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Tapas K. Sen
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BY HAND

Ref: NIPFP/TKS/03/ 105

21 May 2003

Dear Dr. Srivastava,

With reference to your letter dated 22 April 2003, I am enclosing my comments on the Terms of Reference for the Twelfth Finance Commission. I have also raised some other relevant issues that may be of interest to the Commission in the accompanying note.

With regards,

Yours sincerely,

(Tapas K. Sen)

Office of Secretary, TFC
Dy. No....L....544..
Date....22-05-2003

Dr. G.C. Srivastava
Secretary
Twelfth Finance Commission
Jawahar Vyapar Bhawan
1, Tolstoy Marg
New Delhi 110001.

Note on Terms of Reference and related issues for the Twelfth Finance Commission

Some of the Terms of Reference are fairly standard and I am not making any comments on those. I confine my attention to only those Terms of References where I have something to say.

1. TOR no. 6(i) requires the Twelfth Finance Commission to use base level data for the year 2003-04. Given the date by which the Commission has to submit its report I am not sure whether final figures for the financial year 2003-04 will be available. In that case there will be two options: the Commission can either use the revised estimates or use actual figures of the previous year. If a choice has to be made, my preference will be for the latter.

2. The TOR does not make any distinction between plan and non-plan expenditures for the purpose of projections. This gives an opportunity to the Commission to take a holistic view and avoid the exclusive attention to only non-plan side preferred by the previous Finance Commissions.

3. The TOR to examine tax efforts of Central and individual State governments and suggest ways to raise the tax ratio, in my view, imposes a heavy responsibility on the Finance Commission, turning it into a taxation enquiry commission for all states and the Centre. This is because suggesting specific measures to raise tax ratio would require a detailed estimation of taxable capacity and tax effort, and then looking into the reasons for low tax effort, finally identifying curative measures.

4. The TOR do not mention upgradation grants at all. Ensuring minimum level of identified basic services is a valid purpose of intergovernmental transfers. Therefore, as long as it is done into an objective manner, I personally would prefer that the Commission does not rule such grants out.

5. TOR 6(vi) concerns non-salary and non-wage expenditures for maintenance. This leaves the issue of salary and wages component completely open, although this is a large part of the State governments' expenditure and the Central Pay Commission impact on this item has been a controversial issue. The Commission would thus have complete discretion as to the manner in which this item will be accounted for.

6. TOR 8 pre-supposes the continuation of the fiscal reform facility. I personally do not believe that it is such a good scheme that its continuation can be taken for granted. The Commission may seriously think about evolving a different scheme together for ensuring participation of states in the process of fiscal reform.

7. TOR 9 mentions debt problems and issue of debt sustainability in the same breadth as human development and investment climate. The link is not obvious to me. Human development typically is linked to expenditure on social services, which, even when considered to be investment in human capital, have a long gestation period. Loan financing of such expenditure, which the TOR appears to presume, would normally be considered inappropriate. Further, "investment climate" is a term which is vague. The most important determinant of investment climate is probably availability of infrastructure. Physical infrastructure can appropriately be financed by debt, and therefore, linking debt to infrastructure availability explicitly may be a better idea.

8. Taking into account human resource development could be tricky. Does the idea involve rewarding the states with better HDI? Or, using a need based approach, should the low HDI states be given special dispensation? It is possible to argue both ways.

9. In the context of almost universal fiscal problems at the state level, horizontal imbalance has to be identified carefully for the purpose of equalisation. Financial indicators at this point may be misleading and it is necessary to combine physical indicators with financial indicators to get a proper picture.

10. The issue of general vs. specific purpose grants is potentially an unimportant one. In my view, the key determinant of an appropriate use of specific purpose grant is the likelihood of adequate monitoring. Without monitoring, even the specific purpose grant can become fungible and the whole purpose may be lost.

11. As I have argued in greater detail elsewhere, the problem of state indebtedness has to be tackled from both the sides of demand for and supply of debt. While fiscal reforms should reduce the demand for debt, there is need to harden the budget constraints of the States to treat the problem from the supply side. Provisions like fiscal reform facility would actually contradict the prescription for hard budget constraints given the way the system of MOUs actually functions.

12. Much has been said about the so-called trade-off between equity and efficiency. This is mainly because the use of the normative approach has been rather limited due to various constraints. However, in the interest of appropriate methodology a simple normative approach must now be adopted.

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DEPARTMENT OF ECONOMICS
PUNJABI UNIVERSITY
PATIALA

Janak Raj Gupta
Professor

Dear Dr.Srivastava,

Thank you for your letter dated 22/4/2003. I have already submitted vide my letter dated.........some suggestions regarding the Twelfth Finance Commission.

However, some additional observations/views on some of the issues as mentioned in your letter are enclosed. If you wish I can also write a detailed note on any specific issue to be dealt with by the XII Finance Commission.

