

## Chapter III

### Restructuring Public Finances

3.1 Large fiscal deficits fuelled increasingly by deficits in the revenue budgets have been the bane of government finances in India for nearly two decades now. While a part of the capital expenditure has always been financed out of borrowing, revenue deficits signifying financing of current expenditure also by borrowing have become malefic fixtures in the Central budgets since 1979-80, and in the all-States profile, since 1987-88. Virtually all States, first the fiscally weaker ones and then even the better off among them, have slipped into revenue deficit. Embedded as they are in fiscal deficits that are universally acknowledged as unsustainable, revenue deficits are only visible manifestations of multiple and deep-seated imbalances in government finances calling for basic restructuring.

3.2 Clause 4 of our Terms of Reference (ToR), the first of its kind for a Finance Commission, brings this issue to the fore. It requires us *to review the state of finances of the Union and the States and suggest ways and means by which the governments, collectively and severally, may bring about a restructuring of the public finances so as to restore budgetary balance and maintain macroeconomic stability*. In addressing this task, we feel it necessary to (i) consider the relevant parameters of macroeconomic stability; (ii) based on the parameters chosen, outline the contours of the restructured public finances of the country with suitable disaggregation between the Centre and the States needed to underpin macro-stability; (iii) specify the contents of restructuring; and (iv) spell out the ways and means by which such restructuring can be brought about by the Central and State governments, collectively and severally.

3.3 In the context of the task of formulating the ways and means for achieving budgetary balance, an additional term was subsequently referred to the Commission requiring us to *draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the States and recommend the manner in which the grants to States to cover the assessed deficit in their non-Plan revenue account may be linked to progress in implementing the programme*. We shall address this additional term in a subsequent report.

3.4 The structure of public finances in an economy is defined by the level and composition of expenditure of the government (current and capital) and the instruments relied upon to finance them, viz., the tax and the non-tax revenue sources and borrowings. The excess of government expenditure over current revenues and other non-debt receipts gets reflected in fiscal deficits financed either by way of borrowings from internal and external sources or through seignorage, that is money printing. If expenditure persistently exceeds revenues, fiscal deficit, to the extent it is not covered by seignorage, steadily adds to outstanding debt, resulting in increasing interest payments<sup>1</sup>. Unless met with larger revenue receipts, this gives rise to a self-perpetuating spiral of debt and deficit. In the absence of commensurate increase in domestic savings, deficits in government budgets tend to spill over to the external sector in the form of current account deficit leading eventually to adverse balance of payments. This, in turn, jeopardises the macro-stability, judged by stability of prices consistent with growth at attainable full employment levels. The solvency of the economy also comes under doubt. A restructuring programme is called for to steer public finances away from such a spiral towards sustainable levels of debt and deficit.

3.5 It should be noted that not all changes in a fiscal system can be regarded as structural in character. We need to distinguish between changes that affect the very basis of inter-relations among fiscal variables and among fiscal and other variables from those that reside at the surface, and changes that are enduring from those that are transitory. Changes in tax rates aimed at raising the level of tax revenue, for instance, do not constitute structural change. On the other hand, shifts in the composition of taxes seeking, say, to reduce the government's reliance on foreign trade taxes or move towards a non-distortionary tax regime by replacing turnover type sales tax with value added tax, is structural. Similarly, compositional changes in government expenditure, signifying disengagement of the public sector from direct participation in the productive activities in the economy, are structural. Also, changes in the tax base brought about by fiscal and non-fiscal causes would qualify as structural. In a federal economy, changes in intergovernmental financial relations comprising assignment of powers and functions among different levels of government and the system of fiscal transfers belong to the structural category. Again, certain changes in the public finances might be called for to meet short-term exigencies while some others might be needed from a long-term perspective. In formulating a scheme of restructuring it has been our endeavour to identify the content of restructuring and formulate measures to achieve them keeping these distinctions in view.

3.6 As required by our ToR, we have, in Chapter II, reviewed the state of finances of the Union and the States, and analysed the causes of the deterioration in the public finances of the Union and State governments, both proximate and basic. In this Chapter, we consider issues of macroeconomic stability focussing on the implications for intergovernmental fiscal transfers. We have outlined an adjustment path for fiscal restructuring and worked out a package of ways and means for its implementation, keeping in view a medium term goal of fiscal consolidation in the Centre as well as in the States.

### Public Finance and Macro-economic Stability: The Interface

3.7 Public finances impact the economy in many ways, directly and indirectly, in the long as well as the short run. Spending by government represents a draft on the national resources for public use. The size of the draft that the public, i.e., the government sector makes to carry out its expenditure programmes, as also the instruments used for securing them, influence the macro-economy in fundamental ways. The public sector provides services which are not catered to by the markets such as defence, justice, public administration and needs of the social sector like primary education and healthcare. Public sector also promotes growth by helping build basic infrastructure and creating an environment conducive to the development and growth of the economy to its full potential. But, unless employed efficiently, the use of resources by the public sector can retard growth in the long run. Being a component of the aggregate demand, government expenditure constitute the major determinant of the macro-economic outcome in the short run. The manner of financing the government expenditure also impacts the macro-economy, depending on the extent to which such expenditure are financed out of taxation and borrowing or seignorage and the instruments used. An ill-designed tax structure can cause distortions and inefficiencies while reliance on either borrowing or seignorage beyond a point creates problems in the form of explosive accumulation of debt and inflation. Borrowing has its ramifications in terms of inter-generational burden of debt, pressure on interest rates and crowding out of private investment. It also has implications for the external sector balance as deficits in government budgets in excess of what can be met out of domestic savings entail drafts on foreign savings through current account deficits.

3.8 It may be useful at this point to look at the conditions of macro-stability that are of general application. Commonly, macroeconomic stability is associated with stability in prices, allowing for a moderate rate of inflation. However, price stability can coexist with unemployed resources in the economy. Hence, for all practical purposes, macroeconomic stability is viewed as stability of prices at full employment of available resources<sup>2</sup>. In an open market economy, macro-stability is attained and preserved through the behaviour and interaction of the various markets. Depending on the state of the economy, macroeconomic instability can originate from imbalance in any one or more of the principal markets, viz.:

- i) excess of aggregate demand over aggregate supply in the commodity market;
- ii) excess of demand over supply in the financial markets including the market for money and foreign exchange;
- iii) excess of supply over demand in the labour market; and
- iv) imbalances in the market for non-financial assets.

The markets are interdependent and imbalance in one spills over into another. Fiscal stance of the government plays a key role in maintaining or disrupting macroeconomic stability *via* its impact on the various markets, although policies in other fields also influence the outcomes. For instance, physical controls over investment and production, and wage policy can distort the incentives and retard economic growth resulting in shortages and incipient inflation. When prices are controlled, instability may not be apparent even though supply demand imbalances persist. While public finances alone cannot counteract imbalances in all markets, inappropriate policies in the fiscal arena can act as a source of instability.

3.9 For operational purposes, it is useful to look at macro stabilisation issues in terms of internal and external balance. For internal balance, we require a growth trajectory whereby resources are fully employed and inflation is at a low level. For external balance, we need to keep the current account deficit within a reasonable limit that is what can be serviced in the long run out of export earnings and factor incomes abroad. Macro stability also depends critically on the handling of monetary policy and the exchange rate.

3.10 A distinction needs to be made also between stabilisation in the short run and in the long run. The emphasis in the short run has to be on counter-cyclical measures. Thus, in a period of recession, the government has to embark on an expansionary fiscal policy even if this raises the level of fiscal deficit as a proportion of Gross Domestic Product (GDP). Counter-cyclical stabilisation may also be helped by reduction in tax rates to stimulate private spending. On the other hand, when the inflation rate is on the rise, fiscal stance has to be contractionary and fiscal deficit, relative to GDP, may have to be reduced.

3.11 The long run stabilisation objectives are different and more structural in character. From a long-term perspective, one needs to determine the right size of the government, the composition of government expenditure and the size of debt and fiscal deficit, all in relation to attainable or potential full employment output. It would also require a tax structure conducive to savings, investments, risk taking and work efforts. The long run stabilisation provides the necessary time frame for all adjustments to be completed, while ensuring that the economy is on a growth path whereby the available resources, physical and human, get fully employed. The relevant objective then is to select the size and composition of government expenditure and the right mix of financing instruments that maximise growth and welfare, with stability. The focus of fiscal restructuring to ensure macroeconomic stability has to be on this objective. What should be the size and shape of the public sector in a country is ultimately a matter of public choice and, in a way, the level of public expenditure reflects the demand of the people for public services. However, given the concerns about the sustainability of the public sector in India in its present size and form, propped increasingly by borrowing, in addressing the task of restructuring, we first consider the limits to which government expenditure can be financed through debt and deficit and then explore the lines on which the public finances can be reshaped to subserve the objectives of growth with stability.

### Sustainable Debt and Fiscal Deficits

3.12 Government's fiscal stance as reflected in the size of the fiscal deficit and the manner of financing it plays a critical role in macro-stabilisation. The apparently cheapest source of finance for governments is seignorage, which adds to base money or high powered money. As the economy grows, the demand for money also grows, and depending on the elasticity of demand for money, some increase in money supply can be absorbed without inflation. But beyond a limit, increases in base money can result in unacceptably high rates of inflation. It has been suggested that in developing economies the "*ratio of seignorage of much more than 2.5 per cent of GNP would not be sustainable and that even that rate would only be possible in a rapidly growing economy*"<sup>8</sup>. In India, in recent years, borrowing from Reserve Bank of India (RBI) has been subjected to strict limits through a memorandum of understanding between the Government of India and the RBI. Ideally, the extent of monetised deficit should be subjected to a limit linked to GDP.

