the Commission in regard to the resources and the requirements of the Union and the States. Based on such a judgement the Commission will provide resources to different States for achieving certain levels in regard to different items of revenue expenditure. The normative approach is a tool or a method which can be used in making such a judgement and may be an improvement over the attempts made in this regard by previous Commissions. The Commission will naturally spell out the normative approach it has adopted and this would itself be a

guideline and an incentive for utilising the devolved resources and grants-in-aid for this particular purpose. But it would not be admissible to go beyond this and make the transfer of resources conditional on the achievement or observance of certain norms since this would go against the spirit of the Constitution. It can be argued that the legal difficulty involved in making devolution conditional can be got over by attaching the conditions to grants-in-aid. It is well known that the extent of devolution and the magnitude of grants-in-aid are inversely related - the larger the devolution the lesser the need for grants-in-aid. The objection to devolutions across the board has been that they can be regressive, in that they benefit the prosperous States as much as they benefit the poorer States, despite any corrective mechanism that may be introduced in the formula for distribution. On the other hand the advantage of devolution is that it is unconditional and elastic whereas grants-in-aid would be restrictive and inelastic. The relative role of devolutions and grants-in-aid in the total transfers has been an issue to which every Commission has addressed itself. The Seventh Commission had noted that the States had "stressed the point that the fiscal transfer should be affected mainly, if not wholly, through devolution of taxes".

We are clearly of the view that the grants-in-aid element in the transfer scheme should as far as possible be a residuary item and the attempt should be to make the bulk of the transfers through tax sharing. It would therefore be a short sighted policy and contrary to the spirit of the Constitutional provisions to deliberately increase the role of grants-in-aid merely to acquire the right of making the transfers conditional.

Plan and Non-Plan Revenue Expenditure

Item 4(i) of the terms of reference of the Commission states that the Commission shall "adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre". The corresponding provision of the terms of reference of the Eighth Commission

mentions "requirements on revenue account of States for non-Plan expenditure". Because of this difference of the wording of this particular clause it has been rightly inferred by the Commission that it "has been asked to consider the total receipts and expenditure on the revenue account without any distinction between the Plan and non-Plan". In its letter to the State governments the Commission has stated that "this means that the Commission will have to get an idea of the revenue component of the next Plan as well as the contemplated additional resource mobilisation efforts". The implication of this is that these two will be incorporated in the Finance Commission's forecasts for revenue receipts and expenditure and then a normative approach will be applied. This will mean that the assistance required for the revenue component of the Plan will now be covered by the devolutions and the grants-in-aid recommended by the Finance Commission. In that case the Gadgil Formula will have to be replaced since there would be no need or justification for a 30 per cent grant component in the Central Plan assistance and the residuary part of the Plan will be only its capital component. There are, however, practical difficulties in such a procedure being adopted since this will require the work of the Eighth Plan to be finalised before the Ninth Finance Commission completes its work. The normal schedule of work of these two is such that it would be difficult for this to be done. But, more importantly, the Eighth Plan work, if it is to be done on the present basis, cannot be completed unless the award of the Ninth Commission is known since this will determine both the resources of the States and the magnitude of Central assistance. We will then be caught in a vicious circle - the Eighth Plan cannot be formulated unless the award of the Ninth Commission is known, while this award can not be finalised till the Eighth Plan outlays are known. The abolition of the distinction between the Plan and non-Plan revenue expenditure cannot therefore be done without a fundamental change in existing procedures of Plan formulation and in the relative roles of the Finance and Planning Commissions.

This difficulty can be got over by interpreting the terms of reference in such a manner that the present procedure can be reversed. After all the terms of reference merely stipulate that the Commission shall adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre without any specific mention of Plan or non-Plan expenditure. They do not suggest any particular procedure regarding the manner in which the consequences of this abolition would be dealt with. It is the Commission that has drawn the inference that the abolition of this distinction will mean that the revenue component of the Eighth Plan as prepared by the Planning Commission, as well as the contemplated additional resource mobilisation for that Plan will have to be taken into account while making its own recommendations. Therefore the Finance Commission is free to adopt any procedure so long as it takes all revenue expenditure into account and adopts a normative approach. We have discussed above how the normative approach can be applied to the committed expenditure at the base level. At the base level we have both non-Plan and Plan committed expenditure. In the previous procedure the committed expenditure in respect of the Plan was treated on a separate footing and after a measure of scrutiny, it was added on to the expenditure at the base level so that for the forecast period it became non-Plan expenditure just as the other items. Now that there is no distinction between Plan and non-Plan such a separate treatment would not be necessary. The entire committed expenditure, both Plan and non-Plan can be examined with reference to such norms as the Commission may select. The forecast for the period of the award can also be made on this basis without making any such distinction. The Commission would be free to adopt such norms as it considers desirable in respect of all items of revenue expenditure without any distinction of Plan or non-Plan. We have suggested earlier that the Commission should set itself a modest objective for the task with which it is concerned viz: the correction of imbalances between the States at the base level. These imbalances are so substantial, and the total resources likely to be available for transfer to the States are so

limited, that it would not seem possible to correct the existing imbalances within the period covered by this award. Therefore some modest target will have to be set for this period by the Finance Commission taking all these factors into account.

According to this procedure the Plan will be finalised subsequently by the Planning Commission. They will have before them the award of the Finance Commission, which, unlike the awards of the previous Commissions would cover some sectors which traditionally form part of the Plan. The norms adopted by the Commission and the transfer of resources made by them on the basis of such norms would become the minimum targets for these sectors, so far as the Planning Commission is concerned. Nothing, however, prevents the Plan exercise from attempting to do more than what these norms anticipate, if additional resources can be found for this purpose either by additional resource mobilisation by the States or by further Plan transfers from the Centre to the States through the Planning Commission. The terms of reference have removed the distinction between Plan and non-Plan on the revenue side but this need not be interpreted to mean that in the succeeding Plan nothing can be done over and above what the Finance Commission may have taken into account in arriving at its own forecast of revenue expenditure.

In regard to the distinction between Plan and non-Plan in so far as revenue resources are concerned, it is interesting to note that the Eighth Commission also was asked to take into account the "revenue resources of the State including targets set for additional resource mobilisation". On the resources side therefore there was, even then, no distinction of Plan and non-Plan as there was on the expenditure side. The Ninth Commission has in its letter specifically taken note of the fact that, "the Eighth Finance Commission was also asked to keep in view the additional resource mobilisation efforts for the Plan". It is surprising that the Commission should quote the terms of reference of the Eighth Finance Commission and yet draw the inference that the additional resource mobilisation refers to "contemplated additional resource mobilisation efforts". The

significance of the mention of the "targets set for additional resource mobilisation for the Plan" was discussed in great detail in the report of the Eighth Commission. There was some difference of opinion between the members of the Commission in this regard but the entire discussion related to additional resource mobilisation during the Sixth Plan period and not to such additional resource mobilisation contemplated for the forecast period for that Commission viz., the Seventh Plan period. The Eighth Commission came to the conclusion that "the only possible interpretation of these words is that the targets set for the annual Plan for 1983-84 had to be taken into account". That means they were taking into account the additional resource mobilisation during the Sixth Plan period and not such additional resource mobilisation contemplated for the forecast period by the Commission viz., the Seventh Plan period. The Eighth Commission came to the conclusion that "the only possible interpretation of these words is that the targets set for the Annual Plan for 1983-84 had to be taken into account". That means they were taking into account the additional resource mobilisation for the base year and not for the forecast period. It is therefore not clear on what basis the Ninth Commission has inferred that the abolition of the distinction between Plan and non-Plan means that "the contemplated additional resource mobilisation efforts" should be taken into account. No doubt, if a State's effort happens to be below any norm that the Commission may adopt under the normative approach, then that State would, by inference, have to undertake additional resource mobilisation in order to come up to the norm adopted. But we cannot reverse this position and assume that there is some additional resource mobilisation for the Eighth Plan which the Ninth Commission has to take into account in fixing its own norm. On the revenue resources side also, therefore, the normative approach will require that the Finance Commission finish its work first on a normative approach before the Planning Commission finalises the Eighth Plan rather than vice versa.

The Roles of the Finance and Planning Commissions

The argument so far proceeds on the assumption that the respective roles of the Finance and Planning Commissions remain what they have been. Now that the Ninth Finance Commission, according to its terms of reference, has to take into account Plan revenue expenditure also, there is no valid reason for making this assumption and then trying to see how best the work of the two Commissions can be coordinated. The Commission has also been asked to keep in view the objective of generating surpluses not for the "Plan" but for "capital investment". This, taken with the modifications in the terms of reference of the Ninth Commission compared to those of earlier Commissions, provides a sufficient basis for this Commission to take the view that it can cover the entire Plan revenue expenditure and leave to the Planning Commission only the task of planning capital investment. If the Finance Commission chooses to take such a radical view of the opportunities provided by its terms of reference, there may be a considerable body of opinion that would support such a modification in the relative roles of the Finance and Planning Commissions. There have been criticisms, from time to time in the past, of the fact that the Planning Commission is only a wing of the Union government and is not a statutory body like the Finance Commission. In the latest of these criticisms Dandekar has observed that, "the Planning Commission - leaves for (the States) hardly any sphere which they may call their own - the successive Planning Commisions have imposed and promoted unitary elements into the system"[7]. Apart from such criticism of the method of functioning of the Planning Commission, there has also been a view that while the transfers recommended by the Finance Commission are statutory in nature, the Central assistance distributed by the Planning Commission is purely discretionary, even though a major portion of it is regulated in accordance with the Gadgil Formula. The effect of bringing Plan revenue expenditure within the purview of the Finance Commission would therefore be to enlarge the sphere of statutory transfers and to that extent restrict discretionary transfers. The only argument against

enlarging the scope of the transfers through the Finance Commission used to be that these tend to be regressive in character. But even here the view has changed and as Gulati and George point out, "It must be said to the credit of the recent Finance Commissions that progressiveness of statutory transfers has been improving compared to that of Plan assistance". Even after pointing out that the non-Plan surpluses of the States have "tended to be extremely regressive" they go on to say that, "the Finance Commission cannot simply get away by saying that its task is only to meet non-Plan deficits and that the Planning Commission is to be concerned with Plan finance"[8]. With the present terms of reference the Ninth Finance Commission certainly cannot take this view.