With personal regards,

Yours sincerely,

(J.R. Gupta)

Dr. G.S. Srivastava,
Secretary,
Twelfth Finance Commission,
Jawahar Vypar Bhawan,
1, Tolstoy Marg,
New Delhi-110 001.

Office of Secretary, TFC
Dy. No. L-524
Date 19-05-2003

Some additional Observations/Views pertaining to the Twelfth Finance Commission.

Janak Raj Gupta
Professor
Dept. of Economics
Punjabi University,
Patiala

I. There is no escape from filling the revenue-expenditure gap on current(revenue) account. The Twelfth Finance Commission must follow the footsteps of its predecessors. However, some incentives to better performing States must be given. The States which have achieved some upward shifts in their tax-GSDP ratio must be rewarded. As tax-GSDP ratio is bound to be higher in the richer States, therefore, what is required is to reward for the <u>positive incremental tax-GSDP ratio</u> and not for the higher tax-GSDP ratio as we commonly believe.

Similarly States expressing higher user charges must also be rewarded. For this purpose, total expenditure on public goods may be divided into two categories: (a) expenditure on revenue account, and (b) expenditure on capital account. All the States must be encouraged to recover full expenditure on revenue account. The States which recover partial return on capital account must be progressively rewarded.

One of the alternatives could be to compare the total revenue/GSDP ratio instead of tax/GSDP ratio. As far as possible a distinction between merit and non-merit goods must be made in this regard.

II. As regards the third term of reference regarding "measures needed to augument the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities....." is concerned apart from the recommendations of the State Finance Commission(SFC), the views of the NCRWC must also be kept in mind. A different set of weightage can be designed to compel the States to implement the reports of the respective SFCs. The States which have already implemented the reports of the SFC could be given a weightage of 25 per cent. And the same percentage can be set apart to encourage the States to implement the reports and receive their shares. Then 50 per cent can be given directly to Panchayats/ULBs in the form of matching grants so as to induce them to make additional efforts to mobilise resources. As far as possible resources should be transferred directly to the PRIs/ULBs.

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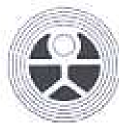
III. In the field of human resource development(HRD), main problems are population control and provision of education and health services. Apart from giving weightage to the performance of the states, there is an urgent need to assist the States which have been left behind in these fields. What is important is to evolve a mechanism of monitoring the schemes which are financed by the Union Government.

IV. For achieving macro-economic stability attempts should be made to move towards zero Revenue Deficit. More emphasis should be given to Revenue Deficit than to Fiscal Deficit, which is a Western concept.

Similarly, to achieve the objective of debt reduction, the disinvestment proceeds must always be used for retiring the public debt. Under no circumstances the Centre or the States should be allowed to spend these proceeds for consumption purposes i.e. for expenditure on revenue account. Further, the debt swap scheme introduced in the Union budget 2003-04 for the States should be popularised.

V. Last but not the least, the Twelfth Finance Commission, must give due attention to the problems like poverty, unemployment, education, including quality education (I.T.) medical services, population explosion, etc.



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M. A. Oommen
Malcolm S. Adiseshiah Professor
Development Economics and
Decentralised Planning

18 September 2003

Dr. G. C. Srivastava
Secretary
Twelfth Finance Commission
Jawahar Vyapar Bhawan
1 Tolstoy Marg
New Delhi 110 001

Dear Dr. Srivastava

Please find enclosed a brief note I have prepared for consideration by the Commission.

Regards

Yours sincerely

M A Oommen

Encl – 1

Office of Secretary, TFC
Dy. No. 4-1021
Date 19-09-2003

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Local finance and the restructuring of Public finances: Issues before the Twelfth Finance Commission

M.A.Oommen

For the first time in the history of finance commissions in India, the eleventh finance commission (EFC) was required to "bring about a restructuring of the public finances so as to restore budgetary balance and maintain macro economic stability". Given the normal tasks any union finance commission (UFC) has to perform and the short time at its disposal, this was no small or sinecure task to perform. Even so, this was repeated and included in the terms of reference (TOR) of the twelfth finance commission (TFC), this time widening the scope further by including "debt reduction along with equitable growth". The renewed inclusion of the restructuring task in the terms of reference of the TFC is an admission that EFC has failed in performing this task. This note seeks to raise some issues related to the restructuring of public finances with reference to the finances of local bodies in the country.