3.13 Borrowing from foreign sources, the other alternative for financing deficits, tends to appreciate the exchange rate. However, by its very nature the flow of foreign funds depends on many factors, not all economic. The economy's aggregate external borrowings (public and private) have to be managed by the central bank taking into account the safe limit to the current account deficit, the structure of existing external debt and their time profile. The government's external borrowings should be limited considering that its vulnerability to external shocks increases if external debt servicing requirements are too large.

3.14 Domestic borrowings are the other main source for financing deficits in government budgets. However, it has implications for the rate of interest and the availability of savings for the private sector. A critical issue that we need to consider is whether government borrowing and debt are sustainable at the present level. For their sustainability over a period of time, an essential condition is that the ratio of debt to GDP does not grow beyond a point. The debt ratio may, however, remain stable even while there is a primary deficit (i.e., the excess of expenditure excluding interest payments over receipts), as long as the rate of interest does not exceed the rate of GDP growth. This is known as the budget constraint rule. However, the level of primary deficit relative to GDP should not exceed the threshold derived from the difference between growth rate and the effective interest rates on government borrowing<sup>4</sup>. It can be seen that currently the sustainability condition is violated in the budgets of the Centre, in the combined accounts of the Centre and States, and individually in many States (Appendix III.1, Tables A III.1-5). Unless the present trends are reversed and the deficits are brought down, the debt-GDP ratio will keep growing undermining the solvency of the public sector. From the angle of sustainability, it is necessary not only to contain the deficits to levels permissible under the budget constraint rule but also to bring down the debt ratio from its present level which is rather high. The need to reduce the debt level also arises from difficulties in debt servicing associated with high levels of indebtedness. When debt-servicing liability is large – as it happens when the level of debt is high and a large chunk of the revenue receipts is used up in servicing the debt – the budgets should either cut down non-interest expenditure to the barest minimum or generate adequate revenue to finance the essential expenditure of the government after meeting the interest liabilities or do both.

3.15 Ultimately the right size of fiscal deficit relative to (full employment) GDP depends on how the borrowed resources are used. If borrowing is for consumption or current expenditure, borrowed resources will not create any assets that can yield a return to service the additional liability in the future. Hence, the dictum that there should be no deficit on the revenue account; rather the revenue budget should generate surpluses for government investment. An exception can be considered for revenue expenditure that fosters human capital formation. The sustainability of fiscal deficit would depend on the expected rate of return on government investment, including expenditure on human capital, and the efficacy of the revenue system to finance the resulting debt servicing needs. Other things remaining the same, if the rate of return on government investment financed by deficit is lower than the interest rate at which the incremental debt to finance the deficit is incurred, then debt and fiscal deficit will tend to spiral. In comparing the rate of return on government investments against the interest rates, it is necessary to look at not only the financial returns on government capital but the social returns as well. Fiscal deficit may be sustainable to the extent it helps to support government expenditure so that GDP growth warranted by full employment of available resources becomes possible, provided the revenue sources are also buoyant enough to take care of the requirements of debt servicing. However, there are clear limits to increasing full employment output growth rate by continuously running a high fiscal deficit because of the solvency question. Further, if the debt level is high, interest payments will pre-empt an unduly large share of current receipts leaving too little for expenditure on other essential heads of the budget. There are also limits to the extent to which the rise in the tax level that may be required to meet mounting expenditure commitments, would be acceptable to the community.

3.16 The immediate issue for us is (i) whether at the present juncture the fiscal deficits of governments at the Centre and in the States should increase or decrease and (ii) at what level relative to GDP should they settle down or stabilise. The answer to these questions cannot but be different for the Central and the State governments taken severally. Considering the State governments first, answers will be different for different States, depending on their existing debt to GSDP ratios, their growth rates, and the return on government capital that they may obtain, as also the rate of interest at which they can borrow. The constraints for the Centre are not the same as for the States. One important reason is that the rate of interest is more endogenous to the Central government because of its ability to influence the growth of money supply *via* the share of monetised deficit in total fiscal deficit, its capacity to administer the interest rates (despite deregulation of the financial market) and the lower risk premium on its borrowing. These need to be borne in mind while considering appropriate rules to set limits for borrowing and debt of the governments at the two levels.

### **Fiscal Rules for Maintaining Macroeconomic Stability**

3.17 The formulation of fiscal rules in the context of macroeconomic stability involves, basically, setting a rule regarding the size of the deficits that the government can incur in financing its expenditure. In setting this rule, account should also be taken of the existing level of the debt. According to available information, the ratio of government debt (including external debt) to GDP is currently about 65 per cent. This does not take into account the debt of the public sector as a whole inasmuch as the borrowings of public sector enterprises are not included in this computation<sup>5</sup>. At the current level of indebtedness, over 40 per cent of the gross revenues of the Centre goes into interest payments alone. In the case of the States, interest payments constitute on an average about 22 per cent of their revenue receipts (for some States, over 30 per cent). Growth of interest liabilities has been a major factor in driving up revenue deficits of both Centre and the States in the nineties. If the public finances are to be restructured, the level of government debt should be brought down to a level that would help to contain interest payments to a reasonable proportion of revenue receipts so that adequate revenues are available with the governments for providing essential public services. Simultaneously there should be a limit on the fiscal deficit in order that the debt-GDP ratio does not grow to undesirably high levels.

3.18 While benchmarks for sustainable debt and deficit would differ depending on the extant situation of a country, in the context of the European Monetary Union, the Maastricht Treaty has laid down certain norms for the member countries to follow. The rule regarding deficits is that the fiscal deficit should not be more than 3 per cent of the GDP and the debt-GDP ratio should not be more than 60 per cent. These levels of deficit and debt, however, have to be seen in the context of the rate of GDP growth in the countries of Europe averaging around 3 per cent per annum. For a developing country like ours, aiming at a higher growth rate (such as 7 to 8 per cent) for eradicating poverty and realising the full growth potential, a higher level of deficit may be permissible. However, from the angles of solvency and the likely impact of a high debt-GDP ratio on the economy, and the government budgets *via* interest burden, it is desirable to bring down the level of debt-GDP ratio and stabilise it at a level of no more than 55 per cent. A reduction in debt-GDP ratio is required particularly in view of the fact that our interest rates are much higher than in advanced countries. By this rule, if the economy grows at a nominal rate of 13 per cent, a fiscal deficit of 6.5 per cent may be sustainable.<sup>6</sup> This is the level which we have put forward as target for the combined fiscal deficits of the Centre and the States by the year 2004-05, given the relativities between interest rate and the GDP growth rates.

3.19 Another rule to guide the fiscal behaviour can be derived by relating interest liabilities to revenue receipts. As emphasised earlier, a major problem with large deficits and consequent growth of debt is the growth of interest liabilities. Unabated growth of deficits leading to continuous growth of interest payments pre-empts a large chunk of government receipts and the balance left may be inadequate for meeting the required expenditure liabilities of the government, necessitating borrowing and thus creating a vicious circle. To break this circle, a rule may be laid down whereby the interest payments as a proportion of revenue receipts is confined to a level which permits the available receipts to meet the requirements of expenditure<sup>7</sup>. This rule is particularly relevant for the States, as in their case, access to instruments that influence the interest rate is limited. In other words, a composite rule laying down the limit of the fiscal deficit for the economy as a whole and an operative rule restraining the growth of interest payments as a proportion of revenue receipts appears to us to be necessary to ensure that long run macro economic stability is not jeopardised by imbalances on the fiscal side.

3.20 For deriving the ratio of interest to revenue receipts at the optimal level consistent with the objective of maximising growth at full employment while maintaining macroeconomic stability, it is necessary to take account of the elasticity of government revenues and expenditure to GDP growth and of the interest rates to deficit, in a macro-model incorporating the relevant structural relations. Given our limitations of data and time, it was not possible for us to set up such a model. However, a study commissioned by us at the Institute of Economic Growth, New Delhi, shows that the interest rate does bear a significant and positive relationship with fiscal deficits. Keeping in view this situation and the past behaviour of the tax revenues, expenditure and interest rates, we feel that the following norms of debt and proportion of interest rates to revenue receipts may be followed to underpin the restructuring plan:

- i) For the system as a whole, i.e., the Centre and the States combined, the debt-GDP ratio currently stands at above 65 per cent (Annexure III.1). For reasons mentioned earlier, we feel that this needs to be brought down to around 55 per cent. For this level to be attained and sustained, the proportion of interest payment to revenue receipts should not go beyond 25 per cent as against the current level of about 35 per cent. This will further require raising the level of revenue receipts (tax and non-tax taken together) as a proportion of GDP to 20 per cent.
- ii) For the Centre, we propose to set a norm of 35 per cent as the desirable proportion of interest payments to revenue receipts (net to Centre) as against the existing proportion of 51 per cent. Given the target of 10.28 per cent as the ratio of Centre's net revenue receipt to GDP in the terminal year, it may not be possible to bring down the interest to revenue receipt ratio to 35 per cent in five years. However, this should serve to bring down the Centre's debt-GDP ratio from the present level of 53 per cent to 48 per cent within a five-year span.
- iii) For the States, the proportion of interest payments to revenue receipts including devolution and grants should be about 18 per cent as against the present average proportion of 22 per cent. However, some inter-State-variations may have to be allowed so as to avoid causing shocks. We strongly commend that the States endeavour to move towards this ratio keeping it as their medium term objective.