Therefore there would be a considerable body of opinion that would support any initiative taken by the Ninth Commission to so interpret its terms of reference, particularly the normative approach taken with the removal of the distinction between Plan and non-Plan revenue expenditure, as to cover the whole revenue component of the Plan. In this view of the matter the Finance Commission need not wait for the Planning Commission to plan exercises and take into account the revenue component as formulated by the Planning Commission. It can extend the scope of its normative approach to cover the entire revenue component of the Plan in its own forecasts and recommendations. The Planning Commission would then be concerned only with the capital component of the Plan and, if it is so desired, it can prepare an overall plan of which the two parts would be the revenue component as recommended by the Finance Commission on the basis of its normative approach and the capital component as formulated by the Planning Commission itself.

There may be no theoretical objection to such an approach but, as pointed out earlier, there would be certain practical difficulties in view of the fact that the Finance Commission is not a permanent continuing body. The normative approach that the Finance Commission can adopt, in the limited time available to it, will not be able to cover all the details

that would be necessary for the norm to be converted into practical schemes. The finalisation of such details requires not only time but an iterative process with the States. The nature of the discussions which the Finance Commission has with the States is different from those which the Planning Commission has and these may not be sufficient for formulating detailed schemes intended to make the norms operational. Of course, a view can be taken that it is precisely these details that the Centre should try not to work out or dictate. Dandekar specifically makes the point that "a Planning Commission should function and perform in essentially the same manner as does the Finance Commission"[9]. If such a view is taken then this particular objection would have been met. The Finance Commission would merely prescribe broad norms and make devolutions and grant-in-aid on that basis and it would be left to the States to work out the details necessary for achieving the stipulated norms.

Another objection to this procedure could be that it is not possible to divorce the revenue component of the Plan totally from capital investment. There are several items in the revenue component which will require corresponding capital investment for their fulfilment; for instance under health, the staff will be in the revenue budget while the buildings would be in the capital budget. This would be true of most of the sectors. This, however, need not be an insurmountable difficulty. A provision can be made that, in preparing the capital Plan, the Planning Commission will first take into account the capital requirements of the revenue component of the Plan as recommended by the Finance Commission. Notwithstanding this, a view can be taken that this would not be the best way of planning for the development either of a State or of the country. It can be said that a more rational and logical way of planning would be to take an overall view of the resources available after meeting commitments at the existing level and then decide on the priorities. These priorities would then dictate how much of the Plan outlay would be required for expenditure of a revenue type and how much would be available for capital investment. On the other hand the revenue and capital components of the Plan

being dealt with by two different Commissions and by two different methods of transfer of resources would make it difficult to take such an integrated view of the planning process.

The separation of the revenue component from capital investment in the process of decision-making may also give rise to certain apprehensions. In the present process where a total view is taken of the process of development, the decisions regarding capital investment are also tempered by considerations such as the overall level of development of a State, the distortions in its economy etc. If decisions regarding capital investment are taken in isolation and made the sole duty of a particular body or authority then quite unconsciously and unintentionally only economic criteria may be applied in arriving at such decisions. There is no doubt that this is how such decisions should be taken, but other factors do have to be taken into account even in deciding capital investment. It can be argued that provision can always be made for taking into account such factors, such as the backwardness of a given area etc., even when a separate authority takes decisions on capital investment. But the experience of existing all-India financing institutions is such that it would appear that despite specific directions on such matters and even special schemes for such areas, the pull that well developed areas can exert on capital investment cannot be fully countered. There may, therefore, be a view that on balance, it would be more conducive to the overall development of a given area to consider its plan for development in its totality and not separate it into revenue and capital components and make such separation almost rigid by making two different authorities responsible for the two components.

It will thus be seen that the terms of reference of the Ninth Commission can be so interpreted as to have far reaching consequences both in regard to the relative roles of the Finance and Planning Commissions as well as in regard to the Gadgil Formula for Central assistance. These are all matters which fall within the purview of the National Development Council.

Apart, therefore, from the general point that the terms of reference of the Finance Commission should be finalised after consulting a body like the National Development Council, at least, in regard to the specific issues affecting the previous decisions of that Council and the planning process, which by convention have been within the sphere of that Council, the National Development Council should have been consulted before they were referred to the Finance Commission. This situation can be remedied even now. A final decision on the recommendations of the Finance Commission is taken by the Union government. In view of the far reaching implications these recommendations may now have in regard to Central assistance for the Plans and the planning process itself, at least those parts of the recommendations of the Ninth Commission which impinge on these aspects should be referred to the National Development Council before a final decision is taken by the Union government.

Conclusion

Para 4 of the terms of reference has features which are unique to this Commission. When the four parts of this para are read together a consistent scheme emerges, the objective of which seems to be the generation of revenue surpluses through financial discipline. In the case of the previous Commissions also mention used to be made of better fiscal management and economy in expenditure consistent with efficiency. Even if this had not been mentioned, it is but natural that any authority that is concerned with the distribution of taxes between the Union and the States as well as the determination of the need for grants-in-aid would take into account the question whether the bodies to which financial resources are being transferred have been utilising such resources in a prudent manner. What makes para 4 unique is that the various considerations have been mentioned more explicitly and in greater detail than before. As mentioned earlier, an inconsistency in the pattern as set out in para 4 is that except in regard to the normative approach, the other considerations relating to discipline and efficiency seem to apply only to the

States and not to the Centre. We have already urged that the Finance Commission should interpret this para in such a manner that it applies equally to both the Centre and the States. Nobody can gainsay the fact that governments need to exercise financial discipline. The question, however, is what is meant by financial discipline? Obviously, it is no longer possible to make a balanced budget the test of financial discipline. However, even if such a test is applied, it would appear that it is the Union government which would fail and not the State governments. From all available reports it would appear that ever since the rules regarding overdrafts have been made more stringent the States have followed this discipline. If, therefore, this is the only criterion of financial discipline, then we have a situation where there is already an instrument available to the Union government to ensure that the States follow this discipline in as much as they have the power to prevent the States from running into overdrafts. What is needed, if at all, is some similar mechanism in the case of the Union government itself. However, balancing the budget is no longer an adequate test for financial discipline. But the question is whether the financial policies of a government whose overall budget is balanced can still be faulted on the grounds of financial indiscipline. Besides financial discipline there are the concepts of financial prudence and financial propriety. One view could be that prudence and propriety are the elements of discipline while another view could be that these are different stages at which, if checks are not applied, transgression will ultimately lead to financial indiscipline.

Whatever these nuances may be, the question is how far the Finance Commission can go in providing mechanisms for ensuring financial discipline. The Commission will certainly take these factors into account in determining the quantum of devolution and the need for grants-in-aid. It can, in so determining, also provide incentives for resource mobilisation, financial prudence etc.; but it should not go beyond this and prescribe any specific conditions as such. In this connection it may be relevant to point out that Article 280 of the Constitution under which the Commission is appointed deals with the distribution

of taxes but has not mentioned any considerations of this nature. It is not as if the Constitution makers were not aware of such considerations or of the fact that there may be governments that would flout even such considerations. That is why it has been provided under Article 360 that, in a situation where a government behaves in this manner, the Union can give "directions to any State to observe such canons of financial propriety as may be specified in the directions". Therefore while any tendency to enter into commitments beyond the available financial resources may be curbed as being financial indiscipline, this approach cannot be extended to passing judgements on the nature of schemes even where a government has found the necessary financial resources for it. Individual schemes or actions of government cannot be judged on the grounds of being financially imprudent. That privilege belongs to the legislature. A duly elected government has the right to raise resources and to expend them in such manner as it deems fit subject to the provisions of the Constitution and the approval of the legislature. These actions, cannot, therefore, be questioned on grounds of financial propriety or prudence so long as these conditions are met. The various considerations mentioned in para 4 have, therefore, to be taken into account against this political and Constitutional background.

Over the past three decades the eight Commissions that have been constituted so far have earned the confidence of the States despite the fact that they had been appointed and their terms of reference had been drafted unilaterally by the Union government. The awards of the successive Commissions have been generally well received by the States perhaps because each Commission has improved over the previous Commission in regard to the quantum of the transfer of resources from the Union to the States. However, even in regard to those aspects of the award which relate to the *inter se* distribution of taxes among the States there has not been much acrimony although there has naturally been some disappointment on the part of some States. One major criticism of the awards of the Finance Commissions used to be that their transfers were generally regressive in nature in their

distribution among the different States. But even here the position has changed and as pointed out earlier, it is now conceded that statutory transfers have become progressive compared even to Plan transfers.

The nature of federal financial relations and their contours are determined by the provisions of the Constitution but the content of these relations and the manner in which they have evolved over the past three decades has been determined to a great extent by the awards of the successive Finance Commissions. The fact that these awards have inspired confidence among the States has helped in federal financial relations evolving along healthy lines and in their being strengthened. This process has been an evolutionary process and much of the acceptability of the process so far arises from this. Each Commission has broken new ground, both *suo moto* and as a result of its terms of reference being different. But every departure from past practice has been modest and has found acceptability because of its being in the direction of strengthening the resources of the States. Even where certain criteria of financial performance or discipline were introduced in the course of devolution or grants-in-aid, they were rendered acceptable because of the overall package being beneficial. The issue here was as between the States, namely that if a State that had not raised resources had been penalised in some manner, States who had done so lent support to such a measure. The Union was not in the picture in this regard. These considerations, therefore, weighed in favour of the horizontal distribution of resources rather than the vertical distribution and this was crucial to their acceptability.

