RECORD OF DISCUSSIONS OF THE FIRST MEETING OF ECONOMISTS AND ECONOMIC ADMINISTRATORS

The first meeting of the Twelfth Finance Commission with the Economists and the Economic Administrators was held on 18.02.2003 in Jawahar Vyapar Bhawan, New Delhi. The meeting was chaired by Dr. C. Rangarajan, Chairman, Twelfth Finance Commission. A list of the participants is annexed.

The Chairman, in his opening remarks, laid down a broad framework for the discussions and sought the views of the participants, inter-alia, on the following issues:

1. The vertical imbalance between the Centre and the States and ways of correcting it, particularly in the light of similar attempts made by the Eleventh Finance Commission.
2. The horizontal imbalances among the States and the relative importance of equity and efficiency criteria in correcting these imbalances.
3. The use of the devolution formula vis-à-vis the grants-in-aid route for addressing equity issues.
4. The role of conditional grants as opposed to unconditional grants in equalizing public services across the States and the need for incentivising the transfers.
5. The normative considerations which should go into projecting revenues and expenditure of the Centre and the States particularly in the context of the proposed introduction of VAT.
6. Restructuring of the public finances in general and arriving at an appropriate level of fiscal deficit that may be sustainable in the medium term at the national and state levels.
7. Considerations which should go into sharing of States' revenues with the local bodies.
8. Gap filling approach and norms for assessing the gap.
9. Financing of disaster management.

The responses of the participants are summarized as under:

1. Dr. Shankar Acharya

a) The Commission should highlight the gravity of the fiscal deterioration that has occurred both at the Centre and the States and recommend strong measures for fiscal correction.

b) Although the tends towards conditional grants is on the rise, automaticity should be the preferred option as it precludes the influence of politics and other extraneous factors. The imposition of hard budget constraint can alone bring in the necessary discipline in the management of public finances.

c) The vertical devolution of taxes should stay at 29.5%. Any tinkering with this level will encourage demands for higher devolutions in future that can only be at the cost of sound finances at the Centre.

d) The indiscriminate growth in Government guarantees at the State level should be checked for the purpose of fiscal consolidation. Such off-balance sheet items should not only be brought on record to enable a clear picture to emerge but to facilitate the framing of rules of governing behavior in the future.

e) In making its recommendations, the Commission should take note of the high salary component in the expenditure on public services which has an adverse effect on the quality of delivery.
f) There should be an assessment of the quality of service/delivery in terms of cost/expenditure with a view to promote fiscal prudence at both Centre and State levels.

2. Prof. Pulin Nayak

a) The removal of regional and social disparities should be a major objective before the Twelfth Finance Commission.
b) The present levels of poverty and destitution in the country call for effective state intervention in several areas which cannot be left to market forces. The need for strengthening the Public Distribution System to provide food grains to the needy at an affordable price is a case in point.
c) Given the excessive strain on the states' finances due to the Fifth Pay Commission's recommendations, the Finance Commission should consider recommending a moratorium on the constitution of future Pay Commissions.
d) Experience in capitalist countries shows that the growth in tax revenues trends to taper off over time. This should be factored in while making projections for the tax : GDP ratio for the Centre and the States.

3. Dr. J.L. Bajaj

a) There is no reason for Central Public Sector Financial Institutions to ask for guarantee for commercial loans given to projects of State PSEs.
b) The largest numbers of guarantees are issued in the Power Sector which are essentially for propping up the finances of the power sector CPSUs. The underwriting by States of all dues of SEBs to CPSUs following the recommendations of the Expert Group under Shri Montek Singh Ahuluwalia has adverse implications for State Finances.
c) As the revenue raised by local bodies has been very low, grants to local bodies should be incentivised by linking them to the growth of own revenues.
d) 65% of the GSDP of States is outside the purview of taxation. The introduction of VAT could lead to a further shortfall in tax revenues for many States. The power to impose tax on services is with the Centre. There is a need to assign more taxes to the States than is presently allowed under the Constitution.

