Record of the Fourth meeting with Economists and Economic Administrators held on 8.5.2003 at Kolkata

The Twelfth Finance Commission, under the chairmanship of Dr.C. Rangarajan, held its fourth meeting with Economists and Economic Administrators on 8.5.2003 at Kolkata. The meeting following those held at New Delhi, Chennai and Mumbai, was attended by economists from the eastern and north-eastern region of the country. The list of participants is annexed.

Chairman, TFC, brought out the following issues to the fore for discussion with the participants.

- There is a need to address the vertical imbalance of resources between the Centre and the States in the light of the constitutional provisions which assign greater taxing powers to the Centre. In this regard, the current level of resource transfers from the Centre to the states may be examined to assess whether these are adequate to redress the vertical imbalance.

- The composition of resource transfers is another relevant issue as national governments in different countries devolve a varying mix of taxes and grants to the sub-national levels. In the Indian context, there have been suggestions to raise the proportion of grants in total transfers as the sharable pool of taxes has been significantly falling short of projections.

- Transfers awarded by the Finance Commission amount to 65 per cent of total revenue transfers from the Centre to the states indicating a significant emergence of alternate mechanisms such as the support to Annual Plans by the Planning Commission and the Centrally Sponsored Schemes of the Ministries. Rationalization of resource transfers may have to be seen in the context of possible conflicts and compatibility among all the available channels of resource transfers.

- In the scheme of horizontal transfers, the criteria relating to equity have been dominant. The efficiency criteria are of a relatively recent origin largely in deference to the demands from the advanced states. However, the weights for efficiency criteria are still marginal and cannot arrest the fall in the share of the advanced states. The decline in their share has become an issue of concern for them in recent years as it has been accentuated by a modest growth of the sharable pool brought about by a falling tax/GDP ratio of the Centre. Consequently, the demand for raising the weight for efficiency criteria is increasingly being made which has to be carefully balanced against equity considerations.

- The equity considerations could be addressed in several ways of which the requirement of equalizing the level of services for each citizen irrespective of the geographic boundaries of his residence has been accepted as an important norm. This concept owes its origin to the practice of fiscal federalism elsewhere in the world and has relevance to Indian conditions as well. It is also in the context of service equalization that suggestions for increasing direct specific purpose grants in lieu of tax shares or in the mix of grants are being made.

- Specific versus non-specific grants is again a conflict, which needs to be resolved keeping in view the flexibility required in resource allocations, efficiency in the use of funds and a normative rather than a trend based estimation of the resource gap of the state governments.

- The role of the national Finance Commission needs to be clearly understood in the matter of providing resource support to the Local Bodies since the 73rd and 74th Constitutional amendment has mandated the state level Finance Commissions to do the same. The recommendations of the national and state level Finance Commissions must converge to achieve the objective of strengthening local self governance.

- The restructuring of public finances would eventually require the determination of an appropriate level of fiscal deficit for the Centre and each state government so as to arrive at a sustainable level of debt burden. Given the mounting burden of borrowings on the committed expenditure of the governments, the restructuring of public finances has acquired an urgent priority.

- The other issues which require to be gone into are levy of appropriate user charges, disinvestment, infrastructure and human development indices, calamity relief etc The Eleventh Finance Commission's initiative to get the fiscal management programme of states monitored through MTFRP is also to be reviewed.

The responses/views of the participants were as under:-

Shri D. Bandhopadhya

- Sufficient time has elapsed since the 73rd and 74th amendments to make available at least two rounds of State Finance Commission reports for the states. A comparison of these reports across states would indicate wide variation in recommendations often inconsistent with the devolution of functions and authority. The national Finance Commission would, therefore, do well to indicate a broad set of criteria for state Finance Commissions to follow so that their recommendations lend themselves to a fair comparison and assessment of the need for additional support.