### The Macro Scenario and Restructuring Targets

3.21 The desirable levels of government debt and fiscal deficit and the associated fiscal restructuring would need to be anchored in a macroeconomic scenario of growth of output and prices over the period 2000-01 to 2004-05. Some of the key macro indicators that define the perspective for restructuring programme prepared by us are set out in Table 3.1. The growth rate of GDP during the mid-nineties (1994-95 to 1996-97) was in the range of 7.0 - 7.5 per cent, but declined towards the close of the nineties largely due to recession. In the mid-nineties, industrial growth rate had touched a peak of 12.8 per cent. It fell in 1998-99 to 3.7 per cent. Alongside there was a price stability not seen before. But the fiscal side already contained seeds of instability. The overall scenario (Annexure III.2) may be summarised as follows:

- (i) Growth rate of the economy had declined from a peak of 7.5 per cent in 1996-97 to 5.9 per cent in 1999-2000.
- (ii) The economy was in the grip of a recession during the last 3 years;
- (iii) Inflation rate was down to about 3.5 per cent in 1999-2000;
- (iv) Interest rates also came down by a margin ranging from 50 to 100 basis points since January 1, 1999.
- (v) The current account deficit was about 1.5 per cent of GDP;
- (vi) Revenue and fiscal deficits on the combined account are estimated to be 6.76 and 9.83 per cent of GDP in 1999-2000, respectively.

3.22 The underlying growth and inflation scenario that we have in mind for 2000-01 to 2004-05 is growth in the range of 7.0 to 7.5 per cent and inflation in the range of 5.5 to 5.0 per cent. A growth of 7 per cent or above was achieved for 3 years in the mid-nineties, but more recently we slipped from this trajectory in the wake of recession. Now that the recession is easing, we expect that a growth of 7 per cent plus can again be attained. With a noticeable decline in the rate of growth of money, (Annexure III.2) we have assumed an underlying rate of inflation in the range of 5.5 to 5 per cent per annum.

3.23 In order to sustain output growth at the targeted level, there has to be stability in the macro-economy and that calls for several supportive actions in the fiscal sector. In particular, tax and expenditure reforms need to be carried forward. Subsidy reforms must be completed so that prices of key inputs like those of power, irrigation, water and petroleum reflect their true opportunity costs. In any case, all subsidies should be explicit so that their justification, or otherwise, can be debated in the legislature. Further, government capital expenditure must increase to sustain the targeted growth rate by providing the necessary infrastructure.

3.24 When the structural reforms and other changes which we recommend are put into practice, the macroeconomic scenario in 2004-05 as compared to 1999-2000 would appear to be as in Table 3.1.

**Table 3.1: Macro Scenario Before and After Restructuring Over the period 2000-05**

1999-2000		2004-05
5.9	Growth Rate (% per annum)	7.0 – 7.5
3.5	Inflation Rate (% per annum)	5.5 – 5.0
-1.5	Current Account Balance (% of GDP)	-1.5
6.76	Revenue Deficit (% of GDP)	1.0
9.83	Fiscal deficit (% of GDP)	6.5
14.0	Tax Revenue (% of GDP)	16.7
2.48	Non-Tax Revenue(% of GDP)*	3.2
4.17	Capital Expenditure(% of GDP)	6.6

\* excludes interest payment from States to Centre.

Source (Basic Data): As in Annexure III.2.

### Contours of Fiscal Adjustment

3.25 Having considered the underlying macroeconomic scenario, we now proceed to spell out the broad contours of fiscal adjustment that we consider necessary and feasible. It is evident that revenue balance can be restored only if revenue receipts grow faster than revenue expenditure.

3.26 On the expenditure side, interest, pensions and salaries provide only limited scope for reduction in the short run. Some expenditure - like those on education, health and infrastructure need to be increased if growth in the economy is to be sustained at the desired level. The revenue side is also marked by rigidities. Non-tax revenues, for example, have stagnated at around 3.5 per cent of GDP for many years. Fiscal restructuring has to be undertaken to overcome these constraints and the cost of adjustment has to be borne by the Centre and the States in their respective fiscal domains. However, the consequences of what would happen if nothing was done and various components of revenues and expenditure were allowed to grow according to their historical drives, as per the estimated trend growth rates may be highlighted.

3.27 The fiscal scenarios that would emerge for the Centre and the States – if the current trends prevailed – called the 'base scenarios,' are depicted in Appendix III.1 (Tables AIII.1 and AIII.3). For the Centre, fiscal deficit rises from 5.64 per cent of GDP in 1999-2000 to above 6 per cent by 2004-05. Revenue deficit touches the level of 4.57 per cent of GDP and

capital expenditure to GDP ratio falls to 2.11 per cent. On the States' side also capital expenditure falls, and revenue and fiscal deficits increase as a proportion of GDP. These trends must be arrested. We need to look for a feasible adjustment path to bring about the required restructuring.

3.28 It hardly needs pointing out that if we set our sights too low, going in for soft options, it will take a longer time before revenue balance is restored, and fiscal deficit reined in. On the other hand, if we adopt a programme that is too ambitious, revenue balance may be achieved in shorter time but the cost of adjustment as well as chances of slippage will be high.

3.29 Given the constraints and compulsions, what is required is to select a path that strikes the right balance between desirability and practicability. For indicating the period that would be required under alternative options to achieve revenue balance, we have identified a feasible path and compared it with the consequences of the base scenario and the soft option. In the soft option, the tax-GDP ratio increases only by one percentage point in the five years up to 2004-05, the non-tax revenues continue to stagnate and only a mild expenditure compression takes place. As a result, a revenue budget balance appears in the distant future, almost beyond the foreseeable time horizon.

3.30 Dissatisfied with the results, sights are lifted and efforts are redoubled. A tougher degree of restructuring is attempted. Bolder expenditure controls, aggressive downsizing and further revenue enhancing measures are planned and imposed. Incentive systems are worked out. In consequence, it appears that a revenue budget balance would be well within sight and the economy is left only with a small and manageable revenue deficit in 2004-05. In the feasible option, we have proposed an increase of about 2.6 percentage points in the tax-GDP ratio, and compression of a little less than one percentage point in revenue expenditure. We have targeted a growth in capital expenditure to GDP ratio such that it comes to about 6.6 per cent of GDP by 2004-05. Unless this is done, the economy will continue to be lacking in the necessary infrastructure and a growth rate of 7.5 per cent may not be sustainable.

3.31 A more aggressive restructuring would call for an increase of 4 percentage points in the tax-GDP ratio within five years. It would require other more vehement fiscal and non-fiscal changes which will neither be economically nor politically acceptable under democratic system.

3.32. Chart 3.1 traces the path of revenue expenditure and revenue receipts with reference to the combined accounts of the Central and State governments. Charts 3.2 and 3.3 depict the corresponding paths of revenue and fiscal deficits, respectively, for the base scenario and the restructured scenario under the feasible and the soft options.



3.33 The adjustment path that we have selected, asks for an increase of 2.63 in the tax-GDP ratio, 1.48 coming from the Central taxes, and 1.15 coming from the State (Table 3.2). The increase envisaged in non-tax revenues will be more from States (0.50 percentage points) and a little less from the Centre (0.25 percentage points). This is because many public services which are not in the nature of pure public goods and the beneficiaries can be identified individually, are delivered more at the State-level. According to available estimates, subsidies embedded in the State budgets amount to nearly 10 per cent of GDP (as of 1994-95). Most of these are implicit in nature as few subsidies are given from the State budgets in an explicit and transparent manner. A tax-GDP ratio of 16.7 should be achievable as this level of taxation was realised in the eighties. Revenue expenditure falls by about 2.30 percentage points of GDP. In 2004-05 we would be still left with a revenue deficit of 1.00 per cent of GDP at the Centre but in the States it would be entirely eliminated. Fiscal deficit comes to 6.50 per cent of GDP as targeted and capital expenditure rises to about 6.6 per cent of GDP. The main features of the fiscal profile that emerges in 2004-05 under the restructuring programme envisaged by us are summarised below:

- i) The growth rate of the economy is restored to 7.5 per cent per annum as achieved in the mid-nineties.
- ii) Inflation rate is kept around 5 per cent.
- iii) The current account deficit is kept below 1.5 per cent of GDP.
- iv) Revenue account balance is restored in the case of the States.
- v) A revenue deficit of 1 per cent of GDP is left in the Central budget.
- vi) The combined fiscal deficit is brought down to 6.5 per cent of GDP.
- vii) Aggregate tax revenues of the Centre and the States measure 16.7 per cent of GDP.
- viii) Non-tax revenues reach a level of 3.2 per cent of GDP.
- ix) Capital expenditure of the Centre and the States taken together will rise to 6.6 per cent of GDP.

