Record of Discussions of the Second Meeting of the Commission with Economists and Economic Administrators held on March 10, 2003 at Chennai

The second meeting of the Twelfth Finance Commission with a select group of economists and the economic administrators of the southern States was held at 10 am on March 10, 2003 in RBI Staff College, Annasalai, Chennai. Dr. C. Rangarajan, Chairman, Twelfth Finance Commission was in the Chair. A list of participants is annexed as 'A'.

2. The Chairman while welcoming the participants, observed that many of the issues have been discussed at length in the reports of the previous Commissions. However, there was a need to look into them again in the context of changing circumstances. He listed out the main issues and sought the views of the participants, *inter-alia*, on the following:-

2.1 The need for the Finance Commission arises on account of the asymmetry of financial powers and the responsibilities of Govt. at various levels. In India, the Finance Commission has been the major vehicle for determining the transfer of resources from Union to the States. The Eleventh Finance Commission (EFC) felt that 37.5% of the gross revenue receipts of the Union should be transferred to the States, including the transfers from Planning Commission. The EFC fixed the share of the States at 29.5% of the net proceeds of all shareable taxes and duties. This translates into 21-22% of gross revenue receipts. If the grants-in-aid recommended by the EFC are taken into account, about 27% of gross revenue are being transferred on the basis of Finance Commission's award leaving about 10% for the Planning Commission and the others. The question is what proportion of the Central resources could be shared. Should the Finance Commission fix a ceiling on this and determine how much out of this should be through devolutions and grants-in-aid on the non plan side and how much should be through other channels including Planning Commission and Ministries of Govt. of India?

2.2 Previous Commissions have evolved various criteria to achieve horizontal equity. Broadly speaking, the relevant criteria have been needs, cost disabilities and efficiency. There has been a trade off between equity and efficiency. Therefore, the issues before this Commission would be:

- Do equity and efficiency have to be mutually exclusive? Can one be pursued without compromising the other?
- What parameters would truly represent equity and what would truly represent efficiency.

2.3 There are two ways in which the transfers are made through the Finance Commission. One is the devolution of shared taxes and the other, the grants-in-aid. Grants-in-aid are generally used to supplement devolutions where necessary, to ensure equity. Certain basic services have to be made available to all citizens across the States. The issues are:-

- What mechanism should be adopted so that minimum standards in the provision of basic services are achieved irrespective of the geographic region in which a citizen lives?

- If it is through the grants-in-aid route rather than the tax devolution route, can the grants be made conditional to achieving those standards?
- What should be the relative proportion of conditional and non-conditional grants?

2.4 Restructuring of public finances of the Union and the States is a major challenge before the Twelfth Finance Commission. This was also in the TOR of the EFC, which was the first Finance Commission to directly go into this question. The EFC wanted the combined fiscal deficit of Centre and States to be brought down to 6.5% of the GDP. It also prescribed that revenue deficit should be brought down to 1% of GDP at the Centre, with nil revenue deficit in the States. Further, the EFC assumed an improvement in the tax-GDP ratio by about 1.5% over the 5 year period. EFC had also indicated that interest payments would stabilize at 4.6% of GDP in view of falling interest rates. These assumptions have proved to be far removed from what we are now witnessing. The Revenue Receipts are stuck at around 9.7% of the GDP for the last 5-6 years. 48.5% of Revenue Receipts are used up in servicing interest liabilities. State Governments. Are defaulting on guarantees. The Narmada bonds are repayable soon but the resources are yet to be found. Therefore, the issues before the Commission are:-

(i) How to ensure that the tax: GDP and Revenue Receipts : GDP ratios go up?
(ii) Whether fiscal deficit is the appropriate parameter to judge the fiscal health?
(iii) What is the sustainable level of fiscal deficit for Centre & States?
(iv) What relief can be offered to the States and how to ensure that such relief actually puts the State Governments on the correction path?
(v) What should be the appropriate level of interest payment as a ratio of Revenue Receipts?

