Record of the third meeting with Economists and Economic Administrators held on 17.4.2003 at Mumbai.

The Twelfth Finance Commission, under the chairmanship of Dr.C. Rangarajan, held the third meeting with Economists and Economic Administrators on 17.4.2003 at Mumbai. The meeting which was the third in the series following those held at New Delhi and Chennai, was attended by economists from the Maharashtra, Gujarat and Goa. The list of participants is annexed.

Chairman, TFC, sought the views of the economists on some of the core issues facing the Commission, namely;

- Given the responsibilities of the Centre and the States, how much of the Central revenues should devolve on the States and how much of it should flow through the Finance Commission award.
- The relative weights of tax devolution and grants in total flows determined by the Finance Commission.
- The choice of variables including weights thereof which should govern the horizontal devolution, specially in regard to equity and efficiency factors and the measurement issues in this regard.
- The role of conditional vis a vis unconditional grants in the light of the concern that every citizen is entitled to certain minimum services irrespective of the geographical boundaries in which he resides.
- The role of the Finance Commission at the national level in bringing about augmentation of the resources of the Local bodies for the pursuit of greater and more effective decentralization of governance.
- The restructuring of public finances in the wake of rising primary, revenue and fiscal deficits and the sustainable level of fiscal deficit for States.
- The norms for for projecting revenues and expenditure specially in the context of VAT and scope for expansion of the service tax base.
- Need for consensus on levy of appropriate user charges.
- Issues relating to CRF, NCCF and the Fiscal Reform Facility.

The comments of the economists are summarized as under:-

Prof. V. Chitre

- There are significant changes in the TOR of the TFC from those of the Eleventh Finance Commission including the following:-
    - ❖ Debt reduction with equitable growth has been indicated under restructuring of public finances in the TOR of the TFC, the emphasis being on equity;
    - ❖ Stress on the committed expenditure of Central government on defence and internal security, which implies a reduced availability of surpluses for transfers to states after taking care of the States' security concerns;
    - ❖ Improving the commercial viability of all departmental undertakings of the States and not merely, SEBs and SRTCs, as in the past;
    - ❖ Upgradation grants do not find mention.
    - ❖ Review of States' Fiscal Reform Facility.
    - ❖ Debt reduction linked to infrastructure and human development indices.

- The Twelfth Finance Commission must recommend incentives for the following:-
    - To take the process of reforms forward;
    - Improvements in tax : GDP and tax : GSDP ratios;
    - Efficient use of resources;
    - Human resource development;
    - Improvement of the investment climate in the states.
    - Achievement of fiscal consolidation and debt management through equitable growth.

- In the scheme of horizontal devolution, the weight of 62.5% for per capita income by distance method should be reduced significantly in favour of appropriate criteria such as growth rate, improvement in human development indicators, participation in second generation reforms and improvement in investment climate. Some of these could include:-

    - Attaching a positive weight to net migration to states

    - Attaching positive weights to policy decisions to remove barriers to inter-state trade such as abolition of octroi, ending discrimination by removing differential rates of fees for insiders and outsiders etc.

Dr. V.A. Pai Panindikar

- The completion of Fifty years of Finance Commissions in India provides an opportunity to look at many issues afresh. The TFC owes it to the nation to explain whether its finances have been managed properly in the last 50 years;
- It must be noted that all articles of the Constitution including Article 280, which provides for the Finance Commission flow from the Preamble, which give the right to citizens to ask whether their finances are being properly managed.
- In view of this, it is difficult to understand why until now, no scheme of consequence has been debated at high level fora like Parliament to restructure the public finances of the nation.
- The Commission should think of a credible mechanism to enforce reduction of fiscal deficit of governments in the country; after all, high fiscal deficits are not in the interest of the poor.
- The growing fiscal deficit in recent years is attributable to the implementation of the Fifth Pay Commission's recommendations, which benefited only a miniscule population.
- Adequate attention is not being paid to ensuring the commercial viability of PSUs as these are perceived as the 'commanding heights' of the economy;
- Equity based growth can be achieved in the medium term only if governments substantially invest in human development and infrastructure. Commission is mandated to attach a positive weight to this in its scheme of horizontal devolution unlike the previous Commissions.
- Governments could be condoned for the fiscal mess they have created but not the poor performance on the development front;
- Reduction of knowledge deficit is even more important than the reduction of fiscal deficit.