In the evolution of federal financial relations in our country the awards of the Finance Commission have played somewhat the same role as judicial interpretation in the case of Constitutional evolution. Article 280 itself is very brief and, therefore, leaves considerable scope for the Commissions to exercise their own discretion. The exercise of this discretion has been sought to be guided by the Union government through the terms of reference. But the Commissions have happily taken the

view that while on the one hand they cannot go beyond the provisions of the Constitution, on the other, they need not feel constrained by any factors other than the Constitutional provisions. It would be relevant to quote here what has been said about judicial interpretation in the context of the American Constitution. "Judges in the mainstream of our Constitutional practice are much more respectful of the framers' intentions, understood as a matter of principle.... They accept the responsibility the framers imposed on them, to develop legal principles of moral breadth to protect the rights of individuals against the majority. That responsibility requires judgement and skill, but it does not give judges political licence"[10]. We can substitute here "the rights of the States against Union" for "the rights of individuals against the majority". The important point here is that the process requires judgement and skill but it does not give "political licence". Our endeavour above also has been to emphasize that no part of para 4 of the terms of reference should be interpreted in such a manner as to pass judgement on the actions of State governments as represented in their budgetary provisions and schemes, which are essentially in the nature of political decisions.

The Ninth Finance Commission has to determine its own approach against this broad background. The new elements in its terms of reference do permit of a sweeping change being brought about in the nature of federal financial relations if they so desire. But, from what has been said above, it will be clear that in such matters change has to be brought about in a manner that is acceptable and without drastically upsetting the delicate balance that might have already been established in Centre-State financial relations. The normative approach may have the merit of objectivity but it has the risks of conditionality and consequently increased Central control. Bringing Plan revenue expenditure within the purview of the Finance Commission may have the merit of rationality but it also has far-reaching institutional implications. A balance has, therefore, to be struck between contrary considerations of this type. In a democratic federal policy this balance has to be struck as a result of a political process. There is a platonic element in the support

that the normative approach has received from experts. Thus, as Socrates puts it, those "qualified for the command of a ship - must and will be the steerer, whether other people like or not". It is "the possibility of this union of authority with the Steerer's art"[11] that the prescription of norms by experts provides and that appeals to them. But in a democracy experts can only show the way, the choice will have to be left to others. We would, therefore, urge that the Commission should look upon its task as only making a beginning in the new directions opened to it. It should take such a measured step as would be sufficient to establish the new direction but would not be so large as to unduly disturb the equilibrium that the old relations and procedures might, in the course of practice and over a period of time, have already established.

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2

Evolving Fiscal Norms for Central and State Governments : Some Methodological Issues

M. Govinda Rao

Working of the Finance Commissions in the past has been criticised for two important reasons. First, the guidelines given to the successive Commissions and their own hesitancy confined them to a much narrower role than was envisaged in the Constitution [Chelliah et al 1981]. While the Constitution does not make a distinction between Plan and non-Plan sides, over the years the Finance Commissions have been led to confine their scope to assessing the needs of the States to meet only their non-Plan needs. Secondly, the practice of taking budgetary gaps to represent fiscal needs of the States and filling the gaps through grants-in-aid has been vehemently criticised for its disincentive effects on States' revenue raising effort and expenditure economy. [Thimmiah, 1981, Rao, 1987]. The approach followed by the Commissions, it is necessary to state, did encourage fiscal profligacy though it is difficult to assign the exact role of this factor in the deteriorating fiscal trends at both Central and State levels.

In recent years, the growth of revenue expenditures has outpaced revenue receipts. While the revenue receipts grew at an average annual rate of 14.5 per cent during 1975-76 and 1986-87, revenue expenditure grew at a higher rate of 17.2 per cent. This has brought about the era of government dissaving beginning from 1982-83; the combined revenue deficit of the Central and State governments is estimated at Rs 10,132 crore which is expected to form 3.1 per cent of GDP. This implies that

investible savings of this magnitude are being diverted to meet public consumption. The large debt servicing liability that is left by this would only result in the vicious circle of more revenue deficits - larger public dissaving - higher net interest burden leading to even more deficits. It is in this context that the departures suggested in the terms of reference of the Finance Commission, that it should adopt a normative approach to assess total revenue receipts and revenue expenditures of the Centre and States without making a distinction between Plan and non-Plan expenditures, assume significance.

In fact, the need to reverse the trend of governmental dissaving by raising more resources and/or curbing uneconomic spending by both the Central and State governments has long been recognised. At the Central level, towards this, the Union Finance Ministry brought out the Long Term Fiscal Policy (LTFP) in December, 1985. Unfortunately, the norms fixed in the LTFP were not adhered to and the intended objectives were not fulfilled. Public savings did not increase as contemplated, the contribution of public sector undertakings did not show the desired improvement, reversing the declining share of direct taxes could not be achieved, subsidies could not be reduced as laid down and the budgetary deficits could not be contained as envisaged. At the State level, the approach adopted by the Finance Commissions in fact encouraged fiscal profligacy. Even when some attempts were made to adopt norms, the Planning Commission's reassessment legitimised their non-fulfilment. In view of these factors, the reference to the "normative approach" in the terms of reference enables the Ninth Finance Commission to make a desirable move towards the adoption of an appropriate basis for assessing the States' revenue account needs. The Commission should seize this opportunity and evolve an approach that would induce fiscal discipline in the country.

However, it is necessary to bear in mind that in adopting a suitable approach, the Commission cannot be expected to become a full-scale investigation body exploring in detail the transactions in the entire public sector. The principal

objective of the Commission should be to lay the stepping stones towards building a proper environment for putting in greater effort in mobilising revenue and curbing uneconomic spending. The purpose of this paper is to highlight some important issues towards developing a suitable normative framework that can be adopted by the Finance Commission.

Evolving the Basic Approach

The substantive clause of Article 280 of the Constitution requires the Finance Commissions to recommend primarily (i) 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, and (ii) the principles which should govern the grants- in-aid of the revenues of the States out of the Consolidated Fund of India. Through these instruments of tax devolution and grants- in-aid, the Commission is expected to resolve vertical and horizontal fiscal imbalances in the federation.

In meeting the problem of vertical and horizontal fiscal imbalances, proper consideration should be given to three important issues. First, both the revenue sources and expenditure functions of the Centre and the States should be appropriately balanced. Second, the expenditure requirements of different States in excess of their revenues should be provided for, so that individuals, irrespective of the State of residence, are entitled to a certain minimum standard of basic public services. Third, the problem of vertical and horizontal imbalances should be harmonised without creating disincentive effects on revenue mobilisation efforts and economy in spending.

The emphasis therefore has to be on balancing revenue capacities and expenditure needs rather than filling the gaps between projected revenues and expenditures. In this task, we may take the measurement of revenue capacities and expenditure needs at the State level as the starting point. This gives us an estimate of the minimum transfers necessary to balance

capacities with needs. The assessment of Central resources and expenditure needs would give us an idea about the amount of surplus available for distribution. It is necessary to ensure that the normative surplus of the Centre should at least be equal to the total normative deficits of the States having excess expenditure needs over their revenue resources so that we are not left with any revenue deficit in the economy as a whole. If these are not matched, the norms will have to be reworked to ensure this overall balance.

This, however, gives only the minimum that the State should receive. The requirement of tax sharing necessitates making devolution to all the States including those with no normative deficits. Therefore the total amount to be transferred has to be determined exogenously, keeping in view the overall developmental needs and priorities. Then, by appropriately choosing the proportion of shared taxes and grants-in-aid and by giving an appropriate weight to the backwardness factor even in the distribution of shared taxes, the required degree of progressivity may be brought about.

It must be emphasised that as all the fiscal parameters of the Centre and States - normative revenues, expenditures and deficits - are to be determined simultaneously, the desired results would have to be achieved through simulations. It is only through this procedure that the minimum amount required to be transferred to enable the States to meet their expenditure needs and the surplus available from the Centre for this purpose can be matched. Adopting such an approach would help to reverse the current trend of growing revenue deficits too. The broad method of applying norms to the revenues and expenditures of the Centre and State governments are outlined in the following sections.

Financial Norms for the Centre

Fixing financial norms for the Centre undoubtedly is an uphill task. Unlike in the case of the States where the norms can be fixed by making inter-State comparisons, no such method

can be evolved in the case of the Central government. The norms fixed in LTFP cannot be taken as they are, for they have not been found to be realistic. International comparison to fix the norms too does not lend itself for easy operational use as the economic situation varies widely from country to country. The Commission has to devise the norms on the basis of its own judgement, and in doing so, the norms adopted should have the same basis as that adopted for the States.

Broadly, in fixing norms, the Commission may proceed in the following manner. First, the tax revenue to be generated by the States on a normative basis can be translated into growth rates and the Central tax revenues may be required to grow at the same rate. In the past, in fact, the growth of Central tax revenues has been slightly lower than that of the States in spite of the Centre having potentially more buoyant tax handles. The requirement that the Central taxes should grow at least at the rates of growth of State taxes would be a realistic norm. Besides, in cases where under-exploitation of revenue sources can be clearly identified, the potential from such sources may be separately estimated and added to the total revenue potential of the Centre. Targets for non-tax revenue may be fixed, like in the case of the State governments, on the basis of the estimated investments made by the Central government.

This approach needs a little more elaboration. Essentially, the method implies specifying normative rates of growth for individual tax revenue items and supplementing this with known and identifiable sources of revenue which are underexploited. Excise duties, for example, can be broken up into specific and ad-valorem components. While the former may be required to grow at least at the rate of growth in real incomes, the normative growth for the latter should be equivalent to the growth of sales tax. In the case of direct taxes, the Commission may fix the target on the lines of LTFP which had targetted that the direct tax ratio to GDP should rise from 1.5 per cent estimated in 1985-86 to 2.1 per cent in 1987-88. However, instead of showing a rise, it fell from 2 per cent in 1985-86 to 1.7 per cent

in 1987-88 (estimated). It is in respect of direct taxes that underexploitation of existing potential is considered to be very high. Given that there exists considerable potential for raising revenue from the income tax by withdrawing exemptions, deductions, concessions and reducing widespread evasion, the Commission could broadly indicate the additional revenues the Centre could raise, so as to be in consonance with the overall revenue targets. This could be done not necessarily by raising tax rates but also by widening the tax base. In the case of Customs duties it may not be possible to fix any norms as such, because their revenue collections depend essentially on the import policy and quantum of imports. In this case, the past trend modified to take into account possible import policy changes may have to be taken as the norm. In the case of non-tax revenues, as mentioned earlier, the potential may be estimated on the lines of estimated loans advanced and interest rate charged (for interest receipts) and estimated investments and rates of return normatively fixed (for returns from departmental and non-departmental undertakings).