- Full decentralization of governance could only be achieved through the fulfillment of three types of transfers, viz., Functions, Functionaries and Finances (3Fs) as mandated in the relevant schedules of the Constitution. In this connection, the TFC must attempt to recommend rewards in direct proportion to such transfers. The extent of transfers could be captured in a devolution index, which can be appropriately constructed by the TFC. The devolution index must recognize the transfer of 3Fs only if the increase in the activity of local bodies is accompanied by a decline of the same at the state government level.

- Apart from the devolution index, another criterion, which can aid the TFC, in determining the commitment of the State to empower its local self governments, is the presence of district plans within the state plan. A large presence would imply deeper commitment and thus qualify for a possible reward by the TFC

Member (D) observed at this stage that although the transferable functions have been listed in the relevant schedules, it does not mean that all the functions need to be necessarily transferred. Had this been the case, there would have been a mandatory clause in the Constitution itself for a complete transfer. The fact that there is no such clause implies that it is for the State legislature to decide the appropriateness and extent of transfer of different functions.

Dr. K.N. Tiwari

- The MTFRP needs to be reviewed as the broad indicator used for measuring the performance, namely the ratio of Revenue Deficit to Revenue receipts has hardly shown any improvement across the states.
- The indicator is specially problematic for a state like Bihar which suffers from the absence of accounts data since 1998-99. As a result the ratio is not being firmed up and the state is losing its share of the incentive fund. The problem of absence of accounts data would have to be addressed by the TFC as it would have no data to make projections for the state. It is necessary that the TFC finds some alternative data base for projection and also prevails upon the state to finalize its accounts expeditiously in close coordination with the CAG.

- Despite the recommendations of the Eleventh Finance Commission, the Central Government has not reviewed the Gadgil formula. Thus, non Special category states continue to receive Normal Central Assistance in the form of 30 percent grant and 70 percent loan. This ignores the large revenue component of the state plans. As a result, the revenue account deficit continues to deteriorate for states. The deterioration is more acute for Bihar resulting in losses from the incentive fund under MTFRP.

- Just as the MTFRP monitors the Fiscal performance of states, a similar mechanism need to be put in place for the Central government as well. Rewards and Penalties would need to be prescribed so that there is incentive for the Central Government to perform. The Fiscal Responsibility and Budget Management Bill of the Centre provided some hope but the introduction of a watered down version in the Parliament recently has rendered the whole exercise meaningless.
- The TFC should also explore ways of ensuring that the state governments act upon the recommendations of the State Finance Commission. An improvement in the quality of recommendations is possible if the right people are appointed to the State Finance Commission.

- The TOR of the TFC makes no reference to the upgradation grants. This denies certain states the opportunity to achieve equalization of services.

Prof. Srinath Baruah

- The increase in the education and health care requirements of the states makes it necessary to raise the vertical revenue transfers from 37.5 percent of Centre's revenue receipts to at least 45 percent.

- The TFC should take note of the fact that the share of Assam in the horizontal transfers has steadily declined making it increasingly difficult for the state to meet insurgency related expenditure.

- The scope of the Calamity Relief Fund should be widened to include the restoration of damaged physical infrastructure.

- The parameters employed under MTFRP should be reviewed and improved so as to enable a fair assessment of the Fiscal performance of the states.

Dr. Raj Kumar Sen

- The vertical share of States indicated by the Eleventh Finance Commission at 37.5 percent of Centre's revenue receipts must be raised to 50 percent.

- A devolution index reflecting the transfer of functions from the state to the Local Bodies must be developed with a view to encourage decentralized governance and assist the TFC in recommending suitable rewards. The utilization of funds by the Local bodies must be a factor in the devolution index.

- The operations of the Calamity Relief Fund should be carefully reviewed to ensure its best possible use for the real purposes it is intended for.

- A proper evaluation of the benefits arising from the transferred resources needs to be done as these are far less than what Finance Commissions had anticipated.