The Primary Tasks of an UFC

It is abundantly clear from the TOR of both EFC and TFC that one of the major objectives of the so-called restructuring of public finances is to promote privatization and market mediated growth by accelerating the fiscal reform process underway in the country. The recently enacted Fiscal Responsibility legislation of the Centre and similar legislations by some of the states and item no. 8 of TFC's TOR requiring a review of the fiscal reform facilities introduced by the central government clearly point this out. Presumably to stave off possible criticism that growth *per se* can be iniquitous, the TOR of TFC have thoughtfully used such palatable expressions like "equitable growth" and "weightage to the performance of the states in the field of human development and investment climate". (Hopefully no correlation between the latter two is implied!). If the TFC's recommendations were to contribute to growth with equity and if it were not to end up as an exercise in number game, allocations and policy choices to promote employment, primary education, primary health care, regional equalities, reduction of poverty and the like will have to be considered. Indeed, fiscal responsibility does not mean fiscal correction alone. How fiscal correction is achieved is more important than how much is achieved insofar as your

objective is equity and people's well-being. Can the TFC ignore the stark reality that the employment elasticity of the economy has dropped from 0.68 in 1983-88 to 0.16 between 1993-2000. Truly, "jobless growth" cannot be growth with equity. Pruning public expenditure in primary health care, primary education, drinking water, street lighting roads in remote areas and the like can achieve fiscal balance, but at the cost of people's well being in a country where poor people and poor places abound.

The primary task of a finance commission as laid down in the Indian Constitution [See Article 280(3)] consists in evolving a transfer system that will seek to rectify the vertical and horizontal imbalances. In a federal system the need for intergovernmental fiscal transfers arises largely because of vertical imbalances in resources and responsibilities as well as due to inter-jurisdictional imbalances in fiscal and economic endowments. Horizontal equity is of paramount consideration given the admittedly growing disparities in income, infrastructure, social conditions and the like. Now that India has chosen a market mediated growth path, spatial equity can be secured only through the vast network of Panchayati Raj Institutions (PRIs). The 73rd constitutional amendment recognizes explicitly the need to provide a national minimum of basic services to every citizen irrespective of the choice of his/her place of residence. To deprive a citizen of adequate level of schooling, primary health care, drinking water supply and the like because of remote location is an injustice. When the TOR of EFC referred to Articles 243G and 243W which seek to ensure 'economic development and social justice' at the local level, it was in a way recognizing this [See clause 6(b), sub clause (ii) and (iii) of the TOR of EFC].

That the UFC should make its recommendations regarding local self-governments "on the basis of the recommendations made by the Finance Commission of the State" [Article 280(3) (bb) and (c)] is meant to underscore the organic link in the Indian fiscal federalism cannot be ignored. The recommendation of the EFC to abolish the sub-clauses (bb) and (c) because of the "heterogeneity in approach, content and periods covered" is untenable. Clearly the EFC has failed to appreciate adequately the letter and spirit of the Indian Constitution and the 73rd and 74th Constitutional Amendments. Can any one expect uniformity in approach from 28 different state finance commissions (SFCs)? The historical realities and objective conditions obtaining in the various states naturally differ. The best alternative is to amend the wording of Article 280 (3)(bb) and (c) to "after considering the recommendations of the State Finance Commission". Indeed the UFC has a

responsibility to take initiatives and offer operational guidelines to SFCs in the interest of the Indian economy.

Multiple Channels of Transfers

No attempt at restructuring public finance can ignore the reality that there are multiple channels of transferring resources from the centre to the states. Many of them besides being distortionary are also unconstitutional. Regarding local self-governments it is important to examine how the 29 'subjects' handed over to the panchayats as per the XI Schedule continue to be handled by the central and the state governments. According to the Tenth Plan Approach Paper prepared by the Planning Commission, the share of the Centrally Sponsored Schemes (CSSs) in the plan budget of the Central Ministries has today increased to 70 percent against 30 percent in the early 1980's. Besides the CSSs, there are 26 sectoral programmes /schemes under the expenditure responsibilities of the centre, but belong to the 29 subjects of the XI Schedule. Probably the state governments are more guilty on this score. But that is an issue to be addressed by SFCs. At any rate these trends are neither constitutionally neat nor sustainable exercises.

One can also find 'parallel' flow of funds to rural areas for items falling within the 29 subjects such as anti-poverty programme funds through the DRDA (District Rural Development Agency), literacy promotion funds through the Saksharata Samiti and funds for fisheries, women's development etc. passing through various registered societies promoted by the central government. It is strange but true that the Union Ministry of Rural Development which has to monitor the progress of Panchayats in India is actively strengthening DRDAs which ought to have been abolished by now. Apart from these Government of India provides extra budgetary loan facility under the RIDF (Rural Infrastructure Development Fund). The huge special funds (Rs. 2 crore per MP) placed at the disposal of MPs (MPs Local Area Development Fund) and MLAs to be spent on items that fall directly within the functional domain of local bodies are other conspicuous examples of distorted transfer arrangements prevailing at the national and sub-national level. Can the TFC ignore the whole range of transfer arrangements which cover a far wider spectrum than those mentioned in any effort at reconstructing or restructuring public finance in the country? There is an imperative need to redraw the functions funds matrix currently emerging in India on a rational and constitutionally valid basis.

No comprehensive package of restructuring of public finance can ignore the potential role of local finance in Indian federal system. Can the local self-governments be left out of any package of reform for restoring fiscal balance? The estimated own tax-GDP ratio of local bodies in the country which is only around 0.49 percent in 2002-03 (in this the contribution of Panchayati Raj Institutions is negligible) could be raised manifold provided more functions, funds, financial powers, training and technical personnel are given to them. Capacity-building and autonomy are key aspects here.