**Table 3.2: Fiscal Adjustment: Centre and States**

	1999-00 (% of GDP)	2004-05 (% of GDP)	2004-05 over 1999-00 (% points)	Annual Adjustment (% points)
<b>Combined Finances</b>				
Tax Revenues	14.09	16.73	2.64	0.53
Non-Tax Revenues*	2.48	3.23	0.75	0.15
Revenue Receipts	16.57	19.96	3.39	0.68
Revenue Expenditure	23.33	20.96	-2.37	-0.47
Capital Expenditure	4.17	6.61	2.44	0.49
Revenue Deficit	6.77	1.00	-5.77	-1.15
Fiscal Deficit	9.84	6.50	-3.34	-0.67
<b>Centre</b>				
Tax Revenues	8.80	10.28	1.48	0.30
Non-Tax Revenues	2.75	3.00	0.25	0.05
Revenue Receipts	11.54	13.28	1.74	0.35
Revenue Expenditure	13.10	11.47	-1.63	-0.33
Capital Expenditure	2.62	4.00	1.38	0.28
Revenue Deficit	3.81	1.00	-2.81	-0.56
Fiscal Deficit	5.64	4.50	-1.14	-0.23
<b>States</b>				
Tax Revenues (own)	5.29	6.44	1.15	0.23
Non-Tax Revenues (own)	1.03	1.53	0.50	0.10
Revenue Receipts	10.38	12.96	2.58	0.52
Revenue Expenditure	13.33	12.96	-0.38	-0.08
Capital Expenditure	2.06	2.85	0.80	0.16
Revenue Deficit	2.96	0.00	-2.96	-0.59
Fiscal Deficit	4.71	2.50	-2.21	-0.44

\* does not include interest payments from the States to the Centre.

**Note:** Ratios of receipts and expenditure of States are based on assessment after making adjustments for contra-entries, identified subsidies and net of lottery receipts.

**Source (basic data):** Budget documents.

3.34 Having selected a fiscal reform path couched in a macroeconomic scenario, we shall now spell out the content of restructuring and the ways and means to achieve it. Before spelling out our suggestions, we first go over the views of the Central and State governments on the subject.

### Restructuring of Public Finances: Views of the Central Government

- 3.35 In the context of restructuring, the Central government, in its Memorandum, made the following main suggestions:
- (i) Tax devolution and article 275 grants should be regulated by taking into account the overall resource transfers from the Centre to States. This is important for restructuring, as one of the main reasons for the high level of fiscal deficit of the Centre is the high level of resource transfers to the States.
  - (ii) In order to curtail the revenue deficit component of the Centre's fiscal deficit, devolution of taxes should be regulated by taking into consideration the combined revenue deficit of the Centre and the States. A reduction in revenue deficit is urgently needed for better use of borrowed resources and also to achieve intergenerational equity. Except for human resource development through current revenues, consumption expenditure should be financed from tax and non-tax revenue.
  - (iii) As global integration of trade and capital markets is taking place, an emerging economy like India's needs to maintain a sound fiscal environment for the inflow of foreign capital. An increase in the fiscal deficit of the Central government may affect the economy adversely more than that of State governments as the perceptions of foreign investors depend more on the Centre's fiscal situation.
  - (iv) A reduction in the fiscal deficit of the Centre is more important, as increase in the Centre's fiscal deficit means an increase in the rate of interest *via* market borrowing and thus an upward pressure on the overall interest rate structure, which, in turn, may crowd out interest sensitive components of private spending.
  - (v) The role of the State and the Central governments should be redefined and there should be a gradual reduction in the role of the Central government as a financial intermediary for the States and the Central Public Sector Enterprises (CPSEs); consideration should be given to rationalisation and better targeting of subsidies; and closure of unrevivable PSEs with government guaranteed market debt to fund the closure costs.
  - (vi) Year-wise fiscal deficit targets for both the Centre and the States may be recommended. The Commission has been urged to prescribe the type and limit of expenditure of the States that should be financed by their own tax revenues and through devolution and grants. Any additional expenditure should be financed by Central Plan assistance and by raising loans within the fiscal deficit target.
  - (vii) Any measure of debt relief to the States should be linked to quantifiable improvement in fiscal performance.

### Restructuring of Public Finances: Views of States

3.36 The views of State governments were focussed more on the concerns of their own finances. The salient points of their suggestions are summarised below:

- a. **Macro Aspects:** Some States (e.g., Karnataka and Manipur) suggested the need for taking an overall view of finances covering not only revenue but also capital accounts of the States. A few States (e.g., Bihar) called for a general lowering of interest rate in order to step up required capital expenditure and reduce debt-servicing burden. Bihar also wanted a reduction in the rate of interest specifically on Central loans. West Bengal emphasised that more resources could become available by bringing black money into the tax net.
- b. **Expenditure:** Many States emphasised the need for increasing developmental expenditure in social and infrastructure sectors. Andhra Pradesh expressed the need for a substantial stepping-up of expenditure in primary health care, primary education, and expenditure on operation and maintenance. Gujarat has emphasised the need for reducing the size of government and privatising State parastatals. Jammu and Kashmir highlighted the importance of avoiding wasteful and avoidable expenditure on items such as vehicles and telephones, and travelling by government officers. Punjab advocated reduction in non-merit subsidies, rationalisation of non-salary expenditure, and better management of public debt. Uttar Pradesh emphasised economy measures including non-filling of vacancies arising on retirement and an across-the-board cut of 10 per cent in non-salary non-plan expenditure. Several States stressed the need for increasing capital expenditure as a proportion of total expenditure. Assam suggested that this ratio be taken to 70 per cent.
- c. **Revenues:** Many States acknowledged that their sales tax structure needs to be rationalised so as to generate additional revenue as well as to provide a better tax environment for private sector growth.
- d. **State Level Public Enterprises:** Several States (e.g. Orissa, Punjab, Rajasthan, Uttar Pradesh) emphasised the need for restructuring public sector undertakings, favoured increases in user charges and disinvestment, voluntary retirement schemes and an appropriate exit policy. As a component of State level reforms, Haryana emphasised the need for restructuring the power sector. Haryana also wanted enhanced participation of the private sector and reduced capital expenditure by the Centre so that more funds may become available for the States. Jammu and Kashmir advocated reduction in the budgetary support to public sector enterprises.
- e. **The Role of the Centre:** The role of the Central government in providing congenial economic environment by maintaining monetary and fiscal discipline under restructuring was emphasised by Karnataka. Tamil Nadu was of the view that the Centre's fiscal restructuring might take precedence over that of the States.
- f. **Borrowing:** Maharashtra suggested that borrowing by the States should be assessed with reference to their ability to service debt, rather than consideration of economic backwardness alone.
- g. **Fiscal transfers:** Maharashtra wanted a mechanism for redistribution of resources favouring the States and a curtailment of Centrally Sponsored Schemes (CSS). Several States (e.g. Maharashtra, Karnataka,

Meghalaya and Punjab) recommended introduction of incentives for prudent fiscal management. Tamil Nadu wanted a normative basis of assessment. It also emphasised the need to assess the CPSEs with some objective criteria. It further said that the States should be consulted before the constitution of a Central Pay Commission. Rajasthan recommended rationalisation and greater use of taxes under article 269.

3.37 While the suggestions taken individually do not present a full programme of restructuring, the views of the States, and those of the Centre, provide valuable inputs for the restructuring programme contemplated by us. Most of our restructuring plan is consistent with their suggestions except that we do not agree with the contention that a reduction in the Centre's fiscal deficit is more important than that of the States. We are also encouraged by the fact that most State governments seem to recognise the need for fiscal restructuring. Their commitment to undertake the requisite steps towards fiscal reforms also came out quite clearly during our interaction with the States in the course of our visits, when we had detailed discussion with them on various aspects of restructuring and the issues involved.

### Contents of Restructuring

3.38 To attain the targets set for the various budget variables in our restructuring plan, reforms will be needed over a wide area, embracing the revenue sources, composition of expenditure, public enterprises and intergovernmental fiscal relations. We consider below the broad directions of reform that will be needed in the relevant areas.

### Restructuring of Revenue Sources

#### a. Tax Revenue

3.39 The extent of increase in tax-GDP ratio called for in the restructuring programme has already been indicated: 1.48 for Central taxes and 1.15 for State taxes. The content of adjustment by major taxes is indicated in Table 3.3. These targets cannot be regarded as over-ambitious in view of the fact that this was the level that prevailed in the latter half of the eighties, peaking at 17.1 per cent (old GDP series) in 1987-88. The ratio had dropped thereafter and the drop was particularly sharp – by as much as 2 percentage points – between 1993-94 and 1994-95. This was the time when the Central taxes underwent extensive reforms. It is relevant to note that during the eighties many countries succeeded in raising their tax ratio dramatically along with reform. The setback to revenue that occurred in the post-reform years in India, therefore, needs a thorough analysis and investigation. It was not possible for this Commission, nor was it within its purview, to undertake such an inquiry. Nevertheless, a few observations might be in order.