4. Dr. Charan Wadhwa

a) Governance is the key issue as it impacts the quality of services made available by the Public Sector. Fiscal indiscipline can only be contained by imposing hard budget constraints.
b) The Finance Commission should bring into focus the pro-reform policies in the context of rising levels of indebtedness.
c) Strict norms would need to be adopted for revenue raising and expenditure and the basis of arriving at these norms should be transparent.
d) The finances of the local bodies are in a poor shape and would need to be improved with emphasis on delivery. There is a need to enhance their autonomy as well as accountability consistent with their responsibility for delivery of public goods with adequate transparency.
e) Wherever population is a criterion for devolution/grants in aid, it should be ensured that the achievements in population control are duly rewarded.
f) International experience specially of countries like Australia should be looked at.

g) Appraisal of fiscal reform facility should be undertaken.
h) Efficient states should not be penalized.

5. Prof. Indira Rajaraman

a) The projections of the revenue and expenditure need to be realistic and not ambitious as was the case with the Eleventh Finance Commission.
b) The achievements claimed by the States under the Medium Term Fiscal Reform Plan submitted to Ministry of Finance are exaggerated and are in sharp contrast to the modest projections being made to the Planning Commission.
c) Conditional grants in the form of an Incentive Fund as under the MTFRP has had a positive impact on States as reflected by their attempts to contain the revenue deficit.
d) The Commission should guard against corruption of procedures resorted to by the State Governments. Dipping into Provident Funds for current expenditure should not be condoned.
e) Instead of considering the devolution of Central taxes only, the Commission may consider the feasibility of the Centre sharing its total revenues including non-tax revenue.
f) While recommending any increase in user charges under irrigation etc., the Commission should note the fall in compliance due to recent hikes in the user charges.

6. Dr. Sudipto Mundle

a) Politics and such other extraneous factors could not be wished away whether the grants are automatic or conditional.
b) The Medium Term Fiscal Reform Facility must have its canvas broadened to include programmes like AIBP, APDRP etc., in order to make it more effective.
c) The Commission should comment on the overlapping jurisdictions of the Planning Commission and the Finance Commission and consider the revenue account as a whole without distinguishing between plan and non-plan expenditure.
d) The Commission must give its views on the opportunities available to the States for restructuring their debt and while doing so, take into account their contingent liabilities also.
e) The service delivery at the local-bodies level is poor. The Commission may suggest ways of raising own revenues for the local bodies. The local bodies could do this by taking into confidence the Associations of different Stake holders and User Groups to ensure their cooperation. This will also improve satisfaction levels in the beneficiaries.
f) Method of projecting revenues and expenditure needs a review.
g) Participative management should be encouraged to improve the quality of governance.

7. Prof. B.B. Bhattacharya

a) The role of the Finance Commission is to correct regional imbalances which have further widened in the 90s. Recent studies point to a negative correlation between growth of State Domestic Product and population growth. Quality of governance including proper management of infrastructure is critical to attracting investments.
b) The commission should ensure that the grants provided to the States are not frittered away in meeting salary expenditure.

c) Employment growth should be used as one of the criteria for devolution.
d) In recommending steps for fiscal consolidation the Commission should ensure that unproductive expenditure is restricted. For example, the interest saved through debt swap could be reserved for productive capital expenditure.
e) The devolution formula should have built-in incentives for improving the quality of governance both at the State and the local bodies level.

8. Dr. Atul Sarma

a) The Finance Commission should look into total revenue expenditure including the plan expenditure. Planning Commission may deal with capital resource transfers only.
b) The tax design and its potential at the State level have got distorted and eroded due to adhocism in raising the plan size and seeking ARM for plan financing.
c) Finance Commission transfers should be directed at improving social and economic infrastructure and reducing disparities among states. Equalisation of services should get adequate stress.
d) The Twelfth Finance Commission must review the procedures used by the Eleventh Finance Commission and make them transparent.
e) Grants should be unconditional.
f) Centrally sponsored schemes should be reviewed.