2.5 There are a number of problems in forecasting the resources and expenditure of the Centre and the States. These include the falling nominal GDP growth rate on account of both real growth as well as the inflation rate, proposal to introduce VAT in place of Sales Tax etc. The criticism that the Finance Commission's approach is gap-filling may not be valid as the forecasts are often normative. The issues therefore are:-

- What should the approach of the Twelfth Finance Commission be in making these forecasts?
- How to assess the impact of switch over to VAT and reduction in CST; what about the moral hazards in offering to compensate the revenue losses fully; how would the losses be determined accurately; would such compensation not impact the Centre's resources and committed liabilities?

2.6 Devolution to *Panchayati Raj* Institutions and Urban Local Bodies is primarily the responsibility of the States and the State Finance Commission. It is in this background that the role of the Twelfth Finance Commission in making supplementary transfers should be viewed.

2.7 The Commission is also required to review the present arrangements of disaster management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund. The issues range from the optimum size of the funds to how they should be operated, what expenditure should be allowed etc.

3. The participants expressed their points of view on each of the issues raised by the Chairman. These are summarized below :-

(i) Prof. Raja J. Chelliah

a) The Govt. of India itself is responsible for the fiscal crisis in most States as it has not been able to meet its revenue targets. It must improve the tax-GDP ratio.
b) The assumption that the gap-filling approach has given way to normative approach may not be correct. The TOR for the Twelfth Finance Commission requires it to generate a surplus on the revenue account.
c) The States tend to forecast low growth in revenues and high growth in expenditures. Even if these are moderated, the actuals become the basis for the next Commission. Thus the effect of moderation lasts only for five years.
d) In true federations, the States are left to decide their own income and expenditure levels. Ultimately the State should be responsible for their needs. Devolutions are a matter of right. No attempt should be made to influence the States' decisions through the mechanism of conditional grants-in-aid.
e) The Commission may fix the percentage of devolution through all the sources and determine the formula for horizontal distributions. Once done, there should be finality to this. The States should be expected to manage their affairs within the revenues available. Whether they want to be in surplus or deficit is their choice.
f) States cannot borrow in the same way as the Centre. The whole mechanism is faulty. Smalls savings loans, Market borrowings etc. are allowed to States without looking into the States' capacity to service the debt. Factors such as Debt: GSDP, Revenue receipts : GSDP should be reckoned before allowing a State to borrow.
g) The practice of following the Central Pay Commission defies federal principles. Each Govt. should pay the salary to the staff according to its own capacity based on its per capita income. Poor States may be subsidized by the Centre.
h) Budgets have implications not only for the financial year but even subsequently. It is therefore, necessary to have a three year rolling expenditure plan for the State.
(i) It is difficult for the Commission to enforce conditionalities.

(ii) Dr. Paul Appaswamy

a) The pace of reforms in irrigation and power should be taken note of. Some States are doing better than others in this area.
b) Local Govt. finances are in a crisis and, therefore, should be given a serious thought for more transfers to local bodies even though it is State subject. Otherwise the 73^{rd} and 74^{th} amendments to the constitution will remain a dead letter. The pace of urbanization is a relevant factor.

c) There should be a proper mechanism for transfer of funds for handling calamities. One way would be through insurance. The Center and the States could share the insurance premium.

(iii) Shri S. Venkitaramanan

a) Emphasis should be on containing revenue deficit rather than fiscal deficit. Measurement issues have complicated the Fiscal Deficit as an indicator of Fiscal health. Insisting on specific numbers for fiscal deficit could do more harm than good. The tendency to resort to off- balance sheet expenditures through SPVs etc. should be discouraged.
b) Too much emphasis on Fiscal deficit hurts investments.
c) The revenue component of Plan varies from State to State. The revenue component of Plan assistance should, therefore, be based on the balance of current revenue.
d) The pattern of Central Assistance in the form of loans and grants should be reviewed with a view to raise the grants component.
e) Declining tax : GSDP ratio is a matter of concern. Some thought should be given to increase the taxable capacity of States. In this connection it may be considered whether the power to levy personal income tax could be transferred to the States. This will incentivise the States to levy tax on agricultural income.
f) States can be forced to perform by stipulating conditionalities especially in respect of user charges. Upgradation grants are already conditional and are well monitored. Achieving fiscal reform targets should be an important condition.
g) There should be a National Wage and Income Policy. This task may be assigned to the Planning Commission. Finance Commission could recommend grants-in-aid to the States to meet their requirements.
h) Redressing inequities in development is the Planning Commission's job. The Finance Commission should not concern itself with effecting total charges in the existing structure.