**Table 3.3: Restructuring of Tax Revenues**

Taxes	1999-00	2004-05	(per cent of GDP)
			2004-05 over 1999-00 (% points)
Income Tax	1.38	1.77	0.39
Corporation Tax	1.55	2.18	0.63
Union Excise Duties	3.26	3.69	0.42
Custom Duties	2.47	2.57	0.09
Central Taxes(Gross)	8.80	10.28	1.48
States' Own Tax Revenues	5.29	6.44	1.15

**Source:** Budget documents and estimates.

3.40 Major head-wise break up of the Union taxes shows that the main reason for the drop in the tax ratio in the nineties was the slump in the revenue from customs and Union excises that account for over two-thirds of the Central tax revenues. As noted in Chapter II, the buoyancies of these two taxes with respect to GDP declined to 0.74 and 0.71 in the nineties as against 1.45 and 1.04, respectively, during the eighties. Some decline in customs revenue was to be expected following the drastic downward revision of custom tariffs in the wake of liberalisation under the new economic policies. Reasons for the decline in the buoyancy of Union excises however are not very obvious and need to be identified. Introduction of Modified Value Added Tax (MODVAT) is sometimes cited as a possible cause. Here again, it is salutary to note that the Value Added Tax (VAT) has been the anchor of successful tax reforms in many countries across the world over the last two decades.

3.41 One possible reason for the sluggishness of excise revenues in the latter half of the nineties could be the recession that adversely affected the growth of industrial production. There could be more fundamental causes as well. Narrowness of the excise tax base with services excluded can also be a major cause. With services emerging as a fast growing sector of the economy and constituting over 50 per cent of the GDP, it is imperative to increasingly bring in services under the tax net for improving the buoyancy of indirect taxes.

3.42 Services are now being taxed by the Centre selectively in exercise of the residual powers given in the Constitution but the tax on services is being levied separately from the tax on goods. This can be a source of distortion which the tax reforms initiated during the 1990s sought to mitigate. Hence, ideally, services should be taxed like goods both when a service is integral to goods or independent of it. This will form a comprehensive base for the VAT, going down to the retail stage. However, if they are taxed outside the VAT umbrella, as far as possible, services which are, *prima facie*, meant for final consumption should be taxed and in case the net is sought to be cast wider, some way should be found to provide relief for the tax paid on services used in business as under MODVAT. Power to tax services which are delivered in retail and those which are incidental or appurtenant to the sale of goods (such as works contracts) should be given to the States who, in turn, may delegate the power to local bodies. Wherever feasible, this will open up a rich source of untapped revenue and augment the resources of both the Centre and the States substantially. Several initiatives have been taken by the present Union government to transform the excise system into a Central VAT designating it as "CENVAT" and by moving towards a single rate. However, the task will remain incomplete unless a way is found to bring in services under taxation along with goods under a comprehensive VAT.

3.43 The tax reforms undertaken by the Union government in tandem with economic reforms in the 1990s have helped to rationalise and simplify the direct tax system considerably. The rates have been moderated and many exemptions and concessions have been weeded out. In the interests of stability, the rate structure should not be disturbed especially since the revenues from the direct taxes have been quite buoyant. Care should be taken not to re-introduce the concessions and exemptions as they tend to erode the revenue productivity of the taxes and create inequities and inefficiencies which the reforms sought to alleviate.

3.44 On the States' side, buoyancy of sales tax, the principal tax source of the States, also suffered a decline in the 1990s as in the case of Union excise duties. This again, may be due partly to recession. But another factor that may have weakened the revenue productivity of sales taxes has been tax competition among the States. Low levels of sales taxes in the Union Territories adds to this unhealthy competition. With liberalisation of the economy, States have been vying with each other more vigorously than before to attract industry and trade to their respective trade regimes through offer of generous concessions in sales tax and rate cuts. It is encouraging to note that the States have now joined together to organise their tax system by introducing floor rates of taxes and easing out the existing concessions and tax holidays. If pursued earnestly, these measures should help to strengthen the buoyancy of sales tax appreciably in the coming years.

3.45 There are a few other taxes which the States can levy but remain unexploited or under exploited. Taxation of agricultural incomes is one of them and profession tax is another. The land revenue which has traditionally been the principal mode of taxing agriculture in the country has almost fallen into disuse. Taxes on land/farm incomes in some form may be levied to augment the resources of the Panchayats. The Panchayats may be given the powers to fix the rates, collect the tax and retain the proceeds. Stamp duty and registration fees and motor vehicle tax can also yield more revenue through better administration in which computerisation of information relating to taxable transactions can be of immense help. The local governments may be empowered to levy a surcharge on some of these taxes. Urban properties also constitute a potent source of tax revenue which also is not fully exploited. A major difficulty has been the entangling of municipal property tax laws with rent control legislation. This has been the most important single factor that has impoverished the municipal bodies. Laws governing the levy of property / house tax should be suitably modified to improve the productivity of these taxes.

3.46 The profession tax is presently imposed only in 13 States. The Constitution lays down a ceiling on the amount of the tax that can be levied by the States. The present ceiling of Rs.2500 was prescribed in 1988. Consideration may be given to an upward revision of the ceiling levied by the States, by amending the Constitution. It should be made possible to change this ceiling through a parliamentary legislation instead of a Constitutional amendment.

3.47 The existing potential for raising the tax-GDP ratio, at bearable tax rates, remains unrealised because of administrative weaknesses. In the administration of direct as well as commodity taxes, computerisation opens up new possibilities of checking evasion through exchange of information between the Central and the State governments and among the State governments.

3.48 Massive arrears of assessed but uncollected revenues remain on the account books of both Central and State governments. Effective steps for collecting these arrears in the next few years can help to ease the resource position of the governments at both levels.

#### **b. Non-Tax Revenues**

3.49 Non-tax revenue accrues to governments from (i) investments in the form of dividends on equity and interest on loans, (ii) user charges and fees for goods and services provided by the governments, (iii) royalty on minerals, (iv) forest revenue and (v) miscellaneous general receipts.

3.50 In the case of non-tax revenues not only structural change, but a paradigm shift is called for. Where governments consider it essential to publicly provide private goods, such provision should be at efficient costs, and the costs should be recovered from all users who can pay for them eliminating the subsidy implicit in under-pricing. Governments, at both the Central and the State levels, provide an array of social and economic services. In many cases, it can recover the costs from the users, because the services are individualised, and users can be identified and charged according to the extent of their consumption. However, while the costs of providing services have been increasing, the fees and user charges have remained virtually frozen in nominal terms for years. As a result, implicit subsidisation has increased, draining the governments' budgetary resources, and getting ultimately financed by borrowing. User charges should be index-linked (to input costs) and the process of periodic revision should become automatic. However, users can be persuaded to pay if the quality of services is commensurate with the price charged and the production of the services is cost-efficient so that the users are not made to pay for the inefficiency of the public sector. Autonomous tariff commissions should be appointed to advise on the revision of railway tariffs, bus fares and administered prices so that the link to costs is maintained while protecting the interests of the consumers.

3.51 The main reason for the declining trend in the receipts of the State governments from interest is the low rate of return on loans and advances. The rates of return have generally been hovering between 2.5 to 3.5 per cent in the last twelve years. In several States the average rate of interest realised on loans and advances is less than half per cent, while their cost of borrowing has been consistently more than ten per cent. This implies heavy subsidisation of borrowers. An increase in the recovery of interest by even one percentage point on the outstanding loans and advances will considerably strengthen the States' finances.

3.52 A major structural drag on the public finances in India has been the poor return on investments of the government in public sector enterprises and statutory corporations. Directions of reform of public sector enterprises are considered in a subsequent section. The other two major sources of the non-tax revenue of the States – royalty on minerals and revenue from forests – depend to a very great extent on the policy and approach of the Central Government. The royalty on minerals other than coal and lignite was last fixed in 1997. For 19 out of a total 54 minerals included in the relevant notification, the rates are *ad valorem*. In the case of coal, the last revision was done in October 1994 and specific rates were fixed for different grades of coal. The prices of coal have been revised several times since then and judging by inflation, the royalty rates fixed in 1994 have gone down in real terms. The irony is that the State Electricity Boards have to pay the continuously increasing price of coal for their power stations but State Governments have no share in the increased price because of the fixed rates of royalty. Periodic revision of the rates of royalty would improve the financial position of several States, and ease the burden on the Centre. However, the impact of such revision on the economy and the incidence of higher mineral prices on the non-mineral owning States needs to be kept in view.

3.53 We recommend that royalty rates on minerals be revised regularly and the decision about the revision of the rates of royalty be taken well before the date on which the revision falls due so that it can be notified immediately after the completion of every three-year period as provided under the law. In case the process of revision is not completed by the date the new revision is due, the States should be entitled to compensation.

3.54 Fixation of royalty rates is done by the concerned Ministry/ Department. For the sake of transparency and fairness, the task of making recommendations on royalty rates should be entrusted to an independent body.

3.55 Forests also constitute a significant source of revenue for States having large forest areas. However, forests should not be seen merely as a source of revenue especially since the forest cover of the country has come down below the desirable level. The forests need to be nurtured in the context of the national forest policy, in order that the rate of afforestation is greater than that of denudation. In recent years, the revenue from forest has declined markedly for many States. Revenue from forests can be augmented even while keeping in view the objectives of national forest policy, provided the States having forest potential prepare scientific work plans for management of forests. Such Plans should be drawn up expeditiously. The procedure for approval of plans may be simplified and streamlined in order to reduce delays.