On the basis of substantial evidence available with me (based on a World Bank supported study), I can assert that only less than 40 percent of the tax revenue potential from property tax, profession tax and entertainment tax is collected in Kerala. Similarly the tremendous potential of land revenue from states like Punjab, Haryana and Andhra Pradesh remain untapped. I may hasten to add that there is no implication here that the centre and the states have a good record of tax effort. Actually the tax-GDP ratio of central government fell from around 10.1 percent in 1990-91 to only a little over 8 percent in most of the subsequent years. Given a Central government tax buoyancy of 0.85, this has serious implications for the size of a divisible pool that can be set apart for the states. The states tax-GDP ratio remained stable at around 5.4 per cent with buoyancy around unity during the last decade. The Report on Tax Policy and Tax Administration (2001) (the Shome Committee) set out a tax-GDP target of 10.88 percent for centre and 6.9 percent for the states for 2006-07, the last year of the Tenth Plan. Seen from the current scenario, we are way below this target today. The award of the service tax base in its entirety to the states and local bodies along with strengthening the PRIs by devolving the three Fs-functions, funds and functionaries to the local bodies, aggregate revenue of Indian federation could be enhanced. A total local revenue (tax plus non-tax) – GDP ratio of around 2 per cent by 2010 cannot be considered an unrealistic target for local self-governments in India. Augmenting the revenue resources is not only the best way to restore fiscal balance and reduction of debt, it also promotes accountability in a democracy.

Local Governments: The Key to Horizontal Equity

Along with efforts towards effective fiscal decentralisaion, some issues that are relevant to horizontal equity may also be mentioned.

The Externally Aided Projects (EAPs) are independently negotiated by the so-called donor and the state concerned. As EAPs are treated as additional central assistance, they are invariably allocated by the centre in the loan – grant ratio of 70:30. Even if a foreign country gives its entire assistance as grant, it is passed on to the states in the 70:30 ratio. In fairness the centre should have passed on EAPs at the donor – specified terms and conditions. The volume of EAPs may expand in the market-dominated economy that is emerging in India. The UFC may have to lay down criteria to ensure horizontal equity.

Although not related to EAPs, but certainly related to debt reduction of states is the question of altering the 70:30 ratio fixed as far back as 1969, when that roughly reflected the capital revenue proportion of the plan. Today the revenue component has gone above 60 percent and in quite a few states like Kerala as high as 80 percent. The TFC may have to technically establish the revenue component. If that cannot be done immediately the component can be raised to, say, at least 50 percent as a transitional measure.

The Planning Commission's 70:30 ratio has an important bearing on the states' debt situation. The restructuring of public finance must address the reverse flow from the states to the centre which for some states like Kerala started as far back as 1996-97. In 1999-2000, the gross loans from the centre (plan + non plan) was Rs.21589 crore. But the repayment of loans plus interest to the centre was Rs. 34619 crore. This means a reverse flow aggregating to Rs.13030 crore. The average rate of interest charged at that time was 12.5 per cent. The magnitude of the reverse flow increased to Rs.19003 crores in 2000-01 with a repayment of loans plus interest of Rs.37969 and a gross loan from the centre to the tune of Rs.18966 crore. Although it declined subsequently the problem persists despite the fact that the rate of interest has come down subsequently. Given the fact that the centre's debt management, policy has affected the size of states' debt, there is a strong case for debt relief. Even so, general debt relief can only encourage inefficiency. Any debt relief should be comprehensive taking small savings, ways and means advance, state guarantees etc besides based on performance and the specific fiscal situation of a particular state. All socially desirable but unproductive loans like, for example, calamity relief loans, must be written off. Strictly speaking, there is no escape from the rule that the rate of return on borrowed funds must be greater than or equal to the rate at which they are held.

Horizontal equity is achieved best by working towards equalizing the revenue capacity of the different states and by ensuring a minimum of basic services to every citizen. Of course this is true for sub-state level devolution by the SFCs as well. Statutory grants are important instruments in achieving this. But the role of grants in fact has been small and on the decline. Of the total transfers of resources from the centre excluding gross loans in 2000-01, to the states, the share of statutory grants was 9.4 percent and in 2001-02, 8.7 percent which fell further to 7.8 percent in 2002-03.