9. Shri Om Prakash Mathur

a) The Commission should clearly spell out the considerations that have gone into the determination of the level of financial support for the local bodies.
b) The Commission may find itself handicapped as the second report of the State Finance Commissions is not ready and no reliable data on the finances of the local bodies exist.
c) The Finance Commission in recommending the total amount of grants for the local bodies should divide this into urban and rural components in an objective manner keeping in view the differential rate of growth of their population and the increase in the number of urban local bodies.
d) In deciding the allocation of grants for local-bodies among States, the criteria used by the Eleventh Finance Commission must be carefully reviewed. Own revenue efforts should be assessed by the total revenue generated/earned and not by the number of taxes levied by the local body.
e) Fresh measures including tax reforms and tax on government property may be evolved for strengthening local bodies.

10. Dr. Janak Raj Gupta

a) The devolution formula should take into account the difference between tax potential and the tax effort of the States.
b) The devolution scheme should incentivise movement towards zero revenue deficit.
c) Funds for local bodies should be on the basis of index of decentralization and own revenue efforts.
d) Population as a criterion should be dispensed with. Rewards for family planning may, however, be built into the tax devolution formula. The rationale of having 1971 population figures as basis may be looked into.
e) States must be educated on the powers already available at their disposal for taxing services. The recent judicial verdict on the constitutional validity of sales tax on cell phone services should be taken note of.

11. Dr. Mahesh Purohit

a) The normative approach of projecting revenues and expenditure used by the previous Commission should be reviewed and modified for better results. The norms should be totally transparent.
b) Taxation of services is being brought under the Union List. The Commission should asses the tax potential of various services.
c) Revenues from the State VAT on imports should go to the States. States should also get revenues against credit allowed for CENVAT. The compensation to the States on account of CST withdrawal would cease by the year 2004-05. The Finance Commission should look into how the asymmetric impact of VAT across states could be moderated thereafter.
d) The Finance Commission should recommend grants for capacity building for administering VAT at the State level. At present some states have tapped external assistance while others have no funds for this purpose.
e) The plethora of inefficient taxes like Octroi, entry tax etc levied by the local bodies should be examined for their possible abolition as they go against objective of a common market.
f) The issue of compensating the States for the abolition of Octroi should also be examined.

12. Dr. C.S. Mishra

a) Normative approach has not done justice to the States. Devolutions from the Centre have been much less than EFC projections. TFC should suggest a mechanism by which States could handle crisis situations that arise from factors beyond their control.
b) The Commission should take into account the fact that while the committed expenditure of local bodies is rising, resource transfers have been meager. Transfer of functions should be accompanied by transfer of resources from the States. It is also not proper to treat FC grants as plan funds.
c) The debt of the States should be restructured after which further additions to the debt stock should be regulated by guidelines to be prepared by the Finance Commission. Indiscriminate borrowing by states leading to abnormal increase in interest burden should be curbed.
d) Low population density and a backwardness criterion that takes account indices of social and economic infrastructure, population of SC, ST etc. should also be included in the criteria for devolution.

13. Prof. P.N. Mehrotra

a) The approach of the Commission should be one of compassion coupled with strictness.
b) The genuine needs of the States should be addressed ensuring, however, that profligacy is not rewarded.
c) Agriculture must be brought under taxation.
d) Additional Resource Mobilization by States and efficiency improvements must be incentivised. However, resource transfers, *per se,* from Centre to the States must be non-linear.

14. Prof. S. Gangopadhyaya

a) Successful market development is impossible without concomitant social development. Equity concerns should be addressed without losing the development focus.
b) Conditionalities for devolution of resources provide an excuse to the States and local bodies for non-performance.
c) The quantum of funds earmarked for the local bodies should be known to them in advance.

15. Dr. Narain Sinha

a) The Finance Commission should develop an expenditure efficiency model against which rewards and penalties to the States may be determined.
b) The Finance Commission should look into the definition of special category States and see if States with special problems of an endemic nature could also be included therein.
c) There should be a moratorium on additional DA to government employees.
d) The holes in the data generated by states should be detected before being used to assess performance.
e) Social indicators should be introduced while assessing tax efforts.
f) Fall in poverty level should be one of the criteria for devolution.