### **Restructuring of Government Expenditure**

3.56 Alongside revenue augmentation, restructuring of public finances will require structural changes on the expenditure side as well. While the thrust should be on compression, the composition of expenditure would need to be restructured in favour of priority sectors like elementary education, primary healthcare, water supply, sanitation, roads and bridges and other infrastructure. Items that would require a tight rein are salary and pensions, interest payments and subsidies. There has to be a radical change in the method of financing the plan expenditure as well. The order of adjustments in our reform scenario for the major expenditure items is indicated in Table 3.4

Table 3.4: Restructuring of Expenditure

Centre	1999-00	2004-05	(per cent of GDP) 2004-05 over 1999-00 (% points)
<b>Revenue Expenditure</b>			
<b>Centre</b>			
Interest Payments	4.73	4.26	-0.47
Pensions	0.74	0.65	-0.09
Other General Services	2.50	2.14	-0.36
Social Services	0.36	0.29	-0.07
Economic Services	0.36	0.29	-0.07
<b>States</b>			
Interest Payment	2.30	2.55	0.25
Pension	1.15	1.00	-0.14
Other General Services	1.63	1.74	0.12
Social Services of which	5.13	5.81	0.69
Elementary Education	1.32	1.75	0.43
Primary Health	0.17	0.45	0.28
Water Supply and Sanitation	0.29	0.50	0.21
Economic Services of which	2.90	2.33	-0.57
Roads and Bridges	0.22	0.60	0.38
<b>Capital Expenditure</b>			
Centre	2.62	4.00	1.38
States	2.06	2.85	0.80

Source: Budget documents and estimates.

- 3.57 The lines on which action needs to be taken to bring about the desired expenditure pattern are indicated below:
- a) *Salaries:* Wages and salaries have been growing primarily because of periodic revisions carried out on the recommendations of the Pay Commissions of the Centre, and the States falling in line, without due regard to the capacity of individual States to pay. The burden of pay revision is compounded by releases of DA twice a year by the Centre which has an effect on the States too. While it is the prerogative of the States to decide the size of their government, the total wage bill cannot be allowed to rise beyond a certain proportion of revenue receipts which represent the capacity to pay. In this background, we recommend the following:
    - (i) As full neutralisation for the increase in the prices has been given to all categories of employees, there is no need to appoint any new Pay Commission as a matter of routine and at intervals of ten years. A new Pay Commission should be appointed only when warranted by special circumstances.
    - (ii) As the recommendation of the Central Pay Commission have an impact on the States, the terms of reference of the Pay Commission should be settled in consultation with the States. Similarly, the decisions on the recommendations of the Pay Commission should be taken in consultation with the States.
    - (iii) It is noticed that the size of establishment is disproportionately large in relation to the requirements of administration in several States. In implementing the Pay Commission recommendations the Central Government has been in some respects more generous than what the recommendations of the Pay Commission implied. Some States have gone even beyond those levels resulting in the rise of emoluments of the employees beyond what is warranted by their capacity to pay.
    - (iv) Salaries and other allowances should bear a relationship with the revenue expenditure of the Centre and the States and the ratio should be such so as to leave adequate funds for maintenance and development expenditure. It is suggested that an Expert Committee may be appointed to determine the present relationship between salaries and other allowances with the revenue expenditure of the Centre and the States and to suggest the relationship which should be attempted. States having high ratio should bring it down gradually. This will also include the salary component of grants given to local bodies and other aided institutions. This relationship between salary and allowances and the revenue expenditure should be periodically determined.
    - (v) The capacity of the Centre/States to pay salaries from their own resources should be one of the main criteria for determining the pay and allowances of the employees. This position obtained till mid-eighties, when the States determined their own pay scales. States cannot afford to offer pay scales unrelated to their revenue capacity and then expect the Central Government to extend support or resort to borrowing. The same criterion should apply to the revision of salary and allowances at the local level.

- (vi) In order to avoid the shocks to the Central and State budgets that emanate from periodic pay revisions, it is desirable to evolve a national policy for the salaries and emoluments of government employees across the country. Such a policy can be made acceptable and effective only if it is evolved through a consensus among the States and the Centre in the forum like the Inter-State Council. Only a forum like this can lay down the differentials in the pay scales of the Centre, States and local government employees keeping in view their capacity to pay from their own resources. The question of regulating DA releases may also be examined by the Council.
- a) *Pensions*: As noted in Chapter II, pensions have been the fastest growing item of the States' budgets in recent years. At the rate at which pensions are growing, liability for pension payments is going to cast a very heavy burden on the budgets in the coming years. Several factors have contributed to the growth of pensions. One has been the generous rise in the pensions recommended by the Fifth Pay Commission and, two, the recent judicial pronouncement directing that no distinction should be made between people retiring at different points of time and all pensioners should be treated alike in the matter of their pension rights. Another factor has been the addition of the liability on account of pensions payable to retired employees of aided institutions and local bodies to the government's pension bill. The increasing longevity of people, though welcome, has also meant growing pension liability of governments. What causes concern is the fact that pensions are paid by governments on *pay as you go* basis, i.e., there is no corpus or fund which could take care of the pension liabilities. Consideration needs to be given to evolving a system under which pensions do not become an unsustainable burden on the State exchequer. A large amount of pension burden is on account of retired defence employees. A suitable scheme to absorb the retirees from the armed forces in other government departments can help to contain the growth of defence pensions.
- b) *Interest Payments*: Interest as a proportion of the revenue receipts of the States has increased sharply over the years, particularly during the last 10 years. The scheme of deficit reduction outlined in our restructuring plan, should help to check the debt growth of the States and thereby the growth of interest payments. From the supplementary memorandum on small savings received from the Ministry of Finance, it appears that the Centre may offer the State governments an option of pre-payment or rescheduling of past loans attributable to small savings. The guiding principle would be incentive-based maturity reduction. Thus a loan of 25 years' duration could be rescheduled to 15 years' loan with lower interest rates. If such a scheme is introduced, the States will be paying less on account of interest, as the payments will be on reducing balances. We commend that this proposal be given consideration, as without some substantial reduction of the interest burden, it will be difficult for the States to come out of the woods.
- c) *Subsidies*: Subsidies are provided by governments implicitly as well as explicitly. While the Centre's budget provides estimates of explicit subsidies in the State budgets, the outgo on account of subsidies is scattered under several heads. Subsidies, no doubt, have their uses as these help to alleviate the poverty of the low income segments of the population by providing access to essential goods and services free or at affordable prices. However, subsidies are apt to be misused and often go to the benefit of the non-poor. All subsidies should be reviewed continuously to eliminate or reduce them, especially in the case of non-merit goods.

### 3.58 **Reform in the Method of Financing Plan Expenditure**

- a) *Central Assistance for State Plans*: Emergence of revenue deficits in the government's budgets has resulted, to a considerable extent, from the manner of plan budgeting and financing. At the time when planning was initiated, the expectation was that the finances for the plan would come out of surpluses to be generated by the public sector, although some draft on the private sector savings was not ruled out. This expectation did not materialise as the public sector savings turned out to be inadequate and the bulk of the requirements for the plans were made out of borrowings. On the other hand, contrary to the focus of planning geared to investment planning, revenue expenditure has emerged as the major component of the plan outlay. But the budget surpluses have been inadequate to meet the plan revenue expenditure and in most States now even non-plan revenue account is in deficit. In this situation, Plan revenue expenditure are financed to a large extent out of borrowings in all general category States. This has meant accumulation of debt to finance revenue expenditure in larger and larger proportions. A pre-requisite for restructuring of public finances is to bring some discipline in the financing of the plans whereby the plan revenue expenditure are financed mainly out of available balance of revenue receipts after meeting non-plan expenditure and borrowing is resorted to primarily for investments. Revenue deficits are inherent in the practice of giving Central assistance for States' plans in the form of grants and loans in the proportion of 30:70 as is the case with non-special category States, while their plan revenue expenditure constitute nearly 60 per cent of the plan outlay. To remedy this, we suggest the following structural change in the revenue budget:
- i) The requirements of the States for plan revenue expenditure should be assessed with reference to their deficiencies in basic minimum needs. A fresh look needs to be taken at the *Gadgil formula* with a view to evolving a suitable alternative. With the liberalisation of the economy and withdrawal of physical controls over location of industry through licensing, the States are now free to attract private investments from domestic as well as foreign sources. In fact, the States with good infrastructure are attracting private investments in much larger measure than those where the infrastructure is weak. The Central investments hereafter should be redirected taking this fact in view.

- ii) The requirements of the States to meet revenue expenditure as a whole including plan revenue expenditure should be looked after by the Finance Commission. Even if the Finance Commission is not in a position to assess the plan revenue expenditure of individual States, the grants to meet the revenue components of the plan can be dispensed by the Planning Commission within the overall ceiling indicated by the macro parameters for restoring budget balance.
- b. *Financing of the Centrally Sponsored Schemes:* During the course of the last three decades, the Central Sector Plan Schemes/CSS have become an important vehicle for transfer of resources to the States outside the State Plans, and over and above the transfers flowing through the mechanism of the Finance Commission. These were started primarily to provide funding for projects in areas/subjects considered to be of national importance and priority by the Central government. The details of the schemes are drawn up by the Centre and their implementation and funds for their implementation are allocated to the State governments or directly through District Rural Development Agencies or similarly created organisations. There is little freedom left to the State governments to modify the schemes to suit local requirements or to divert funds to areas which are considered of local priority. On the other hand, the State budgets are burdened with additional revenue expenditure when the schemes are completed and their maintenance expenditure is pushed under the “non-plan” category. During the course of our visit to the States, several State governments expressed the view that these schemes along with the funds be transferred to the States. Plans for transfer of CSS are drawn up from time to time. Recommendation for transfer of CSSs were made by earlier Finance Commissions also. But no decision has so far been taken in this regard.