Horizontal equity in a transfer system depends a great deal on the criteria chosen for *interse* distribution. Need, efficiency and equity should be important governing considerations in the choice of criteria. There is nothing amiss in using different criteria for tax sharing as well as for grants. But the logic of using 10 percent weightage for population for sharing of taxes and 40 percent for grants to local bodies by the EFC is somewhat unconvincing. Population is one criterion that has been used by all the finance commissions in the past, of course, with different weightage. This was also one criterion demanded by the states in general. But because several other criteria such as backwardness, tax effort, etc. (e.g per capita income, distance, inverse of percapita income, per capita tax etc.) have been deflated with population and worked out as a share of total population, the total share effectively received turns out to be influenced considerably by population. No wonder in most cases the share of aggregate transfers received by any state given by the UFCs does not significantly differ from their population share. Alternate criteria that are not weighted by population must also be used. For example, realizing the target of additional resource mobilization (ARM) agreed by a state before the Planning Commission could be taken as an index of tax effort. This is the best way to ensure compliance by the states most of whom have been disregarding this target agreed before the Planning Commission with impunity. There is also a case for building a local government component to the ARM in the future. This is one way of ensuring shared responsibility and cooperation in a multi-tiered federal polity.

The political economy of staying backward or proving backward to attract central devolution has to be discouraged. States that have made real progress in terms of goals laid down in the Constitution such as enrolment ratio of children between 6 and 14 years, creation of public medicare facilities, progress made in effective decentralization (the EFC made a mess of it through use of ill-informed

variables in the Decentralisation Index it created) and so on must be used as prominent criteria with appropriate weightage. The actual devolution of funds, functions divided into relevant activities and sub-activities, and fiscal assignments and functionaries should be the major consideration while designing a decentralization index. There is no case for compensating inefficiency in perpetuity even after half a century of the federal republic. The most efficient and fiscally responsible spending consists in progressively achieving the constitutional tasks in a reasonable time frame.

The question of restructuring public finance will be incomplete without reference to the reform of the budgetary process and system. The Fiscal Responsibility and Budget Management Act of the centre and similar legislations by some states are good in that they seek to provide a medium term fiscal policy framework for the country. But what about the 2.31 lakh village panchayats in India where accounting and budgetary process are in disarray? It is the hardware that needs to be restructured first. Several other questions remain unanswered. The Fiscal Responsibility legislations are no guarantee against the wide hiatus between budget estimates of revenue and expenditure and the actual. Incremental budgeting, supplementary demands, uneven monthly flow of receipts and expenditure, indifferent response to audit reports to escape actions, possibility of off budget borrowing through public sector undertakings and transferring the funds to public accounts and so on will continue despite these measures. The fiscal responsibility legislations can lead to fiscal corrections in an arithmetical axing game. The concept of Fiscal Responsibility which is not defined in the central legislation consists in channelling public resources to achieve certain avowed social goals. The term "equitable growth" can take flesh and blood only in that manner. The best way to ensure fiscal discipline and fiscal responsibility is to resort to *zero base budgeting* by all levels of governments which provide the opportunity to scrutinize all major items of expenditure every year using normative parameters.

To conclude, the role of the third stratum of government to ensure territorial equity by providing the basic services to the people continue to assume significance. Like the Union and the States, the local governments must mature as fundamental political units in the country. The restructuring of public finance can ill-afford not to address this question.

(maoommen@asianetindia.com)

PUBLIC EXPENDITURE ROUND TABLE TRUST

(PERT)

May 14, 2003

To

Dr.C.Rangarajan,
Chairman, Finance Commission,
New Delhi.

Sir,

The Public Expenditure Round Table (PERT), Chennai, a registered Public Trust, has pleasure in submitting herewith a Memorandum on the issues before the Commission. The Memorandum was prepared after obtaining the views of a number of experts expressed in a meeting chaired by Dr.Raja Chelliah.

It may be mentioned that PERT had submitted a memorandum to the Eleventh Finance Commission and had also an opportunity to meet it when that Commission visited Chennai.

A brochure on PERT is enclosed for information on its composition, objectives and acfivities.

Yours faithfully,

K. Venkataraman
Chairman

Office of Secretary, TFC
Dy. No. L-537
Date 21-05-2003

Office of the Chairman
Twelth Finance Commission
Dy No. R.394
Date 19/5/03

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MEMORANDUM TO THE 12TH FINANCE COMMISSION

FROM THE PUBLIC EXPENDITURE ROUND TABLE, CHENNAI

Introduction

1. The Public Expenditure Round Table (PERT) is a registered public trust in Chennai. Its aim is to generate awareness and debate on issues related to the neglected theme of public expenditure – in particular the need for efficiency and effectiveness of such expenditure. PERT acts as a think tank and as a bridge to public awareness.

2. PERT had submitted a memorandum to the Eleventh Finance Commission and also had the opportunity to present its views when the Commission visited Chennai.

3. This memorandum is in two parts. Part I flags several issues pertinent to the work and terms of reference of the Commission. Some of the issues have remained unresolved over decades. Each of the points is not elaborated, as the Commission is quite familiar with the issues discussed. Part II addresses in detail the fundamental question of restructuring public finances which is one of the terms of reference. It suggests the adoption of a code of conduct of fiscal policy and management for the Central and State Governments.

PART I

Overall Perspectives

1.1 The terms of reference provide ample scope and indeed an opportunity for the Commission to take an independent and objective view of the Central and State finances and of the fiscal crisis that is enveloping the country. The Commission should not miss the opportunity for frank appraisal and advice on the crisis, the gravity of which has not been understood. What is involved is not an accounting or calibration exercise; the fundamental issues of the system of public finances in India should be addressed. The Commission must set in motion a process by which the restructuring will be achieved and make its own recommendations on a time-bound programme for this purpose.