(iv) Shri K.K. George

a) States are no paragon of virtues but the Centre is at fault to a large extent for their present state of affairs as the share of central transfers as a percentage of GSDP is coming down. Successive Finance Commissions have provided incentives and disincentives for the performance of States. But the Finance Commission is helpless if the Centre does not perform.
b) There was a case for larger vertical transfer to States as they have to render many services especially in the social sector. Market failures are more pronounced in the areas dealt with by the States.
c) Social security should be taken over by the Centre. This would automatically lead to equalization.
d) Reduction in import duties has led to a fall in prices in the domestic market. The Union Govt. should compensate the States which were adversely affected due to the policies of the Centre.
e) Finance Commission transfers have made no dent on regional disparities. Disparity in public expenditure between States should be taken note of.

f) Progressivity in the devolution formula should enable generation of substantial non-plan revenue surpluses. Equity should be built into the devolution formula itself and not achieved through grants-in-aid.
g) The distinction between the Plan and Non-Plan and even capital and revenue has led to undesirable outcomes. Maintenance is neglected because it is non plan. It should be appreciated that non-plan is not necessarily non-developmental.
h) Normative approach should be adopted for State as well as Union Finances.
i) A better normative approach should be evolved for assessing taxable capacity.

(v) Shri P.K. Biswas

a) Efficiency should be given weightage in allocation of resources. Project approach should give way to revenue approach. Choice of investment should be left to the States. Social security should be offered to those associated with products/services that have become obsolete in the changing context.
b) Use of information technology should be one of the considerations in measuring the efficiency of States.

(vi) Shri. K. Krishnamurthy

a) Plan periods and Finance Commission award periods are not conterminous. This has implications for projects. Even base year figures are based on assumption. While the FC makes its projections on certain assumptions which include all India level GDP growth, State level GDP growth, inflation etc. many unintended inaccuracies arise in this process. Therefore, the Finance Commission should also suggest a formula for mid-way corrections.
b) Fiscal discipline has to be maintained both by the Centre as well as the States. There has to be a fiscal framework in the medium term. There should be MTFRP for the Centre matching with those of the States.
c) Horizontal devolution should factor in the deviations from the National average in percapita income, distribution of income, infrastructure etc.
d) The concept of gross fiscal deficit is of recent origin. The Public Sector is neglected on account of an obsession with this while private sector is not stepping in. It is difficult to determine what expenditure is productive and what is unproductive.
e) There is no rationale behind the use of the 1971 population figures. Instead, the 2001 census figures should be used.
f) In making recommendations for *inter-se* distribution among the States, successive Finance Commissions have used per capita income figures. Emphasis should be on the total kitty of resources available with the States.

(vii) Shri Narayan Valluri

a) Expenditure made by the Central Ministries should be studied and determined normatively. Percentage of vertical devolution can be decided only thereafter.
b) All Centrally sponsored schemes should be transferred alongwith the funds, to the States. Expenditure by Central Ministries on items coming under the State List should be disallowed.
c) Subsidies have doubled in the last four years instead of coming down. The growth rate of expenditure on subsidies at 18% is more than the revenue growth.