16. Dr. A.K. Singh

a) The fiscal performance of the Centre has been dismal. Fiscal restructuring targets prescribed by the EFC are not being achieved.
b) Loans from Centre to the States exceed Finance Commission transfers. Also the re-payment of debt and interest together exceed fresh loan advances by the Centre.
c) The Twelfth Finance Commission may like to fix the States' share in Central taxes at 33% as demanded by a majority of the States from the Eleventh Finance Commission.
d) The Commission should take a view on upgradation grants even though there is no mention of it in the Terms of Reference. The need for upgradation has not ceased.
e) The Commission may look into the adequacy of the weight for population which has come down to 10% in the Eleventh Finance Commission recommendations.
f) The Commission may consider assigning equal weight for population and the backwardness criterion.
g) One of the criteria for tax devolution could be the extent of resources the States have committed to their local bodies.
h) The declining autonomy of States in the context of tax harmonization policies should be kept in view while fixing targets as well as assessing tax:GSDP ratios on normative basis. Revenue loss on account of VAT compounds the problem.
i) The flow of resources to states should be looked at in totality. Tax-GDP ratio is better in states than at the Centre.

17 Dr. Tapas Sen

a) The Commission may like to consider pooling the tax devolution and grants to the States.
b) While considering fiscal imbalances the Commission should also take into account the need to correct physical imbalances.

c) There would be no conflict between equity and efficiency if a normative approach is followed in a transparent manner.
d) Normative assessment of the needs of the States must be so done that these are easily understood.
e) The Commission may see if it has the flexibility to change the base year for revenue and expenditure projections indicated in the Terms of Reference.
f) Unless the Finance Commission can ensure effective monitoring, specific purpose grants would not make sense.
g) The Commission may consider whether it can dispense with the Fiscal Reform Facility and substitute it with a better alternative as the FRF goes against the spirit of hard budget constraints.
h) It is difficult to factor in the human development indicators as it is not clear whether performance on this front should be rewarded or low indices would call for greater assistance in favour of the backward states. The relevance of this to debt restructuring is even more doubtful.

The Chairman, in his concluding remarks, thanked the participants for their suggestions and assured them that these would be kept in view while addressing the issues before the Commission. He agreed that the need for ensuring that the grants are utilized for the objectives for which they are given cannot be overlooked. This is as much relevant for equalization grants as for specific purpose grants. Monitoring by Finance Commission is not possible as it ceases to exist once the recommendations are made. A credible mechanism would, therefore, need to be devised for effective follow-up. The Commission would also look into whether the progressivity brought into the devolution formula by assigning increasing weightage for factors linked to equity, have stood the test of time. The relative weightage for equity and efficiency may need to be carefully reviewed in the light of experience. Regional disparities are also an important issue before the Commission and while addressing it, the Commission may have to go into how far they are due to historical deprivations and whether lack of efforts was a contributing factor. He expressed the wish to discuss these issues further with the participants in due course. Chairman indicated that similar meetings will be held in other parts of the country and the present one was only the beginning of the consultation process.

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

ANNEXURE

Meeting with Economists and Economic Administrators (18.02.2003)
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. Smt. Madhulika P.Sukul, Director
8. Shri Rajiv Mishra, Joint Director
9. Dr. Vishwa Nath Alok, Deputy Director
10. Dr. O.P. Bohra, Deputy Director

Economists and Economic Administrators

1. Dr. Shankar Acharya
2. Dr. J.L. Bajaj
3. Prof. B.B. Bhattacharya
4. Prof. S. Gangopadhyaya
5. Dr. Janak Raj Gupta
6. Shri Om Prakash Mathur
7. Prof. P.N. Mehrotra
8. Dr. C.S. Mishra
9. Dr. Sudipto Mundle
10. Prof. Pulin Nayak
11. Dr. Mahesh Purohit
12. Prof. Indira Rajaraman
13. Dr. Narain Sinha
14. Dr. Atul Sarma
15. Dr. A.K. Singh
16. Dr. Tapas Sen
17. Dr. Charan Wadhwa