PART II

Recommendations

Report of the Ninth Finance Commission

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The Second Report of the Ninth Finance Commission was submitted to the President on 18th December, 1989 and laid before the Lok Sabha along with the actions of the Central government thereon on 12th March, 1990. About two months have lapsed since its publication. The announcement of the terms of reference of the Commission in the Presidential Order dated 17th June, 1987 had given rise to a strong protest from the opposition States and to a vigorous controversy among the students of Indian federal finance. Later, during the discussions and deliberations some of the methodologies regarding the adoption of norms had come in for severe criticism. But the Report has surprisingly aroused much less discussion so far. This may be due to a number of reasons. The Finance Commission has dealt tactfully with the points that disturbed the States; the First Report dealing with the recommendations for 1989-90 skillfully prepared the concerned parties for what has followed in the Second Report; consultations with experts were more frequent. The government and the opposition during the tenure of the Commission have now changed sides so that some who had taken cudgels against the terms of reference are a party to accepting most of its recommendations. It may also be that since the Ninth Finance Commission Report is accepted, it is felt that nothing can immediately be done to upset it and that further discussion is futile or it may be that inspite of the envisaged departures in approaching the problem of Centre-State and inter-State transfers the results are so similar to the earlier ones that there is little new to complain about. Since, however, our major interest is in evolving a long-term satis-

factory system of Centre-State transfers, a scientific discussion of the Report will be useful and productive.

From the viewpoint of the States as a whole, the most strategic question is the determination of the quantum of transfers as a whole from the Centre to the States. The Indian Constitution limits the types of transfers the Finance Commission can recommend. The States have to be assigned a share of income-tax; they may be given and are now given a share of excise duties. 85 per cent of shareable income tax and 45 per cent of excise proceeds are now prescribed as the States' shares. The States in need of assistance are given grants under Article 275. Now under some sub-headings all States are recognised as eligible for grants, but these have played a minor part in the transfers of the Finance Commission. The States have insisted on transfers being mostly given in terms of shares in divisible taxes and the Finance Commissions have recognised their legitimacy. The Ninth Finance Commission has been more liberal in the use of grants and has recognised a special category of it — deficits on Plan revenue account. It has also provided a much larger sum by way of the Centre's contribution of 75 per cent towards a Calamity Relief Fund. Even so, the statutory grants for 1990-95 are estimated to amount to only 17.1 per cent of the transfers. Income tax and excises have in the 'eighties grown much less rapidly (14.26 per cent and 14.57 per cent respectively) than corporation tax (15.39 per cent) and customs duties (20.12 per cent) and non-tax revenues have risen much faster (19.3 per cent) than tax revenues (16.3 per cent) so that the statutory transfers are likely to diminish when the shares of divisible taxes are kept constant. This experience is likely to be repeated in 1990-95. The transfers to States are estimated to amount to 22.7 per cent of total Central revenue receipts compared with 24.1 per cent according to the Eighth Finance Commission's recommendations. A question which deserves deep consideration at our meeting is: Why inspite of the greater financial difficulties of the States, the avowed policy for greater decentralization, and the quasi-judicial mechanism of the Finance Commissions have the statutory transfers to the States become more or less constant in terms of

percentages of the Central revenues? Some tentative lines of reply may be attempted.