Shri Amitabha Bose

- The Finance Commissions have laid too much emphasis on the monetary side of public finances for recommending transfers rather than on the impact of expenditure under state budget on the economy. Although it is possible for monetary events to eventually align with expenditure outcomes, this convergence is possible only in the medium and long term. Given the limited tenure of the Finance Commissions, the composition of expenditure would have a more relevant bearing on the considerations for resource transfers.

- The TOR relating to generating revenue surpluses for capital expenditure takes a narrow view of the public finance as the targeted level of capital expenditure would be possible only by taking recourse to borrowings thereby making the eventual distribution of national savings between the public and private sector an overriding concern. In this regard, the merger of the Finance and Planning Commissions is of paramount importance to facilitate a holistic view of the matter.

- The objectives of equity are best fulfilled by efficient use of grants. A larger proportion of grants vis-à-vis share in central taxes is, therefore, called for.

- An inter-state development index needs to be developed for aiding equity considerations. The index should make a clear distinction among states on the basis of the economy of the State, its finances, infrastructure and the human development level of the people of the state. The merger of the Planning and Finance Commission would aid this process as well.

Dr. Amitabha Sinha

- Equity and efficiency considerations need not be contradictory or mutually exclusive. One can lead to the other provided the parameters chosen can simultaneously address the equity and efficiency concerns.

- A devolution index reflecting the transfer of functions from the state to the local bodies should be prepared for aiding the TFC in recommending appropriate grants.

- States with adequate infrastructure do not really need Central support. As such, the scheme of horizontal devolution must raise the weightage for lack of infrastructure.

- The TFC, while laying emphasis on efficiency should also send out a strong signal to the states indicating its support for expenditure exigencies.

Prof. Dipankar Coondo

- Given the heavy burden of debt servicing on the states, an appropriate debt swapping scheme should be in place as a form of debt relief.

Prof. Sujit. S. Sikidar

- The proposed VAT compensation to states is based on the deviation from the average revenue collection from sales tax for the last five years. This needs to be reviewed by the TFC.

- The scheme of horizontal devolution should provide sufficient incentives to states to improve their social conditions.

- Improvement of accounts data base should also be incentivised under the horizontal devolution scheme to aid the states like Bihar and those in the North East.

- The TFC should ensure that the extent of vertical sharing of resources is substantially higher than the present level.

- The TFC, while ensuring that the better performing states are not penalized must also support expenditure on account of insurgency etc. which is beyond the control of the States.

- As the Centre has greater powers to raise resources, it should be more liberal in providing debt relief to the states.

Shri H.N. Das

- A four pronged strategy to improve fiscal affairs comprising tax reforms & selective enhancement of rates, expenditure reforms, debt control and improvement of governance would be a useful starting point for the TFC.

- The continued use of 1971 basis for population will seriously hit the interests of Assam as there has been a large influx of migrants into the state from the neighboring states and countries.

- A large number of autonomous bodies like district councils etc. in Assam has led to a proliferation of expenditure in the states which should be taken into account by the TFC when it makes its expenditure projections.

- For an impartial functioning of the State Finance Commission, serving bureaucrats should not be members of the SFC.

- Timely election to the Panchayat bodies should be one of the criteria for resource devolution to the states.

- The share of Central taxes for Assam has declined steadily despite the increase in its problems, specially those relating to insurgency.

- The corpus of the Calamity Relief Fund should be increased by 20 percent

- The TFC should earmark funds for various training programmes of the states.

- Advance plan assistance is indeed of great help to attend to immediate needs of the states but when it is adjusted against future releases, the plan priorities get distorted.

Prof. Mihir K. Rakshit

- An arrangement for centralized independent decision making for resource transfers should be evolved backed by adequate statistical research.

- For arriving at the need based expenditure of the states, the Commission should take a definitive view of committed expenditure.
- The size of vertical devolution should be determined keeping in view the fiscal discipline being exercised by the Central Government.

- The performance of states on the utilization of funds would need to be assessed on the basis of a rational formula before one can proceed to consider equity and efficiency parameters for determining horizontal devolution.