In our view, CSSs need to be transferred to the States along with funds. All other schemes should be implemented by the panchayati raj institutions and urban local bodies on the basis of plans prepared by the District/Metropolitan Planning Committees. The transfer of these schemes would mean that the staff working in the related Ministries/Departments would become surplus and would need to be redeployed. This would lead to a reduction in the revenue expenditure of the Centre.

### **Rethinking the Role of Government**

3.59 Expenditure restructuring would call for a rethinking on the role of governments itself. In general, governments may have to withdraw from a number of areas and strengthen their role in selected sectors in the overall context of economic reforms. Goods and services may be defined over a wide range from pure public goods at one extreme to pure private goods at the other. In the intermediate space, there may be goods that are basically private in nature but with different degrees of externality. Whereas public goods have to be provided by governments, in the remaining sectors the government sector should have a limited role. Even in the context of public goods, a distinction may be made between private production of public goods financed by public authorities, as compared to public production of public goods. In other words, supply and production need to be distinguished. Where the public authority is responsible for supply, it need not necessarily get into the act of production. Government needs to enter only in those areas where due to large externalities, private sector participation, by itself, would lead to sub-optimal supply.

3.60 In a growing economy like ours, the capital stock as well as the volume of employment is bound to expand. However, this does not rule out the need to eliminate the waste and inefficiencies in government. There is obvious overstaffing in several governmental departments and public sector undertakings leading to low productivity barring very few exceptions. During our visits to the States, we found that several governments are now examining the scope for downsizing the government apparatus. We recommend that rationalisation and redeployment of government employees be taken up in right earnest. Downsizing should be viewed in the context that a developing economy with large gaps in vital social sectors may require public sector involvement in greater measure in some areas while government's presence in other areas may be unnecessary and wasteful. The focus of downsizing, therefore, should be on retraining and redeployment of staff, early retirement of persons in advanced pre-retirement age, supported with a large National Renewal Fund. Work contracts should be modified and fresh contracts should now be considered for all newly employed persons hereafter with suitable conditions of appointment and employment, with a view to evolving a new work discipline.

### **Enhancing the Efficiency of Government Expenditure**

3.61 The task of expenditure restructuring cannot be fully accomplished, until attention is paid to the efficiency of government expenditure. A pre-requisite to this is the reform of budgeting processes and improved management and control of government expenditure. Budgets in India, both at the Centre and in the States, are known for their poor quality forecasts. Frequent supplementary demands and appropriation bills bear evidence to this malady. Budget estimates often turn out to be far out of line with “actuals”. Budgets are also non-transparent and items where government is involved are sometimes kept “off budget”. Various “funds” have been created which add to opacity of the budgeting process. The phenomenon of “March spending” pushes a considerable amount of expenditure to the last few months of the financial year where the quality of decision making suffers. Excessive categorisation of expenditure into plan and non-plan, and developmental and non-developmental categories, also adds to non-transparency of government expenditure. Although provisions exist for examination of accounts in the Constitution (articles 149, 150 and 151), scant follow up of the observations made in the reports of the Comptroller and Auditor General (C&AG) is responsible for not providing the necessary feedback which could improve the quality of budgeting, and management and control of government expenditure.

3.62 It is now well recognised that if the budgets are to remain under control, there should be a multi-year perspective. In U.K., for instance, now the budgets lay down limits on expenditure which the departments can control, for a three-year period, allowing flexibility and incentives for managing the budgets. A comprehensive review on expenditure is undertaken involving a thorough examination of departmental accounts and objectives and a zero-based analysis for each programme to find the best way of delivering the government's objectives. The comprehensive spending review led to significant changes in the framework for planning and controlling public spending. In India too, a similar review of all government programmes and longer-term expenditure targets for government departments/agencies should be laid down and variation or departure should be allowed only very sparingly. In addition, it is necessary to pay attention to the weaknesses in the system of budget formulation and control.

3.63 A major weakness of the budgeting process of governments in the States and also at the Centre is the practice of spreading resources over too many projects. Often only a token amount is provided in the year in which the project is announced but this commits the future budgets also for which no detailed estimates are provided in the current year's budget and the projects remain incomplete for years for lack of adequate funds. For government expenditure to be brought under the discipline of resource availability and efficiency in resource use, proper budgeting and strict discipline in matters of launching new projects is required. Also there should be a commitment to completion of projects within the stipulated period and to provide necessary funds.

3.64 Another necessary reform in budgeting is to do away with the dichotomy between 'plan' and 'non-plan' in expenditure. With the introduction of planning, budget heads have come to be divided under 'plan' and 'non-plan' and the distinction runs through all items of expenditure on revenue as well as capital accounts. Apart from creating problems in keeping the revenue deficits and thereby fiscal deficits in control, as pointed out earlier, the distinction has had a deleterious effect on the quality of public services. Essential maintenance has been neglected as they do not come under the plan and existing assets including schools and hospitals are starved of much needed support for their running. In recognition of these ill-effects of the plan/non-plan distinction in budgeting, the Union Finance Minister had observed in the budget speech for 1998-99:

*The distinction between plan and non-plan expenditure in our budgetary system has created several problems. It has led to an excessive focus on so called plan expenditure with a corresponding neglect of items such as maintenance which is classified as non-plan. Various bodies, including the Finance Commission have advocated the elimination of the plan and non-plan distinction in the budget. I propose to constitute a Task Force, including representatives of Planning Commission, Finance Ministry, Comptroller and Auditor General of India and State Governments to examine these issues in a comprehensive manner and to make recommendations for a functionally viable and more focussed presentation of government expenditure in the budget.*

We fully endorse this suggestion and would like it to be followed up.

3.65 In this context, we would like to suggest that: (i) government may examine the feasibility of introducing a multi-year budgeting process, (ii) introduce objective methods of preparing budget estimates so as to improve the quality of budget estimation, (iii) stipulate a maximum time within which reports of C&AG are scrutinised by Public Accounts Committee and examined by Parliament or Legislature, as the case may be, (iv) review all expenditure classifications other than revenue and capital, and (v) fully computerise cash flow management at all levels of government.

3.66 In order to improve the efficiency of public expenditure we need to have better targeted, beneficiary oriented programmes and an effective monitoring mechanism. It may be mentioned that the evaluation of public programmes has so far been primarily expenditure oriented. However, expenditure is not an end by itself. Evaluation of performance in terms of achievements related to the objective is seldom done. This needs to be remedied.

### **Restructuring of Public Sector Enterprises**

3.67 Disinvestment has often been considered merely as a means of dealing with large budget deficits. However, it needs to be considered primarily in the context of restructuring of the public sector enterprises. Disinvestment is some times conceived in terms of selling of the worst and chronically loss-making enterprises, sometimes as disinvestment of the shares of the highly profit-making and surplus generating enterprises and, at other times, in terms of selling packages or bundles of shares of good, bad and indifferent enterprises together. Some of the best enterprises are being sought to be sold off primarily because their shares are eminently saleable while the shares of the loss making units do not sell.

3.68 Major structural reforms initiated in the nineties have nearly totally bypassed the public enterprises of this country. The structural reforms of the 1990s concentrated on giving greater role to the private sector leaving the public enterprises largely untouched and unreformed. In the second phase of structural reforms, restructuring should be undertaken extensively in the public enterprises, giving them the same benefits of autonomy and freedom as the private sector has lately witnessed. Public Sector Enterprises have to be freed from the shackles of the Ministries from which they originally emerged. The management of PSEs has to be autonomous, professional, accountable, transparent and durable for a good length of time. Such reforms, in terms of autonomy, deregulation, accountability and professionalism in public enterprises, should be immediately launched. After an era of, say, five years of structurally reformed existence, if a public enterprise fails to demonstrate its sustainability and cannot get out of the zone of chronic losses, such an enterprise should be sold off - at whatever price it can sell. When all such chronically loss making and inefficient public enterprises, which bring a bad name to the whole of the public sector, are actually closed down, it will be seen that the profitability of the sustainable

public enterprises will be quite high and much more than is the case today. These successful enterprises will then be a major source of resource generation and budgetary support and will play a substantial role in cutting down the overall deficits, in particular, the revenue deficits, of the Central and the State governments. Many PSEs, even though loss making often possess vast expanses of land and other real estates. Their sale value could be substantial and when realised could be ploughed back into the expansion of other units.

3.69 The main elements of Central government's policy on public enterprises announced in the Union Budget for 2000-01 consist of (a) restructuring and reviving the potentially viable PSEs; (b) closing down the PSEs which cannot be revived; (c) bringing down government equity in all non-strategic PSEs to 26 per cent or lower, if necessary; and (d) fully protecting the interest of the workers. To the extent these elements have been applied in the restructuring of some PSEs, the results have been found to be good. These applications, we believe, should continue. While protecting the interest of the workers, the rationalisation of the workforce in the PSEs has become a necessity and is an important condition for the very survival of these enterprises. Inadequately trained and excessive work force affects the performance of the enterprise adversely. As a means of sustainability and growth of the PSEs, measures to improve the efficiency and productivity of workers are important. Equally important is the need to reduce the surplus work force through such measures as early retirement with adequate compensation, golden handshakes, re-employment of young workers with training and retraining in jobs emerging in new and expanding enterprises and the provision of national renewal funds for the aforementioned purposes.