To be fair to the Finance Commissions it must be noted that they have tried to be responsive to the criticism of the States to the extent it lay within their domain. The Ninth Finance Commission has, for example, examined in detail the revenue and expenditure forecasts of the Centre and also put them to some normative tests. Unlike in the case of States where one can compare performance of one State with that of others to arrive at norms, there is only one Centre and the other countries are so different that comparisons do not help. Perfect symmetry was, therefore, not possible, but all sincere efforts were made to put the Centre's forecasts to as rigorous tests as those of the States. The often made criticism that much less percentage changes are made in Central forecasts than in the States' or that there have been much greater changes in the actuals of the Centre by itself does not mean much. The more important fact is that the Finance Commissions have mainly to confine their attention to the current side, and throughout the 'eighties the Centre had a deficit on revenue account. More recently, almost the entire Central Plan has been financed from borrowing including deficit financing, and both these do not directly concern the Finance Commission. It is borrowing and deficit financing which explain the apparent affluence of the Centre. The States get a small share of the money so acquired by way of Plan assistance but they bear the full impact of the consequent price rise. No sharing formula or grants can tackle this problem at the root. The more promising lines of attack are economy and efficiency of expenditure, prevention of tax leakages and evasion and dropping activities are important but less so. The level at which the Centre and the States have to discharge their functions in the light of their importance to the national economy and the expenditure just needed for them if efficiency was considerably stepped up were the main issues. By their tenure and nature, the Finance Commissions are not equipped to deal with these problems and have not done so. The consequent disappointment to the States and the Centre was natural but also unavoidable.

There are some incidental complaints of States which can be more easily dealt with. The States have often demanded that the corporation tax should be included in the divisible pool. In so far as each Finance Commission decides the quantum of transfers first and the ways of transfer later it should not matter whether a tax is included or not in the divisible pool, till the States shares in the divisible taxes have reached their maximum. The inclusion of corporation or some other tax in the divisible pool should mean that shares in the already divisible taxes will be simultaneously reduced. It is difficult to prove that the States' cooperation is needed in the successful administration of one Central tax more than the other. But the flexibility of different taxes differs so that in the intervening period between two Finance Commissions, the inclusion or exclusion of one tax may make a difference. Also since it is customary to fix different distribution formulae for different taxes, different States may fare differently if the corporation tax is included. It is likely that the more industrially developed States may gain more. Irrespective of the gains and losses to the individual States if an amendment of the Constitution is not thought inadvisable it may be worthwhile fixing the States' shares as a proportion of the total Central revenues and imparting any flexibility needed in assistance through grants under Article 275. This will avoid much of the Centre-State conflicts on the use of Central surcharges and use of prices of Central enterprises rather than excises to get more revenues.

The major changes that were expected in the recommendations of the Ninth Finance Commission were in the inter-State distribution of Central transfers because of the new approach implied in the terms of reference. The approach earlier adopted was picturesquely described by some economists as a "gap-filling" approach. The tax and expenditure forecasts of the States were made on the basis of past trends: tax devolutions were prescribed, and grants under Article 275 were recommended to fill the non-Plan deficits if any. The description was not completely accurate, as successively more and more modifications were made in tax and revenue

expenditure forecasts and in the case of interest on loans and returns from public sector enterprises even some norms were prescribed. Grants often included upgradation purposes and were sometimes given also to achieve certain goals in developmental fields. The terms of reference of the Ninth Finance Commission laid down two new procedures - adoption of a normative approach in assessing the receipts and expenditure on revenue account and of not confining to tax revenues as existing on a particular date or to non-Plan expenditure. The first change had aroused an apprehension among the States that by prescribing norms there would be attempts at encroachment on their powers by the Commission. This fear had been met by the assurance that norms were only for the purpose of recommending transfers and the States were free to attempt better services out of their own resources by taxing more or taxing less if their citizens were satisfied with less services. It had also been pointed out that the prescription of norms in this manner was essential if economy and resource mobilization were to be encouraged. The second change of including Plan expenditure was essential if the States with deficit on non-Plan account - generally very poor States like Uttar Pradesh, Orissa, etc., - were to be enabled to plan on lines somewhat similar to the States with substantial surpluses on non-Plan account. The major problem in the second job was that the Finance Commission had less competence than the Planning Commission to recommend the State Plan size and the pattern of sectoral allocation and had no jurisdiction on assistance through loans which was more important in Plan assistance and linked with Plan grants hitherto.