- For measuring fiscal performance, it is essential that accounts of the states are in a proper form and their budgets transparent. The TFC may endeavor to recommend incentives for the improvement of accounting system in the states.

- For limiting the growth of non-essential expenditure, it is necessary to cut the perquisites available to the bureaucracy at the higher levels.

Prof. Dipankar Dasgupta

- It should be borne in mind that the interests of equity and efficiency need not be conflicting as there is sufficient scope for making these complementary.

- With regard to achieving horizontal equity among states, the use and deployment of funds should be an important consideration prior to determining parameters for horizontal transfers. To ensure effective utilization of funds, it should be possible to think of precise projects administered by precise number of people with clear accountability fixed at each level.

Shri S.P Padhi

- The mention of human development in the TOR provides an opportunity to incorporate the human development index (HDI) in the scheme of horizontal devolution of tax revenues. Both attainment and deprivation aspects of HDI should be favored for awarding higher shares. In other words, penalty for non-performance and aversion to deprivation must constitute the approach to the application of HDI. Ideally, two-thirds weight to attainment and one-third to deprivation could be provided. This would impel the states towards improving their ranking on the HDI scale. Currently, however, the use of this parameter is unlikely to lead to much inter-se differences as the coefficient of variation among States in HDI is not more than 20 percent.

Prof. Madhusudan Dutta

- With regard to improving the viability of public sector units, it is necessary that the efficiency of use of capital is improved. At present, profitability is going down even where there is a 100 percent use of capital as the returns are low. Before recommending disinvestment of a loss making enterprise, it should be seen whether its losses are on account of inefficiency or the restrictive price policy regime. If it is established that profits would have been earned but for the pricing policy, the concerned unit must be protected from disinvestment.

Prof. A.P Mohanty

- As the Centrally sponsored and Central Sector schemes on state subjects eventually add to the expenditure of the States, such expenditure should be accommodated by raising the vertical share of resources.

- The poverty ratio is adequately reflective of backwardness. Since direct grants are most suited for addressing equity considerations, the proportion of grants in the total transfers under the Finance Commission award to States could be the same as the poverty ratio.

- While debt relief would reduce the burden on state finances, the savings on account of such relief is best spent on earmarked development or social sector schemes so that the backward states could reach up to the national average with regard to infrastructure and services.

- The TFC should also recommend earmarking of funds for preservation of environment.

Prof. Pradeep Maity

- The TOR mentions need for macro-economic stability but it is not clear exactly what is meant by the term when currently, the rates of inflation are low.

- The TOR seeks recommendations on the reduction of debt but it is not clear what is the feasible level of debt

- It is difficult to imagine how Finance Commission could effectively bring about macro-economic stability and debt reduction, given the limitations of the instruments it has in hand.
- It is not clear why the year 1971 continues to be the basis for population when the latest census figures can be made use of.

- The definition of 'investment climate' as used in the TOR is not clear.

- The choice of weights in the construction of HDI suitable for the purpose of the TFC's work would be difficult to make.

- The recommendation of the Eleventh Finance Commission to devolve 37.5 percent of the gross revenues of the Centre to the Sates lacks an objective basis with regard to the investment needs of the States. The TFC would do well to arrive at the basis on which vertical transfers are to be determined.
- It is seen that in the case of municipalities in some states the cost of collection of certain taxes is higher than the revenue collected therefrom. This must be borne in mind while recommending devolution of recovery functions from the states to the local bodies.

Prof. Sugata Margit

- An incentive structure should be developed for both the Centre and States so that the revenues are 'earned' and the vertical as well as horizontal transfers are not taken for granted.

- Given the poor exploitation of the tax base both in the absolute as well as relative terms, the TFC may like to recommend ways of improving the tax base and the exploitation thereof.

- The TFC must recommend a limit on total Fiscal Deficit and give higher share to states with low State Domestic Product as the states with higher SDP have a large enough base to raise revenues.

- Most of the action in respect of the governments' responsibilities lies in the states and not in the Centre as the latter is merely a concept. For this reason, it should not be permissible for the Centre to have a revenue deficit.