d) So far as horizontal sharing is concerned, each Finance Commission has tried to out do its predecessor by adopting multiple criteria. The level of infrastructure is one of them. This should be left to the Planning Commission as infrastructure development is not non-plan. Weightage of 70% for backwardness is too high. High income States are made to pay for the poor management in low income States which is not fair.
e) Transfers should be linked to measurable indices of performance.
f) There is no need to adopt the population figures of 1971 for the calculations.
g) The projections made by the EFC are way off the mark. There is a big difference between the actuals of today and the projections made by the EFC for the period, e.g. GDP growth, Revenue deficit, debt, interest payments etc.
h) The debt of States was rising. Interest payments alone exceed their share in Central taxes. Debt relief has to be provided to States. Debt swap should be allowed so that States benefit from the falling interest rates. Debt relief should be linked to performance.
i) There should be a cap on debt and contingent liability. Incremental debt should go into capital investments. Quality of capital expenditure should be stressed.
j) Budgetary subterfuges such as showing the interest payable on irrigation loans as part of capital outlay on irrigation should stop.
k) Share in central taxes should be reduced to the extent of shortfall in maintenance expenditure.
l) While States were accountable for the fiscal mismanagement, the Centre should also be accountable for its fiscal profligacy. There should be a provision for a dynamic Fiscal Incentives Fund and even the Centre should be brought under its purview.

(viii) Prof. M.A. Oomen

a) The issue of local finance is an integral part of the Finance Commission's mandate. The objective of equalization of services and basic minimum facilities would require the Finance Commission to lay adequate stress on local bodies finances.
b) Local Governments are not generating adequate resources. Their dependence on State Governments should be reduced. The Finance Commission could provide the guidelines and set targets for revenue efforts at even sub-State level.
c) The index of decentralizations is not a desirable devolution criterion. On the other hand, infrastructure is an important criterion that should not be missed.
d) 70% of the Centrally sponsored schemes relate to what should be done at the Panchayat level. Such over centralisation should be avoided.
e) EFC grants grossly inadequate for maintenance of capital assets by local bodies.
f) Horizontal equity and equalization of services would not be possible without proper devolution to Panchayats and Municipalities.

(ix) Prof. Hemlata Rao

a) The federal form of governance is changing. The quasi- federal structure is slowly converted into a unitary structure. There is a need to rethink the division of taxation powers. States have a right over their assets. Centralisation is undesirable.

b) The relevance of Excise duties in the context of VAT should be examined.
c) Net proceeds should be determined rationally. Union Emoluments should not be excluded while netting the income tax receipts.
d) The State has a right to the resources in the divisible pool. The phrase “may be” in Para 4 (i) in the TOR of the 12^{th} Finance Commission is not in conformity with the 80^{th} Constitutional Amendment. *(Prof. D.K. Srivasatva, Member pointed out that the TOR is correct reproduction of what appears in Article 280 of the Constitution. This has not been amended by the 80^{th} Constitutional amendment.)*
e) Rates of royalty should be rationalized and made *ad valorem*. It has considerable scope for raising resources for mineral-rich States.
f) How the States use their disinvestment proceeds should be a criterion for assistance. Retirement of debt should be preferred over meeting revenue deficits.
g) It is necessary to study the relationship between public investment and private investment. Blanket cuts may be undesirable.
h) In normative assessment, physical norms should be preferred over statistical growth projections.
i) Expenditures should stick to the time schedules to avoid escalations.
j) Principle of derivation should be used for horizontal sharing. It should be based on backwardness as indicated by infrastructure and human development indices and less on fiscal needs.
k) For normative assessment of revenues, the Canadian model of taxable capacity should be adopted.
l) The third layer of governance should be strengthened. The tax base of local bodies should be widened and agriculture income tax could be assigned to them. Similarly land revenue and profession tax should be assigned to them to ensure better collection. This will reduce the burden on the Centre and the States.

(x) Prof. U. Sankar

a) Equity criterion should be broadened beyond the narrow sense of equalization as such an approach has not reduced regional disparities in fifty years.
b) A large share of loan goes to correct the deficit on revenue account which is not desirable. Appropriate user charges must be levied to increase revenues.
c) Low priority is given to the maintenance of capital assets. It should be appreciated that the return on investment on utilisation of existing potential is far more than the return on fresh investments.
d) Regulatory regimes have been established but the institution has not evolved. They have not been able to keep the necessary distance from the political executive.
e) A mechanism needs to be evolved by which the budgets also reflect the true picture of the public sector undertakings.
f) Legal and administrative reforms including transparency should be brought about in public finance management especially, budget making.