It is interesting to know how both these issues were methodologically tackled by the Finance Commission. As far as the tax norms are concerned the Second Report of the Ninth Finance Commission adopted the modified representative tax system approach which implies that you calculate for each State the tax revenues that would be obtained if the tax bases had been exploited to an average extent. For fees and user charges actuals have been used, and for dividends and interest, normative returns. Expenditure has been divided into four major

categories; general services, economic and social services, social welfare services and maintenance. The average behaviour has been taken as the norm for a substantial part of non-Plan revenue expenditure. For social and economic services the justifiable costs of providing the existing level of services has been estimated and for expenditure on social welfare services certain uniform levels are fixed. For maintenance engineering norms are applied. Since the norms are broadly the averages it is not surprising that while the revenue and expenditure forecasts worked out by the basis of norms differ from the trends worked out on the conventional methods for individual States, for the States as a whole the sum totals hardly differ. The normative tax estimates for 14 major States were more than the conventional ones by less than one per cent and the normative non-Plan revenue expenditure estimates were less by 3.5 per cent. To give more time for adjustment only 50 per cent of the net improvement noticed in the case of ten major States because of the adoption of norms was adjusted.

While it has not always been thought advisable for the Finance Commission to change the combined States' shares of income and excise duty collections every Commission has changed the formula for inter-State distribution. Each Commission has given its own line of thinking, but it is difficult to trace any principles except the desire to make the distribution more progressive. The Ninth Finance Commision has done likewise. As a result of the changes in the inter-State distribution formula, it suggests as well as other changes, among non-special category States Rajasthan, Orissa, Uttar Pradesh and Haryana have relatively gained in that order whereas all others have lost. The biggest loser is West Bengal. It is surprising that the poorest State, Bihar, has gained less in percentage terms than the average. Among the special category States the only gainer is Jammu & Kashmir. For States like Mizoram, Arunachal Pradesh and Goa which acquired Statehood only recently no comparisons are possible. The per capita transfers increased by 169 per cent. Among the non-special category States they varied from Rs 1,190 for Haryana to

Rs 2,529 and Rs 2,517 for Rajasthan and Orissa; among special category States the variations were much higher - Rs 2,705 for Assam to Rs 30,753 for Mizoram and Rs 24,115 for Nagaland.

The question of Plan transfers is treated in an interesting manner. On the assumption that the revenue Plan expenditure of the 14 major States will increase at 7 per cent per annum, it will rise to Rs 40,000 crores in the Eighth Plan. This figure is redistributed among the States to make the per capita expenses more progressive and equitable and a minimum of revenue Plan expenditure for 1990-5 is arrived at for each State. To enable the weaker States to spend more on the Plan, they will be given 50 per cent of the shortfall between this amount and 40 per cent of their revenue surplus on the non-Plan account plus the expected receipts on revenue account from the Gadgil formula of Plan assistance. This will be Plan deficit grant which will amount to Rs 8,674 crores for 1990-95. It is interesting to note that the Ninth Finance Commission has found out a skillful way of helping the weaker States to implement a better Plan without encroaching on the legitimate functions of the Planning Commission regarding the size of the State Plans, their sectoral allocation, and Plan assistance.

An important exception that should be noted when talking of norms is that for well-known reasons these are not applied to special category States which are more liberally treated and only as specific cases as before. As a result the financial allocations to them work out to a higher percentage than before and much higher in proportion to population. The Ninth Finance Commission has for 1990-5 recommended 15.44 per cent of the total transfers to be made to them compared with 14.06 per cent by the Eighth Finance Commission. The population of the special category States is only 5.2 per cent, so that the per capita transfers are about thrice. The Planning Commission treats them equally liberally. This has for a long time been accepted as natural, but some means to ensure that this money is well spent and brings proportionate results is called for. The special category States are very keen on the establishment of equitable standards among them.