- While assessing the committed expenditure and accepting it as inevitable, it should be noted that the committed expenditure of today was optional when the schemes were conceived. Therefore, along with the identification of committed expenditure, an appropriate set of policies must also be recommended so as to restrain discretionary decision making and prevent the proliferation of committed, inflexible expenditure, of an unproductive kind.

- One way of ensuring proper utilization of funds is to specify a matching contribution. Although, matching contribution may not, at times, materialize from the state side, earmarking of this kind is still beneficial.

The Chairman, TFC, in his concluding remarks made the following observations:-

The TOR of Finance Commissions have expanded over time making their task more challenging than before as they address the larger issues relating to fiscal federalism. There is some flexibility with the Finance Commission to interpret the TOR and to that extent, the Commission would not be constrained in addressing all the relevant issues.

- Vertical transfers continue to remain a difficult issue. Past experience suggests that pragmatism is preferred to vadicalism as substantial changes may seriously upset existing arrangements without necessarily bringing in the benefits. An important aspect of vertical transfers is devolving additional powers of taxation to the States. There are indications that the Central Government is conscious of this and may be willing to share the powers and/or the revenues from taxation of certain new services with the States.

- The Commission is also conscious of the need to guard against overestimation of the Centre's revenues. On the one hand, this would reduce the availability of resources for the

Centre and the States' post devolution surplus/deficit would be rendered unrealistic depriving them of the deficit grants that they would receive otherwise. On the other hand, States may be happier to get a higher share in the Central taxes rather than receive grants as the former would be a matter of right thereby allowing them greater discretion/flexibility in the deployment of resources.

- The concept of equity is built into the devolution scheme essentially to compensate disabilities. Some of these disabilities are reflected in the inadequate availability of basic services which are the 'need' of the state. Disability also arises from insufficient resource base to generate revenues. The unit cost of services is also different for different states on account of varying geographical conditions such as area and density of population. Some of the disabilities are also 'historical', getting reflected in the infrastructure indices.

- It is open to the Commission to look into the scope for making grants conditional so that governments at all levels are made accountable and fiscal discipline is encouraged.

- The Commission is focused on determining the appropriate level of fiscal deficit as it would form the basis of a fiscal restructuring programme. Present arrangements like the 70: 30 division of Normal Central Assistance into loans and grants under the Gadgil Formula would need to be reviewed as otherwise the benefits of a fiscal restructuring programme would be lost in no time.

- Even if the revenue account is balanced and the borrowings are deployed entirely on capital outlay it may not ensure proper fiscal management as the return from capital assets is often less than the cost of funds.

The chairman thanked the participants for their suggestions and assured them that these will be kept in view while formulating the recommendations. He would also welcome detailed written submissions from the participants if they wished to substantiate or supplement their arguments.

List of Participants

Twelfth Finance Commission

1. Dr. C. Rangarajan, Chairman
2. Shri T.R. Prasad, Member
3. Prof. D.K. Srivastava, Member
4. Shri G.C. Srivastava, Secretary
5. Shri R. Ramanujam, Jt. Secretary
6. Shri R.N. Chowbey, Jt. Secretary
7. Prof. J.V.M. Sarma, Economic Advisor
8. Shri R.Mishra, Jt. Director

Economists & Economic Administrators

1. Sh. D. Bandopadhya
2. Prof. Srinath Baruah
3. Sh. Amitabha Bose
4. Prof. Dipankar Coondoo
5. Sh. H.N. Das
6. Prof. Dipankar Dasgupta
7. Prof. Madhusudan Dutta
8. Prof. Pradeep Maity
9. Prof. Sugata Marjit
10. Prof. A.P. Mohanty
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12. Prof. Mihir K. Rakshit
13. Prof. Sujit S. Sikidar
14. Dr. Amitabha Sinha
15. Dr. Raj Kumar Sen
16. Dr. K.N. Tiwari