(xi) Shri T.L. Sankar

a) Devolution proceeds are used up in debt servicing and, therefore, may not serve the intended purpose. The increase in debt burden on State Govts. in the wake of the acceptance of Ahluwalia Committee recommendations on power sector is a case in point.

b) The principle of uncertainly governs the power sector. Every state is promising a turn around in 2-3 years. Efficiency of collection is emphasised at the cost of efficiency of spending.
c) States may demand funds for transition. Spending has been extravagant in the name of reforms.
d) Agriculture is not as subsidised as generally believed.
e) Local bodies neglect basic amenities in schools and hospitals. The index of backwardness should take into account not only the number but the quality of services and the funds required to improve them.
f) Public sector should be supported only if it can assure adequate return on investments.

4. Shri. Sompal, Member made the following observations:-

(i) Duties and obligations are an essential part of federalism; not only the rights.
(ii) The burden on States is increased on account of Centrally sponsored schemes. Most schemes are defective as local needs and the capacity to absorb are ignored. They invariably have large revenue components.
(iii) Emphasis on Tax: GDP seems to be disproportionate as the quality of expenditure tends to be lost sight of. Much of government expenditure is not only unproductive but counterproductive if considered in terms of the obstruction and corruption that they engender.
(iv) Lot of funds is being wasted in the name of reforms.
(v) Investments should be more where ICOR is low but the fact is the opposite. Project approach is not followed.

5. The Chairman, in his concluding remarks, thanked the participants for their views and wondered if a consensus has emerged on major issues. He pointed out that some participants had started with efficiency and ended up with equity, and vice-versa. This clearly showed the importance of both equity and efficiency. Previous Finance Commissions used various criteria to balance equity with efficiency. Perhaps the number of criteria could be reduced. He observed that the participants had not suggested a specific percentage for the vertical transfers. But the Commission would have to make up its mind and work out the number. Assignment of more taxation powers to States would require constitutional amendment. For the present, the Commission could only address its terms of reference. The Commission would make recommendations to strengthen the finances of the local bodies. However, its task is limited to suggesting measures to augment the consolidated fund of the States on the basis of the recommendations of the SFCs. Finance Commissions have never attempted gap filling in entirety. Only the gaps as assessed by them have been recommended to be filled. In reality, large gaps have still remained wherever the projections were off the mark or the performance was below expectations. However, the Finance Commission could clarify this issue as it is a question of credibility. Determination of fiscal capacity of States is a difficult task; it may, however, be dangerous to move away from the concept of fiscal deficit. While proper utilization of debt is important, the distinction between fiscal deficit and revenue deficit may only be academic. Conditional and unconditional grants have to coexist. There is merit in the suggestion that utilization of grants should be monitored. There is also a case for raising user charges to recover costs. The five year Plan and the Finance Commission

award periods need not be coterminous. In any case, the Finance Commission has to make an independent assessment for its purposes. The index of decentralization for local bodies funding could perhaps be revisited by the present Commission. These and related issues would be further discussed with all concerned before reaching a conclusion.

The meeting concluded with a vote of thanks to the Chair.

Annex`A'

Second Meeting of the Commission with Economists and Economic Administrators held on March 10, 2003 at Chennai

List of Participants

Twelfth Finance Commission

1. Dr. C.Rangarajan, Chairman
2. Shri Sompal, Member
3. Shri T.R. Prasad, Member
4. Prof. D.K. Srivastava, Member
5. Dr. G.C. Srivastava, Secretary
6. Shri R.Ramanujam, Joint Secretary
7. Shri. R.N. Choubey, Joint Secretary
8. Shri J. Wilson, Director
9. Dr. Vishwa N. Alok, Deputy Director

Economists and Economic Administrators

1. Dr. Paul Appaswamy
2. Shri. P.K. Biswas
3. Prof. Raja J. Chelliah
4. Shri. K.K. George
5. Shri. K. Krishnamurthy
6. Prof. M.A. Oommen
7. Prof. Hemalata Rao
8. Shri. T.L. Sankar
9. Prof. U. Sankar
10. Prof. J.V.M. Sarma
11. Shri Narayan Valluri
12. Shri. S Venkitaramanan