1.2 In considering the restructuring of Central and State finances, the Commission must take a long-term view. It may examine how (and how far) the visions of 2020 could be achieved, given the present limitations of the fiscal system.

1.3 PERT believes that public expenditure management, which has over the years become lax, should be treated as an integral part of fiscal restructuring; restructuring would be meaningless without adequate expenditure management and discipline. Restructuring presents a good opportunity to revive and restore such discipline.

1.4 The Commission should not make supplementary recommendations at the request of the Government. It must maintain the high standing conferred on it by the Constitution.

1.5 The Commission's recommendations must be growth-oriented. Growth inducing elements should be introduced through grants. Only through growth can the fiscal situation improve.

1.6 So far, there has been the practice of multiple projections. States make different projections to the Finance Commission and the Planning Commission. The way that money is spent eventually is yet different. There is need for a transparent assessment of the ex-ante and ex-post situations. The Commission may consider making recommendations to ensure ex-post review.

1.7 In between Commissions, there must be a mechanism for monitoring and feedback to Central and State Governments.

1.8 The Medium Term Fiscal Reform Facility does not appear to have made a dent on the challenge of improving State finances. There must be a stronger and more effective Facility.

Planning and Financing

2.1 The interface between national planning and resource transfers and state level planning and implementation continues to be marked by several unresolved issues. The Commission will need to come out with clear recommendations in this respect.

2.2 A major issue is the definition of the respective roles of the Finance and Planning Commissions. The present dichotomy does not facilitate a total view of transfer of resources from the centre to the states , plan and non plan and grants and loans , on a consistent and rational basis. Another coordination issue involves Planning and Finance ministries. Here again we are faced with an artificial distinction between plan and non plan budgets preventing a total view of expenditure and distorting priorities. The Commission can suggest a suitable institutional mechanism for proper coordination.

2.3 The distinction between plan and non-plan development expenditure should be given up and the two should be treated as a whole. Procedural constraints should not stand in the way of removing the dichotomy that has little merit. No information is available on the work of a Task Force appointed to go into the question. The five year plan period and the five year period for Finance Commission purposes should be the same and one common projection for each State should be adopted for both purposes.

2.4 While playing a guiding role, the Centre should respect the constitutional role of the States, particularly in regard to activities which essentially pertain to the State level.

2.5 The Centre should discontinue or rationalize centrally sponsored schemes which have little flexibility for adaptation to ground level realities; the resources released thereby should be used for other plan activities at the State level.

2.6 The 'Gadgil formula' for transfer of plan resources should be reexamined in the light of the experience gained. The trends in the revenue content of the plans of the States, which is generally much higher than 30%, must be studied and an upward revision recommended. 50% of the plan outlay would be appropriate as plan grants. State plans are staff-intensive, eg. teachers' salaries.

Distribution Issues

3.1 The percentage of devolution should be fixed keeping in view the needs of both the Centre and the States. The approach should be need-based. There is little merit in each Commission altering the 29% formula, if it will be at the expense of focusing on ways and means of increasing the

buoyancy of revenues. The approach should be that of a positive sum game.

3.2 In horizontal distribution, population needs to be given more weight, say by another 10%. Population is always a good index of needs. Criteria for better performing States must be evolved and kept stable for 10 years; such States must be explicitly encouraged. The capital productivity (ICOR) of the States could be an index of efficiency.

3.3 The Commission should pave the way for moving away from a gap-filling approach to a normative approach in distribution. The normative approach should be introduced in the Commission's recommendations in a practical way.

3.4 The Eleventh Commission's recommendations for grants to panchayati raj and municipal bodies were welcome but not adequate. Their implementation must be reviewed and additional resources made available to them. The Commission may recommend the institution by each State of a consultancy-cum-advisory facility for preparation and implementation of infrastructure projects by local bodies.

3.5 Proceeds of disinvestments of State Government undertakings should go to retire debt. Measures should be proposed for improving the efficiency and financial performance of those undertakings which are not subject to disinvestments. A special study must be made of the State Electricity Boards and of the ways and means of improving their efficiency.

Efficiency and Effectiveness

4.1 Appointment of expenditure commissions is a necessary but not sufficient condition for toning up the fiscal system. Their recommendations must be implemented. A one-time effort cannot give enduring results. The Commission may wish to recommend a standing mechanism to improve economy and efficiency of government operations.

4.2 The Commission may request the Central and State Governments to submit a comprehensive paper reviewing existing subsidies and stating their policies on subsidies in future.