Shri S.S. Tarapore

- The question of a suitable mechanism for repaying debt is systematically ignored and the present system of lending without insisting on a Sinking Fund is unsustainable.
- Until the 1960s, states were required to maintain such a fund. It was, however, made optional after the emergence of revenue deficits.
- The biggest transgression, however, is committed by the Centre, which given its unlimited borrowing powers, has never considered the issue of sustainability.
- With the ratio of debt servicing to gross borrowing reaching70 percent for the Centre, there will be a debt explosion unless a Sinking Fund is mandated by bodies like the Finance Commission. A Sinking Fund does aggravate the situation today but, for a better tomorrow.
- Debt management lacks transparency as the deficit figures are not reliable. Even RBI has abdicated its responsibility. Investors will soon lose confidence in the Government Paper.
- A Sinking Fund could be developed as follows
    - To start with, the corpus of Sinking Fund should lie outside the budget
    - If the contribution to the corpus is at the rate of 5 percent of fresh liabilities, the Sinking Fund would become self-sustaining in around 15 years.
    - The contribution to the Sinking Fund could be funded by disinvestment proceeds and profits of the RBI.
- To ensure that Ways & Means advances of the States are not misused as a mechanism to fund regular expenditure, the recommendations of the Ramachandran Committee in this regard must be implemented.
- Plundering of CRF should not be allowed; it should be resorted to sparingly.

Dr. R.H. Dholakia

- The Fifth, Sixth and Seventh Finance Commissions had obtained from the CSO comparable estimates of GSDP at market prices, a practice, which has been discontinued. The Twelfth Finance Commission must revive this practice as the comparable estimates of GSDP at market prices would be a more appropriate indicator than GSDP worked out on factor costs. *(Member, Prof. D.K. Srivastava intervened at this stage and pointed out that the correctness of estimates of GSDP at market prices would be contingent on the accuracy of state wise information on indirect taxes net of subsidies).*
- The definition of debt also varies with implications for the determination of Fiscal Deficit. For the sake of clarity with regard to the sustainability of debt, one should adopt a single rational definition.
- For the purpose of obtaining stable estimates of State Domestic Product, a three year average is not appropriate, as it does not properly iron out huge fluctuations and should, therefore, be replaced by a five year average.
- The use of per capita NSDP at factor cost to indicate regional imbalances is inappropriate as it is only an indicator of production capacities and not the purchasing power. The use of GSDP at market prices would be more appropriate. However, in view of inadequate data on per capita income accrued, the per capita consumption expenditure makes for a better measurement.
- A reasonable norm for economic growth can be used as a factor in the scheme of horizontal devolution since expenditure needs of governments is a positive and significant function of economic growth. Growth should be rewarded and not punished. To determine the growth TGR for 10 years should be taken.

- In the scheme of horizontal devolution, a certain proportion of the sharable pool (say 30 percent) may be earmarked exclusively for backward states among which equity based criteria could be applied. The rest (70 percent) should be available for all the states on the basis of efficiency criteria.
- The determination of backwardness should be made on the basis of the abilities of the States to raise funds from the market. *(Member, Prof. D.K Srivastava observed that under the Constitution, it may not be possible to create two separate blocks of states and wondered if any qualitative difference would arise in designing the parameters for all the states in such a way that the results conform to what one intends to achieve from a two-block scheme).*
- The contribution of States in the collection of Union taxes should be given a positive weight in the scheme of horizontal devolution.
- Fiscal performance indices should include tax efforts, efficient use of resources, levy of appropriate user charges etc. This is not against the interests of the poorer States.
- Equity considerations should include deficiencies in infrastructure and human resource development.
- Public finance restructuring is crucially linked to the scheme of devolution, as the latter affects the levels of revenue, primary and fiscal deficits of the States.
- Inefficiency arises from inefficient devolution formulas which incentivise unproductive spending by some States while creating deficits in others.
- Single monitorable parameter under the Fiscal Reform Facility should be replaced by 7-8 measurable parameters to assess performance.