There are, however, two important issues that need to be taken note of. First, what if the Central government fails to fulfil the targets? In particular, failure to fulfil targetted collections in individual income tax and Union excise duty might result in the loss of revenue to the States. It is necessary to provide adequate safeguards so that inability on the part of the Central government to reach the revenue targets does not result in penalising the State governments. Second, the method of raising resources by the Central government itself may be looked into. It may be necessary to broadly indicate the targetted composition of Central revenues. From the equity and efficiency point of view, it is necessary that the direct-indirect tax mix be specified so that one does not always go in for picking the goose which squeaks the least. Equally important is the issue of increasing administered prices versus enhancing excise duties. In a public monopoly situation, the economic effects of the two measures are identical. However, from the point of view of federal finance, while the latter yields additional revenue to the States, the former does not. It would

be in the federal spirit to resort to administered price increases only to the extent of compensating 'justifiable' cost increases and leave resource mobilisation to the instrument of taxation. From the point of view of the economy, an increase in public sector savings only if achieved by improving productivity would result in the overall improvement of real savings in the economy. Increases in public sector savings achieved merely by raising administered prices would only result in the fall in savings in other sectors. As regards excise duty alterations, it should be in the interest of the economy to have stability - to adhere to the original resource mobilisation parameters envisaged for financing the Plan.

Given the normative revenue - GDP ratio and the ratio of targetted revenue surplus to GDP, the expenditure - GDP ratio of the Central government may be easily determined. Fixing norms for individual expenditure items, however, is a more difficult task. Norms for subsidies, like in LTP, may be fixed so that they grow only at the rate of growth of GDP. Interest payments should be fully allowed for and administrative expenditure should not increase at a rate faster than that of GDP. Defence is the other major expenditure item and its need should be determined in consultation with the Defence and Finance Ministries, keeping in view the expenditures on defence in the neighbouring countries and within the overall parameter of revenue expenditure not exceeding total revenues. This will eliminate financing revenue expenditures out of borrowings. A view has also to be taken on the desirability of the Central government's involvement in State subjects through the Centrally sponsored schemes.

Financial Norms for the States

Norms for the States' receipts and expenditures have to be developed by making inter-State comparisons. Thus, taxable capacities of the States can be estimated by adopting either the representative tax system approach or the regression approach. In the latter, it is possible to make improvements in the estimation by combining the cross-section with time-series in

a "covariance" model. In this, effort indices can be directly derived by specifying dummy variables to different States. Non-tax revenue capacities may be estimated by using realistic norms of revenues. In the case of States' expenditures, however, developing norms is much more difficult and therefore merits more detailed discussion.

Normative assessment of expenditures essentially implies estimation of 'expenditure needs'. This may be broadly defined as the justifiable cost of providing an average (or any other specified) standard of services. To estimate expenditure needs, therefore, we are required to measure the standards of public services provided and the justifiable cost of providing them.

Estimation of expenditure needs to enable the States to provide average standards of public services implies implicitly equalisation in the standards of physical services. But equalisation of per capita expenditures does not necessarily result in equalisation in the physical standards of services. Per capita expenditure variations can also result from differences in the cost of providing public services among different States and differences in the productivities in their provision. Cost variations may, of course, also be due to reasons which may not be justifiable such as high salaries, over-employment and wastages.

Equalisation of physical levels of services, however, presents severe problems of measuring the standards of physical services themselves. The output of the government sector is non- rival and non-excludable and therefore, cannot be quantified easily. Hence, the output has to be measured through the expenditures incurred and here the problem of developing norms becomes all the more difficult. Nevertheless, two alternative methods are suggested below to estimate the expenditure needs of the States.

It has been suggested that expenditure needs can be measured by normatively determining the physical levels of services. Accordingly, short term norms can be derived from the long term goals specified by various national Commissions

and national agencies. The physical targets to be achieved, thus derived, may be translated into normative expenditures by multiplying the targets with realistic or justifiable unit costs. (Thimmaiah, 1987). Thus, educational expenditures may be derived from the goals specified in the Directive Principles of State Policy and National Education Policy. The Minimum needs Programme is expected to give norms for housing for the poor and for rural health; the National Police Commission is expected to provide norms for police services and the National Policy of Health is supposed to lay down guidelines for health services. Similarly, in respect of other services, the Commission may request the respective departments of Central and State governments to provide targets to be translated into expenditures for relevant years.

There are, however, several operational problems with such an approach. First and the most important is that given the resource constraints, it may not be feasible to provide standards of public services as targetted by various national commissions. The targets fixed by these commissions/conferences take only a sectoral view and although these objectives are laudable and desirable, they can not be achieved within the available resources and the time frame of the Commission. The Commission will have to take an overall view to determine the extent of services to be equalised keeping in view the resource availability. Second, "public services" within a major expenditure category itself consists of several services and it will be extremely difficult to go into the details of each of the subcategories and try to equalise them. In fact, such an exercise cannot be done within the tenure of the Commission. This is the problem of measuring justifiable unit costs. It may not be possible to measure unit costs in all the cases due to the problem of identifying and measuring the public service itself. And third, in addition to the expenditures incurred on the services concerned, there are other supporting expenditures which do not directly go into the services in question but, nevertheless, are required for the provision of these services such as travelling, administrative overheads and provision of other incidental facilities. For all these reasons, it seems reasonable only to bring

about some relative parities in the services among the States. Trying to achieve absolute standards of services as set out in the national commissions and committees, though desirable, may not be feasible.

One method of estimating the expenditure needs is to analyse the underlying reasons for the differences in expenditures among the States and evolve behavioural norms. Expenditure incurred on a particular service by a State depends upon the ability of the State to provide the service, the need for the particular service and the cost of providing it. The cost of providing the service in turn may be on account of factors such as average salary levels or environmental factors such as large area (or smaller density of population) and physical terrain. The ability factor influences the level of public services provided - more the ability of a State, higher is the level of public services. The need variable also represents the quantity of public service required in the State as represented by the specific population groups the public service caters to.

The assessment of non-Plan expenditure may proceed along the following lines. First, the 'average' behavioural relationship between per capita expenditures and different ability, need, input price and environmental cost variables may be estimated in a regression equation. Essentially, in the model, expenditure variation among the States may be taken as a function of vectors of variables representing ability, need, input prices and environmental costs in different States. Variables representing input price differences may again be classified according to whether they are within or beyond the control of the State governments, thus, expenditure on the ith service in the jth State is functionally shown as:

$$E_{ij} = f(A_j, Q_{ij}, P_{ij}, C_{ij})$$

where E_{ij} = Per capita expenditures on ith service in jth State.

A_j = Vector of ability variables in the jth State.

Qij = Vector of need factors for the ith service in the jth State

Pij = Vector of input price differences for the ith service in the jth State

Cij = Vector of environmental cost variables relevant for the ith service in the jth State.

By regressing per capita expenditures of the States on these variables, the behavioural relationship between per capita expenditures and these explanatory factors may be estimated.

These parameter estimates, however, only provide the average behavioural relationship from which norms can be developed to determine expenditure needs. The approach however, can be uniform for all categories of expenditures. On the general and administrative services, for example, expenditure need has to be computed as the justifiable cost of providing an average standard of services. In the case of social and community services, on the other hand, expenditure need on the non-Plan side should be taken as the justifiable cost of providing the existing standards of services. The raising of the standards of these services in the below average States to the average levels has to be undertaken on the Plan side. At the same time, recurring expenditure commitments for providing the existing levels of services should be provided for even in the States where the levels are above the average.

To estimate expenditure needs in respect of general and administrative services, actual values of 'need' and 'environmental cost' variables for each of the States and average values of ability and input price variables may be substituted. This would give us the per capita expenditure required to be incurred for providing physical standards of services by a State having an average ability, taking into account various environmental and other cost disability factors. As regards salary levels, instead of the average, any other normative (justifiable) level can be taken to estimate the normative expenditures, as the

salaries are taken at normative levels, expenditures are reckoned at justifiable costs. Further, as the average behavioural relationship with the need variable is considered, expenditures on account of over-employment in performing a public service are ignored. By taking into account the effects of environmental factors such as physical terrain and population density, the justifiable cost of providing average physical levels of services is taken into account. As the expenditure assessment is made on the basis of average behavioural relationship as estimated in the regression equation, evaluation is done at average productivity levels and excessive expenditures arising from wastages are not considered.

In the case of social services, two alternative methods may be employed to assess expenditures. In the first, normative expenditures may be estimated from the expenditure determinants model similar to the one employed in the case of administrative services with some modifications. Here, per capita expenditures on the services may be explained by different variables representing quantity and quality, input cost and environmental cost variables. By substituting actual values of quantity, quality and environmental cost variables and the average values of input-cost variables the justifiable cost of providing the actual standards (quantity and quality) of services may be estimated. Thus, the States providing higher standards of these services are allowed to do so, but their expenditures are reckoned at justifiable costs. In the case of those States having below average standards of services, equalisation may be attempted by bringing them up to the average level at justifiable costs. This can be achieved by substituting the average or any other specified target level achievable in the target period and input cost variables and actual values of environmental cost variables in the equation.

The second method would be to measure the average cost of providing the service. All-States' average per capita expenditure (or per student expenditure in the case of education) may be taken as the first approximation of average costs. To this, cost disabilities arising from specific

geographical features of each State may be added to estimate justifiable costs. This may be multiplied with the beneficiary population groups to arrive at normative expenditure estimates. In the case of below average States, to this must be added the justifiable cost of enrolling additional student population according to specified targets as above. Selected categories of social services such as primary education or basic medical facilities may be chosen for the purpose of equalisation.