There is one long-standing problem which the Ninth Finance Commission has solved more satisfactorily than the earlier ones - the question of satisfactory arrangements for financing of relief expenditure by States affected by natural calamities. The relief expenditure was at the time of the Eighth Finance Commission to be met from the margin money which was calculated by averaging the non-Plan expenditure of the State over the past few years booked under the heads accommodating the relief expenditure. The margin money was to be equally shared between the Centre and the States. Items of direct relief expenditure and expenditure on repairs and restoration of public assets were to be covered, but not on relief employment. Expenditure in excess of margin money was to be borne by the State government out of advance Plan assistance if needed. Every time there was a natural calamity, a Central team visited the scene to determine the ceiling under various headings of relief and there was some hot wangling. Apart from the general complaint of inadequacy of famine assistance, the States bitterly complained of the time taken by the Central team and the ad hoc nature of its recommendations. The Ninth Finance Commission has redressed this complaint by creation of a Calamity Relief Fund of Rs 804 crores a year to which the Centre contributes 75 per cent and the States 25 per cent. The fund has to be deposited in a nationalized bank. The State will have more autonomy in drawing on it to the extent necessary to deal with a natural calamity. If more is needed, the State will have to draw on its own resources though some temporary credit may be extended. Any unspent money in the Fund at the end of the Plan should revert to the State. This new arrangement may prevent much friction between the Centre and the States.

While the Finance Commission looks after the revenue deficits of the State, and the Planning Commission takes care of the Plan needs, revenue and capital, there is no mechanism to look after the non-Plan capital requirements of the States. Large sums are needed to repay the Plan loans taken earlier from the Centre, but apart from the share in small savings there is no regular major source of non-Plan capital receipts which can

provide for repayment. This was regarded as one of the important causes of unauthorised overdrafts by the Fifth Finance Commission. Since then the Finance Commissions have been asked to determine this gap and suggest measures to meet it. The Sixth, Seventh and Eighth Finance Commissions have suggested writing off of some debts and rescheduling of some repayments which fall due in their period. This is a very unsatisfactory way of dealing with the problem because a rescheduling by one Finance Commission creates hopes of the next doing so and the extent cannot be known in advance. The Ninth Finance Commission has been more wisely asked to deal with the fundamental problem and suggest corrective measures with particular reference to investments in infrastructure projects and linked with improvements in managerial and financial efficiency. As long as capital expenditure is incurred for purposes which do not give enough returns to pay the interest and meet the repayments the regular revenue account has to provide for the remainder. Since the Planning Commission thinks there is no purpose in providing for any amortization for repayment of Central Plan loans which will reduce the immediate availability of Plan funds the Finance Commission has recommended that the Plan loans from the Central government should be limited for non-special category States to the extent of Plan grants and the terms of Plan loans should have relation to the terms on which the Centre has obtained these loans and the gestation period of the projects financed from them. The rest should be obtained from the market for repayment of which a separate amortization fund as determined by the Reserve Bank should be created. The implications of these on the poorer States' ability to get funds and the budgetary burden have not been considered. It is obvious that the remedy can create its own problems.

Inspite of the specific recommendations of Finance Commissions no satisfactory mechanism has been created to monitor the impact of the Commission's recommendations on State finances and financial policies. The Finance Commissions have themselves no time to examine this impact with the result that there is no sufficient link between the

recommendations of successive Finance Commissions. The norms that the Ninth Finance Commission has set will need special watching. It is hoped that this time the Central government will make special efforts to make adequate follow-up arrangements.

The working of both the Eighth and Ninth Finance Commissions have brought to light the somewhat casual attitude of the government to the Finance Commission. The Eighth Finance Commission had complained that for a long time after it was set up, no satisfactory office arrangements were made leading to a delay in its Report and the Central government deciding to implement its recommendations for four years instead of five. The frequent changes in the membership of the Ninth Finance Commission are a legitimate cause of concern. One would have thought that membership of a statutory Commission was a great honour and that one who accepted this responsible position undertook not to seek or accept any other responsibility until this work was completed. At least the government should not be a party to tempting him to do so by offering him alternative assignments till the Report was submitted. The departures from this etiquette make a mockery of a statutory Commission.