4.3 A special grant may be considered for governments to carry out a Public Expenditure Review (PER). A major task of PER would be the redefinition of the role of government. The functions and programmes of each government agency must be reviewed in the light of three basic criteria, what government should do and pay for, what it should pay for but not do and what it should neither do nor pay for. PER would also cover the various aspects of public expenditure management, including better management of autonomous bodies, improving implementation of capital projects, efficiency in tax collection, accountability for performance, better estimation and marksmanship, expenditure commitment and cash management and greater transparency. Several of these aspects are dealt with in PART II.

PART II

1. The Twelfth Finance Commission set up under Article 280 of the Constitution of India has been asked to submit its report by 31 July, 2004 to cover the period of five years from 1st April, 2005.The Commission's main concern is the distribution of taxes and grants between the center and the states and among states . In addition , the Commission has been asked to "suggest a plan to bring about a reconstruction of the public finances restoring budgetary balance ,achieving macroeconomic stability and debt reduction along with equitable growth ".Reconstruction implies deficiencies in the existing model and alteration for improvement. This assumes great significance in the present context of fiscal indiscipline and imbalance. Drawing up a fiscal reconstruction plan is a complex , daunting and laborious task. It will be useful to identify the major fiscal problems of the centre and states , possible improvements and the Commission's role in drawing up the plan.

2. There are many serious causes for the present fiscal drift. These are well known but worth reiteration .

2.1 There is no long term fiscal policy. The annual budget is by definition confined to estimates for the ensuing budget year. It is not set against a background of projections for the medium term of at least two years following the budget year. The result is frequent changes and flip flop in tax and revenue measures , difficulty in funding of even committed expenditures in the post budget years and spiraling budget deficits.

2.2 Revenue mobilization has been poor and suffers from narrow base and lack of efficient collection under taxation. The ratio of central gross tax revenue to GDP declined from 10.6% in 1989-90 to 9% in 2000-01 and 8.1%in 2001-02.The budget documents do not indicate the extent of arrears in tax collection and the cost of collection presumably because the budget is not accrual based . Non tax revenue is a neglected area and the coverage and the rates of user charges are inadequate. Promptness in recovering interest and principal in respect of loans advanced by government is another moot point on which the budget papers do not shed any light.
2.3 Capital expenditure for asset creation as a percentage of GDP is showing a declining trend since the early Nineties. Revised Estimate in the central budget for 2002-03 is Rs 62,365cr and is more or less the same in nominal terms and less in real terms (taking into account inflation) as compared with the expenditure in 1998-99. The other disturbing trend is inability to spend the funds budgeted for capital expenditure each year mainly due to poor project management.
2.4 Revenue deficit and fiscal deficit indicated in the budget estimate are invariably exceeded in the revised estimate which itself is exceeded in the actual figures in accounts compiled after the close of the year. The latest budget for 2003-04 shows the revenue deficit of 3.2% of GDP in BE 2001-02 increasing to 4% in RE and to 4.3% in the actual accounts (similar figures for fiscal deficit are 4.7% , 5.7% and 6.1%).This is mainly due to overstatement of revenue especially tax revenue and understatement of expenditure in the original budget estimates as evidenced by supplementary estimates routinely presented in each session of Parliament. The budget is not supported by cash flow statement. There are many examples of expenditure commitments in the budget speech for 2003-04 which are not fully funded in the budgét and may need supplementary provisions in due course like subsidy to LIC for assured return on pension scheme , universal health insurance and the subsidy to equal the gap between user charges and repayment liabilities.
2.5 The rapid increase in fiscal deficit and the resultant huge public debt are a matter of concern. Interest charges preempt more than half of annual revenue. Serious doubts arise about the ability to service the growing debt. The concern about the quantum of deficit is compounded by the quality of expenditure financed by borrowing. Much of loan goes to fund current consumption expenditure and non-priority , unproductive and inefficient expenditure . Debates on the limits of deficit financing by government do not address this crucial aspect. They also tend to ignore the borrowings by

public sector undertakings and special purpose vehicles which are being set up outside government.

2.6 Expenditure policy and management have not come to grips with basic issues. Specific examples of serious omissions will explain.

2.6.1 No attempt has been made to redefine the role and functions of government so that government can withdraw from unnecessary functions and outsource even in areas where government has to continue. Efforts to control expenditure and reduce buraucracy have been ad hoc and futile.

2.6.2 Efforts to reduce subsidies ignore basic policy and management issues. Food subsidy can be cut only through review of food policy on guaranteed procurement and reducing the cost of operation of Food Corporation of India. In fact cost reduction is rarely discussed as a means of reducing the subsidy burden and the preferred route is increasing the issue prices. These observations apply to other subsidies also like LPG and cooking gas.

2.6.3 Public sector undertakings (PSUs) continue to be a burden on government budget. Privatisation has been an excruciatingly slow process. Reengineering those which have not been privatized also seems to be a nonstarter .Meanwhile government continues to bale out such units , the latest beneficiaries in the central budget being UTI, IFCI and nationalized banks. The Railways continue to rely on government for capital funding and default even on paltry dividends to government ; separation of railway finance from general budget does not seem to have achieved the original objective and needs a review. The state governments additionally suffer from bankrupt electricity boards which affect the central government also as these owe central power utilities Rs 40,000 cr for supplies made.