Shri T.T. Ram Mohan

- Assumptions of the Finance Commissions should be anchored firmly in reality and not be too idealistic. The EFC assumptions were hopelessly unrealistic in projecting an ambitious growth of revenues while ignoring the impact of the Fifth Pay Commission's recommendations.
- The sheer magnitude of the debt swap scheme proposed by the Union Finance Ministry for the benefit of states dwarfs the attempts of previous Finance Commissions to provide debt relief. Ideally, a debt swap scheme should remain within the ambit of the Finance Commission.
- The scheme of debt relief should not be made contingent on past achievements but prospective ones. For instance, a debt swap scheme as a part of debt relief could be agreed to if the savings on the interest burden are ploughed back into developing human resources and creating favorable conditions for private investment over and above the current level of expenditures.
- For incentivizing development of human resources and investment climate, appropriate measurement indicators are required. While Human Development indices are available, assessment of investment climate would include factors such as law and order which are not easy to determine. Availability of physical infrastructure and provision of necessary public services are the other factors that would require measurement. Specifically, the investment climate in the states would depend on the extent to which State Financial Corporations are recapitalized. This should be included in the measurement.

- Given the fact that the share of richer states is falling, the TFC may consider fixing a floor level below which the share of the high income states would not be allowed to fall.

Shri P.V. Srinivasan

- The key issue confronting the Commission is regional imbalances, which needs to be corrected through providing appropriate weights to equity and efficiency.
- The derivation of these weights would require a detailed and objective modelling.
- There is an urgent need to enforce fiscal responsibility at each level of government without which it would be impossible to avoid moral hazards. After all, a system wholly based on equity provides no incentives for performance. On the other hand conditionalities may be viewed as an encroachment on the fiscal autonomy of States. The Central Government itself inspires little confidence in matters of fiscal prudence.

- There should be some stability with regard to the devolution regime. Shocks should be avoided.

Dr. Ashima Goyal

- The Finance Commission should serve as a coordinating body to arrive at a consensus on major economic issues so that competitive populism is kept at bay.
- The Commission should deliberate on the best way to bring about a reduction of debt. Low interest rates, high growth, broadening of the tax base, incentives for compliance and collection of taxes etc. would create the necessary primary surplus.
- Block grants to states should be based on equity considerations. However, to avoid conflicts these could be linked to future performance in infrastructure and human development rather than invite confrontation by harping on efficiency which stresses more on the past than the present or the future.
- All Central taxes should be shared with states. This will provide incentives to the Union Government to collect all taxes with equal vigour.
- Grants on matching basis is not desirable as the States would then tend to overspend. However, matching or pro-rata incentives could be provided for tax collection effort.
- Welfare payments should be targetted to improve infrastructure, education and human capital formation. Increasing entitlements and assets of the poor is the most sustainable way to lower poverty.
- States' financial accounting procedures should be improved so that one can properly focus on outcomes for the purpose of taking corrective actions.
- Fiscal Responsibility Act with caps on expenditure will generate primary surpluses.
- The Commission should look at ways to raise land revenue in order to augment the resources of states.
- To have appropriate user charges, rate of return must be emphasized along with price caps, as the latter can reduce wasteful expenditure.
- Fiscal Reform facility should be broadened.

Dr. C.S. Deshpande

- The Commission should devise suitable measures with which to appraise the performance of the States. Some of these are contained in the TOR itself, such as human development, investment climate, user charges etc.
- In the context of increasing share of services in GDP, taxation of services merits attention by the TFC to improve the tax : GDP ratio.

Prof. A. Karnik

- PRIs may have to depend on grants from higher levels of government for their functions but Municipalities have tremendous potential for raising resources. They would need to be empowered to expand their tax jurisdiction through suitable legislations.
- State Finance Commissions must reward better performing local bodies and not penalize them.
- Although equity parameters can be based on current indicators, the efficiency criteria would require a dynamic assessment of progress on a year to year basis. This is particularly true with regard to human development indicators and improvements in the ratio of own revenues to total revenues of the States.
- Personal income tax offers tremendous scope for mobilization of revenues and should be pursued vigorously.
- A Fiscal Responsibility legislation is required to minimize discretion and improve accountability of governments.
- Off-budget borrowings have played havoc with States' finances. Budgetary practices need to be transparent.
- Specific purpose grants should be preferred to untied grants as the latter encourages profligacy.
- Certain revenue sources should be earmarked for specific expenditures to ensure better balancing of the budget.