This approach can be adopted in all cases where revenue expenditure largely determines the standard of public services. Largely, general and social services fall into this category. In respect of these services, the linkage between capital and revenue expenditures is not very strong and raising standards of these services does not involve a substantial amount of capital outlay. Nevertheless, in the case of certain categories of expenditures, some provision will also have to be made for capital upgradation. Provision for more police housing, larger jail capacity, building of courts, school buildings, primary health centres and hospitals are cases in point. Clearly, capital expenditures on these do not involve large outlay, nor is the provision of these services to be determined on the basis of inter-sectoral linkages to be incorporated in the planning exercise.

However, the linkage between the service levels and capital expenditure requirements is quite strong in the case of economic services. Also, their provision involves strong inter-sectoral linkages. In the case of these services, therefore, a slightly different approach is called for. In respect of important items expenditures will have to be derived by using engineering norms depending on the existing capital infrastructure. The spending on these services is guided by the requirements of inter-sectoral consistency as determined by the planning process. In other cases, where the linkage is not very strong the approach similar to the one described above for general and social services may be employed.

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Normative Approach: Genesis and Applicability

Atul Sarma and M.R.S. Kalyani

Before we take up the specific aspect of the terms of reference to the Ninth Finance Commission (NFC) which the paper is addressed to, we would like to make a few observations on the terms of reference to the Finance Commissions generally. Article 280 under which a Finance Commission (FC) is empowered to remedy vertical and horizontal imbalance in Indian fiscal federalism clearly specifies the functions which a Finance Commission is expected to perform. Even so, with the sole exception of the First Finance Commission each of the successive Finance Commissions has been provided a number of guidelines (directions in the case of the Ninth Finance Commission). In addition, each of the successive Finance Commissions has been referred to a number of additional points under 280 (3)(c). While the latter is perfectly legitimate under the Constitutional provision, the former is subject to question.

In both the cases, however, the question that arises is: what are the forces that have led to providing guidelines/ directions and to referring the additional points to Finance Commissions? With a hind sight one can argue that the Constitutional mechanism provided to correct vertical and horizontal imbalances as visualized was completely inadequate in the context of the role assigned to the public sector in economic management and development of the country. Incidentally, it is puzzling that even though there was a considerable debate on planned development and, in fact some Plans were formulated prior to Independence, the need for planned development in the framework of the federal structure was not taken into account while providing a mechanism in the Constitution

for correcting horizontal and vertical imbalances. Therefore, subsequently when the Planning Commission was constituted by the Government of India for pursuing certain goals such as economic growth, balanced regional development, better income distribution etc., (whether any of them is achieved is another matter given the supremacy of the Central government in fiscal and monetary resources under the Constitution) much larger transfer of resources than is warranted for performing the traditional functions of a State government was certainly involved. We submit therefore that the Constitutional mechanism provided with a restrictive view of the role of the public sector, viz., a quinquennial commission cannot be expected to meet the requirements of a continuous planning process. It can be argued that the guidelines/directions given and additional points referred to the successive Finance Commissions essentially reflect the problems that have emerged from the incompatibility of the Constitutional mechanism with the planned path of development in the federal framework.

We may elaborate the point a little further. While the First Finance Commission was given no guidelines at all, the Second and the Third Finance Commissions were given almost identical guidelines. These two Finance Commissions were required to take into account the Plan requirements of the relevant plans and the tax efforts made by the States. Up until the Third Finance Commission, the guidelines can be interpreted as attempts to integrate the need for fiscal transfers arising from the planning process with the restrictive fiscal transfers as visualized in the Constitution on the one hand, and to induce the Finance Commission to keep a watch over the tax performance of the States on the other. Broadly speaking, more elaborate guidelines given to the subsequent Finance Commissions upto the Eighth Finance Commission reflect the Central government's attempts (i) to establish conventions for the respective jurisdictions of the Finance Commission and the Planning Commission for operation, (ii) recognize explicitly the fallout of Plan financing on State finances, (iii) induce States to make optimal tax effort and equalize certain services. The fear of the investible resources for planning purposes being affected by

higher transfers under successive Finance Commissions as also the deficits on the revenue account being experienced by the Central government led to an additional guideline beginning from the Seventh Finance Commission which was related to resources of the Central government and its liabilities. Thus the guidelines basically reflect the Central government's perception of the problems arising out of the Constitutionally conceived role of the Finance Commission in fiscal transfers simultaneously with the necessities resulting from a much wider role of public sector in the framework of a mixed economy. Needless to add, the supremacy of the Central government in fiscal and monetary resources enabled it to give guidelines/directions in which the Finance Commission is to function.

With the guidelines as given to the Ninth Finance Commission a full circle has been completed in one substantive sense. It is that as in the First to Fourth Finance Commissions the guidelines to the Finance Commission do not recognize the distinction between Plan and non-Plan expenditure. These guidelines seem to have an underlying perception of the Central government that there was something basically wrong with the approach made by the successive Finance Commissions in assessing the resources and expenditure of the States. Such an approach was favourable neither to higher resource mobilization nor to better fiscal management. In fact, it has stifled the effectiveness of the government functioning and delivery system. To correct these unhealthy trends in State finances a new rationale for the co-existence of the statutorily provided mechanism and the Planning Commission can be provided by way of demarcating the role of the Finance Commission in revenue accounts and that of the Planning Commission in capital investment in place of non-Plan and Plan accounts in the preceding period.

It is true that all the first eight Finance Commissions either on their own or under compulsion restricted themselves to the non-Plan part of State finances. The only exception was the Third Finance Commission which made recommendations for grants for planning purposes, although it was not accepted

by the Government of India. It is also true that all the preceding Finance Commissions took a partial view of State finances and adopted a gap-filling approach to fiscal transfers. As a result the fiscal transfers made under the statutorily provided Finance Commission accounted for only about 45 per cent of the total transfers made to the States.

Despite these limitations, however one important working convention had been established over the years. For example, the Finance Commission would deal with the non-Plan revenue and capital accounts while the Planning Commission with Plan revenue and capital accounts. But the guidelines/ directions to the Ninth Finance Commission imply a complete departure from the above convention in that the Ninth Finance Commission should consider the revenue account of the Central and State governments in totality. In addition, the Ninth Finance Commission should make a normative approach in assessing the receipts and expenditure on the revenue account of both the levels of government. In this paper we will examine a little closely the operational aspects of the normative approach which the Ninth Finance Commission is required to make while assessing the receipts and expenditures on revenue account.

It will be useful to indicate at this stage the broad methodologies that were adopted by the preceding Finance Commissions in assessing the non-Plan receipts and expenditures. First, the forecast of receipts and expenditures submitted by the State governments were "cleaned" and made comparable. Second, growth rates of each tax and non-tax revenue item and every broad category of expenditure based on time trends and on functional basis for taxes occasionally were worked out. Third, these growth rates were suitably adjusted on the basis of judgement, *a priori* information and in certain cases on the basis of norms. Two examples of using norms can be given. In assessing the deficit/ surplus of State Electricity Boards, norms relating to plant load factor and transmission and distribution losses were introduced by the Eighth Finance Commission. Similarly, in providing for maintenance and up keep of assets

created, norms were used by the same Finance Commission but then no Finance Commission can be said to have assessed the expenditure needs and revenue efforts on the basis of any normative physical standards.

Such an attempt was not made even by the Sixth, Seventh and Eighth Finance Commissions which were required to consider the requirements for upgradation of standards of administration in non-development sectors. Even prior to this requirement, the First and the Third Finance Commissions made recommendations for specific grants on their own. The First Finance Commission identified eight States for special assistance for expanding primary education facilities on the basis of some judgement rather than on the basis of any normative standards. The Third Finance Commission identified ten States for the purpose of giving grants for improving road communications.

Being required to take into consideration the expenditure needs for upgradation of general administration, the Sixth Finance Commission restricted itself to the revenue expenditure needs for upgradation of general administration. It covered general administration, administration of justice, jails, police, primary education, medical and public health, welfare of Scheduled castes, Scheduled tribes and backward classes for special dispensation. Its broad approach was to raise the per capita expenditure level on these services in the deficient States to the all-States average by way of making provision for it in grants-in-aid.

In regard to similar guidelines, the Seventh Finance Commission identified (1) administration of taxes, (2) treasury and accounts administration, (3) judicial administration, (4) general administration consisting of revenue, district as well as tribal administration and the secretariat services, (5) police and (6) jail as the sectors and services in non-development sectors requiring upgradation of standards. It was indicated that it examined the relative position of the States in physical terms and determined the need to make provision for upgrada-

tion of standards in relation to certain norms. The above services were provided from both revenue and capital grants.

But it is not clear what exactly were the norms and how the cost of attaining the norms was worked out. The fact that it did not make a provision for any State larger than that proposed by the State itself indicates that the determination of the provision for upgradation of services lacked the required objectivity because it is perhaps the proposals made by the States which constituted the basis for providing special assistance for the upgradation of services.

In response to the corresponding terms of reference, the Eighth Finance Commission expanded the list of sectors and services comprising the non-development sector to nine by including three sectors services viz., education, public health and training. The Eighth Finance Commission identified the major components in each of the above services, determined absolute physical norms on the basis of judgement and worked out the quantum of special assistance for upgradation of the above services taking the level of achievement and unit cost. Ten States were provided grants-in-aid both for revenue and capital purposes although no such distribution was made as was done by the preceding Finance Commission.

The above discussion brings out the following points. First, the Constitutional provisions did not debar the Finance Commissions from considering both the revenue and capital needs of the States. It is the Finance Commissions themselves which put restrictions on their operation. Second, from the interpretation of the coverage of non-development sectors given by the Seventh and the Eighth, it is apparent that it is again the Finance Commissions which gave restrictive interpretation of the coverage of non-development sectors. Third, even in the restricted sectors and services selected for upgradation, the Sixth Finance Commission attempted to equalize per capita revenue expenditure while the Seventh and Eighth Finance Commissions examined the disparities in the selected sectors in physical terms, but attempted in an arbitrary

manner to upgrade the selected services to a level fixed on some judgement. Finally, none of the Finance Commissions attempted to estimate expenditure needs and revenue efforts of the State governments with reference to any normative standards. The limitations in the approach of the preceding three Finance Commissions to upgradation of services are noticeable despite the fact that a member of the Planning Commission was also made a member of Finance Commission beginning from the Sixth Finance Commission presumably with a view to taking an integrated view of the fiscal transfers to States.