3.70 There are a large number of public sector enterprises in the defence sector. Their interface with the rest of the economy is lower than desired. If they have to improve their productivity and competitiveness, there should be effective performance audit and increase in interaction with the private sector for research and development. These undertakings should have access to wider markets.

3.71 Most State level public enterprises are running at a loss. Therefore, they are unable to pay any dividends. State Electricity Boards and State Road Transport Undertakings are chronic drain on State budgets. The performance of Electricity Boards is critically affected by the following factors:

- i. structure of tariffs involving rigidities and excessive cross-subsidisation;
- ii. high unit of cost of supply due to old plants and bottlenecks in availability of inputs like coal; and
- iii. technical inefficiencies resulting in high cost of generation, and sometimes camouflaged as theft.

The strategy of unbundling the SEBs into separate units looking after generation, transmission and distribution, is presently being tried out in some States. Such unbundling is possible with or without privatisation and States may select a suitable option depending on their circumstances. However, the determination of proper tariffs reflecting costs and keeping subsidisation and cross-subsidisation implicit in the tariff structure should be rationalised and kept at minimum levels. State level tariff commissions need to look at the issue of revision of electricity tariff structure keeping in perspective the interests of different categories of consumers, changes in cost structure, the functional implications for the SEBs, as also for the State governments.

3.72 State Transport Undertakings (STUs) are also running in losses in many States. Poor productivity combined with subsidised tariffs, concessions, and higher share of low profit routes keep the STUs in the red. Key elements of reforms in this sector are tariff revisions in line with input costs, elimination of concessions, suitable mix of profitable with non-profitable routes, and improvement in efficiency parameters, including lowering of the staff-bus ratio.

3.73 Most other SLPEs, subject to exceptions, are in the doldrums. They need to be sold off. Closure, disinvestment of equity, merger of SLPEs operating in the same products and services where horizontal/vertical integration may lead to economies and externalities, and voluntary retirement schemes may help reduce the fiscal burden.

## **Institutional Reform**

### **a. Federal Fiscal Relations**

3.74 Restoration of budgetary balance on an enduring basis would require institutional reform. A major source of fiscal instability is the vertical imbalance that necessitates transfer of revenues from the Centre to the States. The first step towards achieving fiscal stability and accountability is to reduce this vertical imbalance as much as possible so that the governments at all levels are able to raise the resources they require, keeping the need for transfers at a minimum. This in turn calls for a review of the scheme of assignment of tax powers and functions between the Centre and the States in our Constitution. A widened access to the tax bases would enable the States to generate larger revenue and reduce their dependence on the Centre. In some cases, it would lead to better exploitation and yield.

### **b. Management and Control of Debt**

3.75 It would be useful to introduce some methods for explicit control on growth of debt as also of contingent liabilities. Articles 292 and 293 of the Constitution provide for the fixation of limits by Parliament on borrowing and on guarantees by the Central government. Article 293 provides for fixation of limits by State Legislatures in the case of State borrowing as also guarantees of loans extended by the State governments. This article also provides for the consent of the Central

government if there are any outstanding Central loans with the States or if there are any loans in respect of which Central government has extended a guarantee. Clause 4 of article 293 provides for conditional consent. So far, these provisions in the Constitution have not been effectively used. However, considering that the debt problem has become serious, explicit controls need to be laid down, taking advantage of existing provisions in the Constitution. Some States (e.g. Karnataka and Gujarat) have taken the initiative and passed legislation for restricting growth of contingent liabilities, i.e., guarantees. We suggest that other States also consider determining tangible levels on the growth of debt and contingent liabilities. Annexure III.3 provides details on outstanding government guarantees for the period 1992 to 1998. The limits that may be set under articles 292 and 293 should also include the borrowings by the governments from Public account and other sources, which are not borne on the security of Consolidated Fund of the Central government and the State governments, respectively. Any statutory or constitutional amendment, if required in this regard, may also be considered.

### **c. Constitutional and Legal Changes**

3.76 We have said earlier that if other means do not suffice, we may have to also consider bringing about Constitutional amendments, wherever required, as also changes in other statutes. While the matter has been dealt with at some length later, here we mention a few areas where Constitutional amendment may help in bringing about the contemplated restructuring. These are:

- (i) bringing services under the Concurrent List (change in the Seventh Schedule);
- (ii) making Inter-State Council responsible for arriving at decisions on fiscal policies having inter-State or Centre - State ramifications (amendment in article 263);
- (iii) ensuring that the Inter-State Council meets regularly and a national consensus is arrived at all important issues; and
- (iv) taking nominal limits for profession tax out of the Constitution and making it subject to only statutory change (amendment in article 276). These and a few other suggestions are contained in the Chapter on concluding observations.

Shri N.C. Jain, Member, has given a separate note on the restructuring giving suggestions for some Constitutional and legal changes about Finance and Planning Commissions. The note is appended at the end of this report.

### **Restructuring of Finances of Special Category States**

3.77 Out of 25 States currently forming the Indian Union, 10 are grouped under a "special category" for various purposes, particularly plan financing. Unlike the general category States, States of the special category get Central plan assistance for their plans in the form of 90 per cent grants and only 10 per cent as loan. Such special consideration is given to this category of States presumably in view of their weak economic bases. Their own revenue sources meet on an average a small percentage of their revenue expenditure. The bulk of their revenues come from the Centre. Because of their weak revenue base, all the special category States have large deficits on their non-Plan revenue account before devolution. With 90 per cent of Central assistance for the State Plans in the form of grants, the revenue budgets of the States are left with sizeable surpluses. Even so, all the special category States have large fiscal deficits. Even with massive infusion of Central funds, the finances of these States remain under acute stress with fiscal deficits running at over 10 per cent of their GSDP in some cases. Evidently, the system of financing of the expenditure of these States needs a fundamental restructuring. In our view, such restructuring should proceed on the following lines:

- (i) The non-plan revenue gap of these States assessed on the basis of norms relevant in their case after taking into account their share in Central taxes should be met out of Finance Commission grants. There should be no need for any Plan grant to meet these gaps.
- (ii) Responsibility for development of infrastructure of vital importance to the region requiring large investment should be that of the Centre.
- (iii) The system of plan assistance for special category States may be reviewed. The review of Gadgil formula as suggested by us earlier should also cover the review of plan assistance to the special category States.

### **Summing up**

3.78 The plan of restructuring of the finances of the Government recommended by us is designed to move the public finances of the Indian economy away from chronic deficits and unsustainable debt and bring them on a course that will strengthen the foundations of growth consistent with stability. The restructuring plan recommended by us aims at bringing the combined revenue deficit of the Centre and the States to a level of not more than 1 per cent of GDP, containing the combined fiscal deficit to a level less than 6.5 per cent of GDP, restoring the tax-GDP ratio to around 17 per cent of GDP, enhancing non-tax revenues by 0.75 percentage points (of GDP) over 5 years, reprioritising expenditure towards basic needs like elementary education, primary healthcare, water supply, and sanitation and essential infrastructure, and increasing capital expenditure on the combined account to around 6.6 per cent of GDP. The strategy that we have suggested in order to bring about the contemplated restructuring is predicated on:

- (i) widening the tax base and, in particular, bringing services fully under the tax net in a properly designed scheme which requires, among other things, listing of services in the Concurrent List;
- (ii) using profession tax as also taxation of farm incomes to augment tax revenues in the States;
- (iii) gearing up administration for better exploitation of the tax bases, without unduly increasing the tax rates;
- (iv) relying on user charges for enhancing non-tax revenues by index linking them to changes in input costs;
- (v) reviewing the policy towards fixation of royalty rates of minerals by index linking them to inflation for augmenting the revenues of the States;

- (vi) salaries and other allowances should bear a relationship with the revenue expenditure of the Centre and the States. The ratio may be worked out by an Expert Committee constituted for this purpose;
- (vii) building up infrastructure in every State, particularly in the special category States, for the generation of economic activities on a substantial scale which alone can provide them with a strong revenue base;
- (viii) cutting subsidies and making them explicit and transparent;
- (ix) transferring Centrally sponsored schemes to the States along with funds;
- (x) revising the present system of determining and providing assistance for State plans;
- (xi) resizing the governments at all levels by redeployment and downsizing;
- (xii) improving budgetary procedures and procedures for evaluation and monitoring of public expenditure programmes;
- (xiii) introducing comprehensive structural reforms for public sector enterprises;
- (xiv) reviewing the assignment of tax powers between the Centre and the States for better exploitation and revenue yield;
- (xv) suggesting limits on borrowing that may be fixed by reference to norms regarding the ratio of interest payment to revenue receipts, as also the size of debt relative to output (GDP/GSDP), and suggesting that limits to borrowing and guarantees be fixed by relevant legislation for the Centre and for each State; and
- (xvi) restructuring finances of the special category States by changing the method of providing plan assistance and direct Central participation in building up infrastructure in these States.

3.79 While the required restructuring is to be carried out by the Central and State governments, our own approach to designing fiscal transfers is guided by the objectives of restructuring that we have outlined. In particular, our scheme of fiscal transfers is designed to provide incentives to induce prudent fiscal behaviour. We propose to build up effective incentive structures in our scheme of tax devolution as also in our assessment of revenue needs of the States, which is to be on a normative basis for determining grants-in-aid. Debt relief is also to be linked with improvement in fiscal performance. We also propose to further strengthen the incentive structures when we consider the additional term of reference mentioned in para 3.3 in a supplementary Chapter.