Dr. R. Kannan

- The committed expenditure of states including pensions and debt servicing is alarming at 85-90% of total expenditure.
- For allocation of resources, measurable criteria reflecting the need for enhancing user charges, expanding the tax base, reducing the cost of tax administration and restructuring of public sector units, should be constructed. Merit subsidies should be better targeted and non-merit subsidies should go.
- Fiscal transparency in the budget making exercise would call for a cap on State Government guarantees. States must observe voluntary disclosure norms in their budgets.

In his concluding remarks, Chairman, TFC, highlighted the delicate task of balancing equity and efficiency in structuring the scheme of horizontal devolution. Larger issues of fiscal management should definitely be kept in view but TFC could only act through the limited instruments available at hand in the form of its constitutional mandate and the TOR. It was observed that not enough inputs have been received with regard to the appropriate size of vertical transfers. In the past horizontal devolution was not much of an issue as the total resources available for transfer were growing along with expenditure needs of the States. It has now assumed serious dimensions as the total kitty is not enlarging as fast as it should. This has forced some high income States to question the equity considerations which, in their view, seem to reward non-performance and penalize efficiency. Lately, the tax/GDP ratio has fallen considerably. The nominal growth of GDP is also much lower compared to the past. This is attributable to both a fall in the real growth rate as well as modest rates of inflation.

Chairman, TFC also pointed out that the weight for collection of taxes in the scheme for horizontal devolution has been discontinued as it was felt that the states should not be rewarded for any virtues arising out of historical accident. Chairman, welcomed the idea of dynamic use of efficiency criteria but felt that the factors that determine efficiency would have to be carefully

identified. Also, its implementation would be possible only if there is a permanent body to monitor it.

Chairman, TFC, further indicated that it may not be possible for Finance Commission to recommend tied funds in the form of support for specific projects. However, conditional grants are not the same as tied grants. Conditional grants are still possible and the idea is to insist on minimum performance for such support. Conditional grants do involve certain complexities and conflicts would need to be resolved before they are introduced. It would also have to be ensured that conditional grants serve as additionality over current levels of expenditure and are not used to substitute them.

Regarding tax devolutions, Chairman wondered whether it would be possible to protect the entitlements of States in absolute terms and insulate them from the Centre's failures on the revenue front.

The debt burden of the States has increased due to the planning process which provides Central assistance to states with a 70 per cent loan component and 30 percent grant although the revenue component of Plan expenditure is close to 70% in some States. In addition, the debt burden of states has also increased due to market borrowings which, instead of being deployed in asset creation are often utilized for revenue expenditure. Even where it goes into asset creation, the assets do not generate returns. Rising debt and fiscal deficit is a real problem. The CAG has arrived at fiscal deficit figures what are different from the Central Government. The establishment of a Sinking Fund could help moderate the repayment burden caused by the bunching of market loans taken in the past.

Chairman, TFC also assured that the Commission will not be guided by the SDP estimates submitted by the States and has already asked the CSO to prepare comparative estimates of GSDP at market prices. Chairman, also acknowledged the virtues of accrual accounting over cash accounting in certain cases. He was doubtful about the efficacy of a single indicator in measuring fiscal performance as under the Fiscal Reform Facility and felt that it may be necessary to adopt multiple indicators.

Regarding Local bodies, Chairman, TFC opined that the jurisdictional conflict of interests between the elected representative of the states and their local bodies will have to be first resolved, if virtues of decentralized governance have to surface. Added to this is the fact that in many states, transfer of functions has not been adequately backed by transfer of funds. The State Governments seem to be committing the same excesses vis a vis their local bodies which they accuse the Centre of in respect of the States' legitimate claims. The relevant criteria in this regard could be reflected in a properly constructed decentralization index. It would then be possible to leverage the release of funds recommended by the Finance Commission at the national level to the Local bodies on the basis of such an index.

Chairman, TFC, thanked the economists for their views and stated that he would like to hold further consultations with them as and when necessary.

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(I)
6. Shri R.N. Choubey, Jt. Secretary(II)
7. Shri. J. Wilson, Director
8. Shri R.Mishra, Jt. Director

Economists and Economic Administrators

1. Prof. V.Chitre
2. Dr. C.S. Deshpande
3. Dr. P.V. Srinivasan
4. Dr. Ashima Goyal
5. Prof. A.Karnik
6. Dr. R.H. Dholakia
7. Dr. T.T. Ram Mohan
8. Dr. V.A Pai Panandikar
9. Dr. R. Kannan
10. Shri. S.S. Tarapore
11. Dr.J.V.M.Sarma