The failure in making a comprehensive approach and in evolving an appropriate methodology for upgrading services in the States is reflected in the increasing disparity in administrative, social and economic infrastructures among the States when they are examined in physical terms. This can be clearly seen from the table below. For illustration we have taken a few characteristics of administrative, social and economic infrastructures in physical terms and calculated coefficients of variation for 1971 and 1981. The table brings out that the coefficients of variation increased over 1971 with respect to all the characteristics except for irrigated area as a percentage of net cropped area in which case the coefficient of variation somewhat declined.

In this background the operational implications of requiring the Ninth Finance Commission "to adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre....." can be examined.

To start with, it can be observed that this directive is a major departure from the corresponding guidelines given to the preceding three Finance Commissions. In one respect this directive is restrictive while in another respect it is wider in scope. It is restrictive in the sense that like the Seventh Finance Commission the Ninth Finance Commission is debarred from examining capital investment needs of the States even in respect of the non-developmental sectors. It is wider in scope in

the sense that the Ninth Finance Commission unlike its four immediate predecessors should consider revenue needs and efforts disregarding the distinction between Plan and non-Plan. It follows from the above that the Ninth Finance Commission is required to consider the total revenue needs and efforts of the States while the Planning Commission is to deal with the capital investment requirement.

Intertemporal Disparity in Administrative, Social and Economic Infrastructure

Item	1971 co-efficient of variation	1981 co-efficient of variation
A. Administrative infrastructure		
1. Number of Policemen per 10,000 of population	1.119	1.209
B. Social infrastructure		
1. Number of primary schools per 10,000 of population	0.658	0.688
2. Number of dispensaries per 10,000 of population	0.841	0.938
C. Economic infrastructure		
1. Irrigated area as a proportion of net cultivated area	0.630	0.588
2. Per capita consumption of power	0.682	0.747
3. Length of roads per 10,000 of population	0.584	0.922

Source: 1973 and 1983 Issues of Statistical Abstract of India.

This new operational distinction will hinder the equalization of services across the States almost in the same way as the dichotomy between Plan and non-Plan expenditure did. It is because equalization of services involves both revenue and capital expenditure while the Ninth Finance Commission will have to consider the revenue expenditure only. We give an illustration to make the point clearer.

Suppose the Ninth Finance Commission attempts to equalize health services. Taking certain relative norms, it identifies the gaps in terms of physical criteria such as number of doctors, nurses, medical equipment, hospital buildings, etc. Since the Ninth Finance Commission is supposed to consider the revenue expenditure needs, it can provide for the required number of doctors and nurses but not for medical equipment and buildings. In a situation like this a State will have the means to appoint doctors and nurses regardless of whether or not medical equipment and hospital buildings can be provided. These kinds of incongruities arose in the years of dichotomy between Plan and non-Plan expenditure. Thus, even while considering revenue expenditure needs in their totality the scope for equalizing the services will be very limited.

Since a member of the Planning Commission is also on the Finance Commission, it can be argued at least theoretically that the Planning Commission dealing with capital investment will immediately, as a follow up measure, provide for the required investment on medical equipment and buildings. Does it not then mean that a part of the investible resources gets preempted with the recommendations of the Finance Commission? There is one other problem. The planned investment in the State as well as in the Central sectors under the Eighth Plan which is yet to be formulated will also have a revenue component. How does the Ninth Finance Commission estimate the revenue component of the non-existing Eighth Plan? We would suggest a way out while discussing the coverage of the items of expenditures that should be assessed by the Ninth Finance Commission.

The normative approach can be interpreted in terms of absolute or relative norms. While it will be possible or even desirable to take a relative norm in assessing the revenue accounts of the States, the revenue account of the Central government has to be assessed on the basis of an absolute norm. The question is: how does one go about fixing absolute norms for the assessment of the Central government receipts and expenditures on revenue account?

In the past the Finance Commissions have not subjected the forecast of the Central government receipts and expenditure to as much close scrutiny as was done in the case of State government forecasts. This differential approach certainly led to unequal treatment of the two levels of government.

Because of the difficulties of evolving absolute norms in assessing the revenue accounts of the Central government, the two levels of government may be treated still more unequally. The difficulties are, of course, genuine. For example, what absolute norm could one fix for defence expenditure claiming a sizeable portion of the total revenue expenditure of the Central government?

The normative approach in assessing the revenue expenditure of the Central government can be made in the following directions. For almost every function allocated to the States, there is a department/ministry at the level of the Central government. This can be justified on at least three grounds. A department/ministry at the Central level can (a) provide those services which have spill-over benefits across the States, (b) coordinate the activities of the States and (c) carry out research and development programmes and disseminate knowledge and experiences of other States. But the level of expenditure incurred by the Central level department/ministry is far higher than what can be justified on legitimate grounds. For example, the Central government expenditure on public health which is a State subject increased from a mere Rs 25 crore in 1962-63 to Rs 294 crore in 1984-85. Similarly, the Central government expenditure under Centrally sponsored schemes

shot up from Rs 148 crore in 1973-74 to Rs 1311 crore in 1984-85. In areas of the above types, the Ninth Finance Commission should be able to fix norms on an objective basis.

For other services the desirable level in physical terms, taking into account appropriate determinants as also normative unit cost, should be determined. In the services provided by the Centre comparable to those of the States, the unit cost adopted for the States should be used. In other feasible cases, the unit cost should be worked out on the basis of men and material requirements per unit of output/services.

The revenue receipts of the Central government should be assessed on the basis of norms consistent with a federal system. There are numerous examples of Central government measures which adversely affect States' legitimate claim on Central resources or which have an adverse impact on State expenditures. A few examples can be given for illustration. Although the States' efforts for developing various infrastructural facilities contributed to the emergence of Corporation Tax as one of the major sources of revenue, this tax had been excluded from the divisible pool of income tax beginning from 1959 thereby denying the States a share in an expanding source of revenue. In the recent past public sector bonds offering an income tax free interest rate had been floated, which had obviously an adverse impact on the divisible pool of income tax as also on States' share in small savings. Again, the Central government mops up a large amount of resources by raising the administered prices of certain public sector monopoly goods as has been done recently in the cases of petroleum, coal and steel. Some of these products being major inputs in State government projects or their undertakings such as State Electricity Board, Road Transport Corporation, any hike in prices pushes up the cost unexpectedly. It can also be argued that since the effect on the economy of a rise in administered prices or in Union excise duties on this type of goods can be expected to be the same, resources of an equal magnitude could be mobilized by raising Union Excise duties in which case the States could get a share. After identifying all such Central government measures affect-

ing the States' claims on federal resources and the measures having adverse impact on State finances, the Ninth Finance Commission should fix appropriate norms which will contribute to healthy Centre-State financial relations.

The revenue potential of Central taxes should be assessed on the basis of optimal exercises while the contribution from Central public undertakings which are the major sources of non-tax revenue receipts should be on the basis of physical performance criteria comparable to those adopted for State undertakings.

In assessing the revenue position of the State governments the following two general points have to be noted. First, the fiscal measures are, no doubt, expected to serve important economic objectives but they cannot be entirely independent of the interplay of political forces. Second, the resource allocation as well as tax measures depend on the objective conditions prevailing in a State. Both these points suggest that the normative assessment of revenue and expenditure should not be so rigid as to curb the States' autonomy in fiscal decisions. The other point to note is that the methodologies adopted should be as simple as possible and the assessment should be realistic.

As regards the assessment of revenue receipts a distinction has to be made between tax revenue and non-tax revenue. In assessing tax revenue on a normative basis the fiscal effort relative to fiscal capacity of each of the States has to be considered with reference to the all-States' average tax efforts or the efforts of the best performing State relative to the respective fiscal capacities. The Representative Tax System Approach which is a well-developed methodology and has in fact been used in some of the older federal systems like Canada can be adopted. This approach involves an assessment of taxable capacity of each State in terms of tax-base potential for each tax and the determination of the standard rate of tax. By applying a standard rate to the estimated potential tax base of each tax and then aggregating tax potential of all the taxes, the potential tax

revenue can be estimated. While some empirical studies using this methodology have been carried out even in the Indian context, the realistic assessment on the basis of this methodology is circumscribed by the availability of the right type of data and the variability of tax base. For example, for the assessment of the potential base of sales tax, tax exportation has to be estimated and adjusted appropriately. The data base for such an estimate may not be adequate. The problem relating to the variability of tax base can be illustrated taking the example of agricultural income tax. Agricultural income tax as it is levied today is essentially a tax on income from plantation. Since plantation is not equally important in all States, standard tax rate based on an all States' average rate will be unrealistic to estimate the potential of agricultural income tax. Therefore, due caution has to be taken in making assumptions in using a proxy data base wherever needed.

Non-tax receipts mainly consist of contributions from public undertakings. In assessing the contributions from public undertakings, as pointed out earlier, similar physical norms should be adopted both for Central and State undertakings. Some of the preceding Finance Commissions while assessing contributions from State Electricity Boards (SEB) and Road Transport Corporation (RTC) adopted norms regarding plant load factor and Transmission and Distribution losses in the case of SEB and number of workers per bus in RTC. But because of lack of will or because of inherent weakness of these undertakings or because of certain compulsions, these norms could not be realized in reality rendering the assessment based on such physical norms unrealistic. This in turn had an adverse impact on the finances of some of the State governments. Despite such hazards, the fixation of physical norms with reference to all States' average can be expected to create pressures on the public undertakings to perform better.

The real difficulty arises in setting physical norms in terms of all States' average for the undertakings which are set up with some social goals specific to a State and which are brought into existence by way of nationalization of sick private

industries. The number of such public undertakings is quite large in some States. In such cases an attempt has to be made to fix norms in absolute terms.