2.6.4 Effective expenditure control and management is hampered by traditional mindset. There is no awareness of need for austerity vide numerous examples like increasing the minimum procurement price over that recommended by Commission on Agricultural Costs and Prices for non economic reasons , creation of new railway zones at an extra cost of more than Rs 700 cr. , setting up new offices of field publicity and song and dance in the Information and Broadcasting ministry despite recommendation of Expenditure Reform Commission to abolish existing ones, increase of salaries and perks for MPs and MLAs and jumbo size council of ministers . Accountability for expenditure is still in terms of only spending the budget allocations and not for achieving the targeted output and outcomes. Modern management accounting is not in place though this was one of the objectives of separation of audit from accounts undertaken twentyfive years ago at great cost . Time and cost overruns on projects are endemic; some central projects from First Five Year Plan spilled cover to

Tenth. The focus is on expenditure and ignores contingent liabilities of government which are growing rapidly. Such liabilities are likely to become expenditure if government is called upon to redeem their guarantees (central guarantees outstanding on 31.3 2002 was Rs 96,858) ; budget documents throw no light on the performance against the guarantees eg. default of Rs. 10,000 cr. on Enron project.

2.6.5 There is no institutional mechanism to initiate, sustain and monitor fiscal reconstruction. Ministry of Finance at the centre , after decentralization and delegation over the last two decades , lacks expertise for this task .

3. Plan for reconstruction of public finances should aim to remove the deficiencies pointed out earlier and promote sound fiscal policy and management .Essential elements of such a plan are :

3.1 Medium term fiscal policy (MTFP) with a three year projection of revenue and expenditure estimates covering the budget year and the two following it.

3.2 A clear statement of fiscal policy objectives , quantified where possible , and the specific taxation and expenditure measures to achieve these.

3.3 Comprehensive and quantitative macroeconomic framework based on explicit assumptions and parameters like growth rate , inflation rate and exchange rate.

3.4 Reliable estimates based on realistic economic and cost assumptions. Identification of major risks and provision of contingent reserves. Supporting the budget with cash flow statement.

3.5 Extension of tax and non tax base , reduction of the cost of collection and keeping the arrears in collection to the minimum. Presenting in the annual budget data on demand , collection and balance of all dues to government.

3.6 Elimination of unnecessary functions and activities of government which will be a facilitator in a redefined role. Providing a list of schemes and activities weeded out with data on savings thereby.(Over 1500 central plan schemes)

3.7 Tackling subsidies through review of underlying policies and reducing the cost of providing the subsidized goods and services.

3.8 Prioritisation of expenditure with the thrust on essential, productive and efficient expenditure. Transparency of expenditure priorities through data on sector allocations as percentages of budget and GDP instead of indicating percentage increase over previous year's revised estimate.

3.9 Accountability for output and outcome in addition to financial accountability and strengthening the accounting and data base . Improving

project implementation and integrating meaningful performance budgets, which are presented separately and routinely , with the main budget.
3.10 Better control and monitoring of guarantees given by government. Budget transparency of performance against contingent liabilities in the budget documents.
3.11 Action plan to reduce the burden of PSUs , the Railways and statutory bodies on the budget.
3.12 Moratorium on non priority schemes like formation of new states , Railway zones , new districts. Inculcating awareness of need for fiscal discipline and cost consciousness.
3.13 Strengthening Ministry of Finance and institutional support to stimulate and oversee fiscal reconstruction.
4. It is obvious that the Finance Commission , with its limited manpower and time , cannot be expected to draw up a comprehensive and detailed fiscal reconstruction plan . But it can make suitable recommendations on the improvements needed to correct the existing deficiencies , suggest a code of conduct for fiscal policy and management and flag the essential elements in the fiscal reconstruction plan with a suitable time frame for achieving fiscal balance. It can lend its weight to framing a fiscal responsibility law to take away fiscal policy and management from short term interests and populist pressures. The central bill, Fiscal Management and Responsibility Bill , suffers from serious defects. Deficit reduction is viewed as an end itself. How deficit is reduced is as important as by how much it is reduced. Unrealistic targets produce only "creative" accounting What is needed in the fiscal law and rules is a judicious blend of quantitative targets and a code of good fiscal conduct which should be the basis for deficit control plan and targets. There should be provision for temporary deviations from targets to meet economic fluctuations and natural calamities . Many aspects of prudent fiscal policy and management have been highlighted in this paper along with possible lines of improvement. Hopefully , the Finance Commission will recommend changes in fiscal legislation and rules thereunder and prod the central government to more serious efforts in fiscal consolidation. The Commission can also suggest how this approach can be implemented in the states. The central government's clout in enforcing fiscal discipline in the states seems non-existent. A combination of incentives and sanctions may be needed.
5.The Commission may also recommend presentation of a White Paper on fiscal reconstruction.