The assessment of revenue expenditure needs of State governments on the basis of relative physical norms is a far more difficult task. The first problem relates to the coverage of the items of revenue expenditure that should be considered by the Ninth Finance Commission. Following a narrow interpretation, only the essential public services can be covered as was done by the Seventh Finance Commission when it was required to consider upgradation of general administration. If it is interpreted in a wider sense, the Ninth Finance Commission should cover all the services. While there is a case for equalizing all the services-administrative, social and economic - across the States, the Ninth Finance Commission should not take upon itself to equalize economic services. It is true that the implementing capability of the economic departments of the State governments does depend on revenue expenditure. But then the nature of capabilities that are required depends on the level and the composition of capital investment that will be postulated in the planning process. The level and composition of capital investments depends on the endowments - physical and human - and various other factors which vary from State to State. Moreover, planning for economic development of a State involves much deeper understanding of its economy as also constant monitoring which cannot be expected of a quinquennial commission with limited resources - time and expertise - at its command. Therefore the Ninth Finance Commission would do well in not attempting to equalize even the implementing capability of the economic departments of a State under assumptions which can at best be informed guesses and at worst arbitrary. To put it the other way, the Ninth Finance Commission should assess the expenditure needs keeping in view the objective of equalizing the administrative and social infrastructures. In doing so, it should cover both the revenue and capital expenditure requirements of the State governments regardless of the direction given to the Ninth Finance Commission in its terms of reference.

Given this coverage of the Ninth Finance Commission, the Planning Commission will have to interpret the capital investment in a wider sense. It will include investment on construction and plant and equipment relating to economic services under the Eighth Plan, upkeep and maintenance requirements of the assets created under the preceding Plans and the requirements of strengthening implementing machinery. This coverage is consistent with the objectives the Planning Commission is expected to pursue.

Assuming that the coverage of the services suggested above will be accepted by the Ninth Finance Commission, we may discuss in brief the operationalization of the normative approach. The normative approach in this regard should be directed to equalizing services in physical terms across the States. In other words, taking a relative physical norm in terms of all-States average level and better still, the highest level achieved in any of the States, the expenditure requirement of each of the States should be assessed. This will involve identification of (a) the States having a gap between the all-States average level and the existing level of services in physical terms (b) normative inputs - men and materials - required for providing one unit of each of the services. In determining (a), the level of services has to be normalized by taking an appropriate accessibility criterion. For example, the provision of drinking water should be considered taking a reasonable distance factor. In determining normative unit cost i.e. (b), the differential prices of material inputs across the States have to be taken into account. The difference between the normative physical level and the existing level of each of the services has to be multiplied by the corresponding unit cost to estimate the expenditure needs for each of the services.

It is apparent that such exercises will involve a wide spectrum of data. Some of the administrative and social services may not be amenable to consideration in physical terms. Besides, certain services e.g. maintenance of law and order which greatly depend on the local conditions cannot reasonably be considered for rigid standardization. In such cases the assessment of expenditures has to be based on judgement.

The major points that have emerged from the above discussion may be summed up as follows:

1. The incompatibility of the perception of the role of public sector, as reflected in the Constitutional mechanism, for vertical and horizontal fiscal imbalances with the actual role assigned to it in planned development has led to the present dichotomy in fiscal transfers.

2. This dichotomy was greatly responsible for partial assessment of fiscal needs and efforts resulting in disparity in the efforts as well as in the levels of services across the States.

3. Changes in terms of reference to the successive Finance Commissions essentially reflect the Central government's perception of the problems arising out of such a dichotomy and its attempts to resolve them.

4. The normative approach that is required to be made by the Ninth Finance Commission in assessing revenue and expenditures on revenue account will perpetuate the partial assessment of fiscal needs of the States as the distinction between Plan and non-Plan accounts did.

5. For operational efficiency it is suggested that the Ninth Finance Commission should attempt to equalize the administrative and social services across the States assessing fiscal needs in totality i.e. including both revenue and capital needs. The Planning Commission should cover the fiscal need-both revenue and capital - for economic services.

6. For practical reasons the scope for following a normative approach in assessing the revenue and expenditures of the Central government will be limited and this in turn will enhance the unequal treatment of the Central and State governments.

7. It is suggested that in the case of the Central government the normative approach should be interpreted so as to neutralize the adverse impact of numerous Central measures on State finances.

8. It is suggested that tax potentials of the Central government should be based on optimal exercises while that of State governments on the Representative Tax Systems approach.

9. The contribution of public undertakings of both Central and State governments should be assessed on the performance norms.

10. Fiscal needs of the States should be assessed in physical terms with reference to the all-States average.

11. It is suggested that the normative approach should not curb a State's autonomy in allocation of resources or in taking fiscal decisions.

Normative Approach and the Finance Commission : Some Reflections

P. R. Panchmukhi

In his letter addressed to the Chief Ministers of the State governments, the Chairman of the Ninth Finance Commission has specially drawn attention to para 4 of the Presidential Order appointing the Ninth Finance Commission. He points out "there is a distinct change in the approach of the present Commission as evidenced from para 4 of the Order. Instead of identifying non-Plan revenue deficit as in the past, the Commission has been asked to adopt a normative approach in assessing receipts and expenditure, without distinction between Plan and non-Plan. Consequently, emolument provisions and other items of expenditure would have to be judged in the light of norms and not with reference to any specific cut off date." Thus, the main point of departure of the Ninth Finance Commission's approach is the proposed adoption of a normative approach. In the terms of reference proper, there is no amplification of what this normative approach actually means. In the present paper an attempt is made to examine the possible interpretations and implications of this normative approach.

The earlier Finance Commissions used to follow an approach of receiving from the State governments the forecasts of revenues and expenditures on non-Plan account and then subjecting these forecasts to reassessment wherein invariably the receipts got scaled up and expenditures scaled down causing the State non-Plan surpluses if any, to be expanded or

deficits if any, converted into surpluses or at least reduced. Divergence of the rates of growth as adopted by the Finance Commissions from the rates as adopted by the State governments was responsible for the divergence of the reassessments from the forecasts. The State governments and the Indian federal financial system seemed to have accepted this philosophy of reassessment as an inevitable and natural concomitant as it were of a federation. The very title of the chapter in the Finance Commission Reports, "Reassessment of the Forecasts of the State governments", questioning the credibility and trustworthiness of the State governments' exercise, went through without strong protests (though with some murmurs) and resistance. Mutual trust, it need hardly be emphasised, is the very foundation of a healthy federation. The mechanism of forecasts and reassessments induced the State governments to present their forecasts in such a way that the reassessed figures of expenditures and receipts would turn out to be favourable to them in the ultimate analysis. This has further strengthened the mutual distrust between the State governments on the one hand and the Finance Commissions on the other.

The extent of deviation of the reassessments from the forecasts can be taken to reflect the extent of mutual distrust or as a measure of the coefficient of distrust.

The following tables indicate the extent of distrust that the Seventh and Eighth Finance Commissions have exhibited in their policy of reassessment.

Percentage change in reassessments over State Forecasts

State	Revenue Receipts		Revenue Expenditures	
	Seventh FC	Eighth FC	Seventh FC	Eighth FC
Andhra Pradesh	26.98	16.87	-27.22	-26.79
Assam	24.47	15.78	-32.95	12.08
Bihar	35.38	32.25	-39.36	17.03
Gujarat	9.87	34.19	-24.59	-20.66
Haryana	-17.23	12.68	-29.97	15.36
Himachal Pradesh	48.57	46.32	-13.65	-29.26
J & K	-3.40	43.24	-45.33	-21.63
Karnataka	10.80	14.33	-32.98	-32.25
Kerala	12.82	20.88	-34.63	-21.45
Madhya Pradesh	7.17	10.09	-30.38	-22.01
Maharashtra	2.47	8.12	-30.56	-21.05
Manipur	-14.19	113.12	-34.50	-24.49
Meghalaya	33.11	48.83	-39.00	-29.70
Nagaland	12.00	41.19	-34.44	-36.72
Orissa	2.83	18.09	-11.30	-20.95
Punjab	18.93	19.73	-27.57	-26.11
Rajasthan	8.21	10.44	-35.21	-28.66

Cont.

State	Revenue Receipts		Revenue Expenditures	
	Seventh FC	Eighth FC	Seventh FC	Eighth FC
Sikkim	-7.70	25.70	-2.57	-40.17
Tamil Nadu	14.75	29.55	-22.73	-32.04
Tripura	-8.91	69.13	-31.90	-47.07
Uttar Pradesh	10.08	39.91	-44.74	-36.95
West Bengal	5.70	16.03	-33.62	-27.64

Eighth Finance Commission

Percentage change in reassessments over the Centre's Forecasts

	Revenue Receipts	Revenue Expenditure	Capital Receipts	Capital Disbursement
Central Govt.	-5.32	-13.50	20.49	9.28

One may notice that so far as the revenue receipts are concerned, the majority of the States find their forecasts of revenue receipts reassessed in the upward direction by the Seventh Finance Commission. The extent of the upward scaling has been in the range of 2.5 per cent to 48.6 per cent. Only in the case of 5 States: Haryana, Jammu & Kashmir, Manipur, Sikkim and Tripura the State forecasts were considered to be over-estimates and hence they have been scaled down. As against this one notices that without exception, in the case of all the

States, the revenue expenditures have been scaled down by the Seventh Finance Commission. The extent of this scaling down ranges between 2.5 per cent to 45.3 per cent. It is interesting to note that the revenue expenditures of the States have been scaled down by the Seventh Finance Commission to a significantly larger extent in the case of all the States whose level and rate of development is not very satisfactory. For example, the less developed and developing States like Assam, Bihar, Jammu & Kashmir, Karnataka, Kerala, Madhya Pradesh, Manipur, Meghalaya, Nagaland, Rajasthan, Tripura, Uttar Pradesh and West Bengal experienced more than 30 per cent scaling down in their revenue expenditures. It is significant that the majority of the States from this group are backward in respect of the development and maintenance of the physical and social infrastructure. Jammu & Kashmir and Uttar Pradesh found their revenue expenditures cut down by 45 per cent. Obviously, it is these States where the maintenance of the social and physical infrastructure is very poor and the axe of the Finance Commission has fallen precisely on such States.

If we consider the Eighth Finance Commission's recommendations, a more or less similar pattern emerges. Practically in the case of all the States, the revenue receipts have been reassessed in the upward direction wherein the extent of reassessment varies between 8 per cent (Maharashtra) to 113 per cent (Manipur). It is interesting that some of the less developed States found their revenue receipts reassessed in the upward direction by more than 30 per cent. For example, Uttar Pradesh, Tripura, Nagaland, Meghalaya, Manipur, Jammu & Kashmir, Himachal Pradesh and Bihar belong to this group of less developed States. When we consider the revenue expenditures, on the other hand, most of the States experience a scaling down effect in the process of reassessment. The extent of downward reassessment varied between 21 per cent (Orissa) to 47 per cent (Tripura). Only in the case of three States: Assam, Bihar and Haryana, there is a marginal upward reassessment ranging between 12 to 17 per cent. In the case of less advanced States like Uttar Pradesh, Rajasthan, Nagaland, Madhya

Pradesh, Andhra Pradesh, etc., the extent of upward reassessment was 20 to 37 per cent.

From the above discussion it appears that the Finance Commission, as an apex body to effect the statutory transfer of resources, has distrusted the State governments to a significant extent. On an average, the coefficient of distrust in the case of the Eighth Finance Commission seems to be higher than the coefficient of distrust in the case of the Seventh Finance Commission so far as revenue receipts are concerned. Though in the case of expenditures the coefficient of distrust is smaller in the case of Eighth Finance Commission, it is surely of a very high order. This is evident from the following table.

Coefficient of Distrust of all State governments (percentage)

	Revenue Receipts	Revenue Expenditures
Seventh Finance Commission	9.61	-33.13
Eighth Finance Commission	25.18	-20.97

It is quite interesting and revealing that the coefficient of distrust in the case of the Central government is of a relatively lower magnitude. The Seventh Finance Commission has not given data of Central government forecasts and Finance Commission reassessment, while the Eighth Finance Commission Report gives these data. We find that the revenue receipts of the Central government have been actually scaled down by 5.32 per cent and the Central government revenue expenditures have also been moderately scaled down to the extent of 13.5 per cent. On capital account the capital receipts have been scaled up to the extent of 21 per cent and capital disbursement scaled up to the extent of 9.3 per cent. On the whole, one gets an impression from these limited data

published in the Report of the Finance Commission that the coefficient of distrust in the case of the Central government is of a relatively modest order as compared to that of State governments. The fact that there is distrust in the case of the Central government forecasts also is worth noting.

The above discussion raises a basic question as to why it is that the Finance Commission's estimates and the State and the Central government's estimates diverge so far as the receipts and expenditures are concerned. Since the divergence is observed in the case of the exercises of almost all the Finance Commissions in the past the question becomes all the more serious. Does it mean that the State governments in particular and the Central government in recent years, have not learnt the methodology of developing their forecasts of receipts and expenditures, the methodology which is acceptable to the Finance Commission? Or does it mean that since in any case the Finance Commission is going to reassess, it is advantageous to the State governments to adjust their forecasts in such a way that the reassessments - expected as well as actual - would not be too unfavourable to them? This only implies that the mutual disbelief feeds on itself and in this context honesty will not be the best policy.

So far as the methodology of developing the forecasts and also presenting the reassessments is concerned one feels that there is no set methodology adopted by both the State governments and the Finance Commission. Only in the case of the Seventh Finance Commission a fairly rigorous statistical exercise was attempted with the assistance of the National Institute of Public Finance and Policy to estimate the elasticities of revenue receipts. In the ultimate analysis however, these elasticities also do not seem to have been used in the actual exercise of reassessing the receipts. Similarly, in the case of expenditures also an element of judgement seems to have been used amounting to arbitrariness in developing both the forecasts and reassessment. There is no way to find out how more than two scores of State governments have developed their

forecasts. Finance Commission Reports only mention State forecasts and reassessments. The rates of growth of receipts and expenditures adopted are sometimes uniform for some States and different for others. Similarly, in the case of expenditures also the reassessments are based essentially upon judgement in the context of different States. If this is so, can this approach not be considered as normative? In fact the method (there is obviously no single method adopted for different States) adopted by the Finance Commissions is essentially normative in nature both with regard to the receipts and expenditures. Then why should the terms of reference of the Ninth Finance Commission emphasize the adoption of a normative approach in assessing the receipts and expenditures?

The following distinguishing points may be noted in the case of the terms of reference of the Ninth Finance Commission. The Presidential Order requires that there will be a 'normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre' and not reassessment. This according to us is a favourable development in the sense that the Finance Commissions are expected not to distrust the State forecast by 'reassessing' the forecasts. However, in order that the Finance Commission undertakes this exercise in the true spirit of healthy federal financial relations, this assessment needs to be done in full collaboration with the State governments. It may be useful if the Finance Commissioners of the State governments are co-opted as members of the subgroup that may be constituted by the Finance Commission for the purpose of the exercise.

The approach that the Ninth Finance Commission is expected to adopt would become truly normative if the special problems of each State are specifically recognized in the process of assessment. The fact that some of the States are reeling under severe drought conditions during the past four or five consecutive seasons may be one of the specific problems of the States, which needs to be considered in this normative judgement. Similarly, in some States even though the overall

per capita magnitudes relating to the physical and the social infrastructural development are fairly favourable, the intra-State inequalities with regard to rural-urban disparities, rural disparities and urban disparities deserve special consideration in the normative approach. The States are likely to emulate standards and levels of public services obtaining in the neighbouring States to start with and in the most progressive States in the ultimate analysis. The normative approach needs to consider these policy orientations and people's expectations regarding these levels. Since in the letter of the Chairman of the Ninth Finance Commission, it has been indicated that the receipts and expenditures without distinction between Plan and non-Plan need to be assessed by adopting a normative approach, such broader policy orientations and expectations of the people regarding the 'development' of the services and their maintenance become quite relevant considerations. It is satisfying that the scope of the Finance Commission is fairly widened to consider both the Plan and non-Plan aspects of the financial position of the States and the Centre. Such an overall perspective was not taken by apex agencies so far. If the Ninth Finance Commission fulfils this need then possibly it may pave the way for healthier Centre-State financial relations. At the same time one faces a question about this wider ambit of the Finance Commission's purview because then what will be the role of the Planning Commission in this context. The Planning Commission may turn out to be largely an advisory body without its present crucial position of, by and large, determining the annual and Five Year Plans of the States and the Centre. If Plan and non-Plan finances together have to be considered by the Finance Commission (though for a better scrutiny of non-Plan finances only) then the exercises made by the Commission for estimating the Plan component may have to become binding on the Planning Commission. In any case, this suggests that the roles of the two bodies need to be clearly defined to avoid an overlap or conflict.

While the adoption of a normative, State-specific approach in assessing the receipts and expenditures on the reve-

nue account of the States is welcome, the way the terms of reference have been mentioned in the Presidential Order do not seem to be quite in order. The relevant terms of reference say, "in making its recommendations Finance Commission shall adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre and in doing so keep in view the special problems of each State, if any, and the special requirements of Centre such as, defence, security, debt servicing and other expenditures or liabilities." While the special problems of each State 'if any', are to be considered, the special requirements of the Centre which are clearly articulated with open endedness 'have to be' necessarily taken into account. This wording gives an impression that the problems of the Centre have to be compulsorily taken into account, whereas it is up to the Finance Commission to get convinced that there are special problems in the case of particular States and only then these problems should be taken into account. The debt servicing and other committed expenditures or liabilities are the problems of the States also, which are not clearly mentioned in the terms of reference. In this background, the normative approach may be dubbed to be in favour of the Centre. As stated earlier the value of the co-efficient of distrust in the case of the Central government (as seen for the Eighth Finance Commission) even though moderate might itself be responsible for indicating the necessity of taking a normative approach with a special mention of the problems of the Centre. Critics may allege that even a small magnitude of reassessment of the Centre's finances by the Finance Commission was not tolerated and hence under the guise of the normative approach, the Finance Commission is expected to safeguard the interest of the Central government. It may not be proper to reach this conclusion before it is known what will be finally done by the Ninth Finance Commission. However, the working of the earlier Finance Commissions in this regard has only strengthened the fear of the critics with regard to the new normative approach to be adopted by the Ninth Finance Commission.

Some of the other terms of reference of the Ninth Finance Commission also seem to indicate this pro-Centre bias strengthening the doubts about the 'normative approach'. For example, the Terms of Reference No. 7 relating to the merger of additional duties of excise in lieu of sales tax with basic duties is not unexceptionable, particularly because the latter are levied and collected by the Union and may be distributed between the Union and the States, while the former have to be distributed among the concerned States. Again, in the Terms of Reference No. 9 relating to relief assistance, the pro-Union government bias seems to be evident. The Commission has been asked to examine 'the feasibility of establishing a National insurance fund to which the State government may contribute a percentage of their revenue receipts.' A reference to such a fund is made in the Terms of Reference (No. 6) of the Sixth Finance Commission also. It says, 'The Commission may .... examine *inter alia* the feasibility of establishing a National Fund to which the Central and State government may contribute a percentage of their revenue receipts.' (please note the portions underlined). The natural calamities which affect the entire nation in the ultimate analysis are essentially national calamities, and are in the nature of national public bads. The measures to tackle such public bads must be considered as the collective responsibility of the nation as a whole and not the responsibility of only the region or the States where the incidence of the natural calamity falls. Though at the time of the Sixth Finance Commission this seems to have been appreciated, at the time of the Ninth Finance Commission, however, all of a sudden, the approach has changed.

On the whole, we may conclude that the normative approach is desirable but this approach should not be ad-hoc or arbitrary as in the case of the earlier Finance Commissions. The normative approach may pave the way for healthy federal financial relations if the State-specific norms and judgements are adopted and the State representatives are co-opted in the exercise of developing the assessment of receipts and expenditures on revenue account. It would do great credit to the

Ninth Finance Commission if the misgivings about the role of the Finance Commission are dispelled by its sincere adoption of the normative approach involving the equal treatment of equals and unequal treatment of unequals and also fairly equitable treatment of the Centre and the State governments. It is only by adopting such norms in the normative approach that the Ninth Finance Commission's terms of reference can be said to mark a major departure from the accepted practice.