A Synoptic View of the
Twelfth Finance Commission's Recommendations

I am indeed very happy to be in the midst of familiar faces and familiar surroundings. This is perhaps the first public occasion on which I am commenting on the recommendations of the Twelfth Finance Commission. As such, this meeting has some special significance at least to me. I congratulate the Reserve Bank of India in organizing this meeting of Finance Secretaries so that the full implications of the various recommendations of the Twelfth Finance Commission can be understood. It will also pave the way for action by the States, the Centre and the RBI. Today's meeting is yet another example of the proactive role being played by the RBI in the field of economic policy.

In federal fiscal systems, on grounds both of equity and efficiency, resources are generally assigned more to the central government whereas states together with the local governments have the larger responsibilities. The resultant vertical imbalance requires transfer of resources from the Centre to the States. States also have different capacities and needs, and this lends a horizontal dimension to the issue of resource sharing. Neither vertical nor horizontal imbalance is expected to be static. Some of the core provisions regarding sharing of resources are built into our Constitution itself. But changes in the economic and fiscal situation warrant a review of the arrangements from time to time. The Indian constitution has provided for both continuity and change. The Finance Commission is entrusted with the task of periodically examining these issues according to the constitutional provisions and the terms of reference.

The Twelfth Finance Commission has recommended a scheme of fiscal transfers that can serve the objectives of equity and efficiency within a framework of fiscal consolidation. The effort needed to achieve fiscal consolidation must be seen as the joint responsibility of the central and state governments. For achieving vertical and horizontal balance, consistent with the responsibilities of the two levels of governments in respect of providing public and merit goods and services, both the centre and the states need to raise the levels of revenues relative to their respective revenue bases, exercise restraint in undertaking unwarranted expenditure commitments and prioritizing expenditures.

The finances of the central and state governments, individually and in the aggregate, have evinced large and persistent imbalances in the period preceding the Commission's award period. Not only have fiscal and revenue deficits increased, the proportion of revenue deficit to fiscal deficit has increased. Outstanding debt as a proportion of GDP touched 81 per cent in 2004-05. Four factors have accounted for the continuing deterioration: fall in centre's tax-GDP ratio compared to the peak levels achieved in the late eighties,

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substantial increase in the level of salary and pension payments, particularly for the states, in the wake of the recommendations of the Fifth Central Pay Commission, high levels of nominal interest rates in the late nineties combined with the subsequent fall in inflation rates, and the low growth rates in the first three years of the new decade. Besides, the tax devolution to states was less than projected because of the deterioration in the tax-GDP ratio of the centre. While these reasons account for the acuteness of the ailment, there are also underlying structural reasons for the persistence of fiscal deterioration because of the tax structure and expenditure pattern.

Vertical Transfers

In the scheme of fiscal transfers, the correction of vertical imbalance is, to some extent, based on judgment. An assessment has to be made of the gap between resources and responsibilities at the two levels of government. Sometimes it is not recognized that the share of states in the combined revenue receipts undergoes a radical change after tax devolution. For example, during the Tenth Finance Commission's period, the share of states which was 38.6 per cent before transfers became 63.0 per cent after transfers. Taking into account a variety of factors including the historical trends, the Commission had recommended an increase in the share of states in the divisible pool of taxes to 30.5 per cent from the previous level of 29.5 per cent. This increase was also necessary to provide some cushion to states whose share in the total tax devolution might go down as a result of any modifications in the formula of horizontal distribution. The Commission felt that this increase could be accommodated by the central government by pruning their activities that fall in the domain of the states. The Commission had raised the indicative limit of overall transfers out of the gross revenue receipts of the centre from 37.5 per cent to 38 per cent.

Horizontal Transfers

In the context of horizontal imbalance, the Twelfth Finance Commission felt that the equalization approach to transfers was appropriate as it was consistent with both equity and efficiency. It has not, however, been possible to implement this approach fully, as the extent of disparities in the per capita fiscal capacities of the states is too large and some of the better-off states are also in serious fiscal imbalance. In the devolution scheme recommended, the Commission has endeavored to strike a balance among different criteria reflecting deficiency in fiscal capacities, cost disabilities, and fiscal efficiency. While the Commission has retained, by and large, the indicators used by the Eleventh Finance Commission for determining the horizontal transfers, it has altered the weights to some extent. The distance criterion combined with the criterion of population, representing together the needs and deficiency in fiscal capacity have a combined weight of 75 per cent. The cost disabilities get a weight of 10 per cent through Area and fiscal performance 15 per cent.

Role of Grants

The Twelfth Finance Commission has increased the proportion of grants to tax devolution in the scheme of transfers. Grants constitute around 19 per cent of total transfers compared to around 13 per cent in the Eleventh Finance Commission. Grants achieve certain purposes which cannot be fulfilled by tax devolution. First, they provide greater stability to revenues of states which became an important issue in the recent period. Second, they enable the application of equalization principle. The Twelfth Finance Commission has made an effort in this direction by focusing on education and health which are two critical merit services. Third, special purpose and conditional grants can be given which promote specific objectives. It is therefore necessary that in judging the transfer to states, tax devolution and grants should be taken together into account. The coefficient of correlation between comparable GSDP per capita (average of 1999-00 to 2001-02) and the recommended per capita transfers, comprising tax devolution and all the grants, among the general category states excluding Goa, is estimated at -0.89, which emphasises the redistributive character of the transfers.

A word must also be said about the estimation of non-plan revenue deficit grants. Very often such an approach is called 'fiscal dentistry' or gap filling approach. This approach has been misunderstood. No Commission goes by just the gaps projected by the states. The Twelfth Finance Commission also examined each item of expenditure and adjusted it according to some common normative criteria. These are detailed in the Report. Similarly, adjustments were made for revenue projections as well. Even base year figures were adjusted. An important adjustment made by the Twelfth Finance Commission in the base year figures relates to fiscal capacity. In the final analysis, the pre-devolution non plan revenue deficit was 25 per cent of the states projections. It has also to be noted that nearly 85 per cent of the deficit grant goes to special category states.

The Commission has laid emphasis on strengthening the local bodies in keeping with the constitutional mandate for effective and autonomous local self-governance, recognizing that local bodies must be supported by a scheme of transfers that encourages decentralization and own effort for raising revenues. The recommended transfers for the local bodies constitute about 1.24 per cent of the shareable taxes and 0.9 per cent of centre's gross revenue receipts.

Debt Restructuring

The Commission has recognized that the debt burden of the states is currently heavy. It has, therefore, recommended a scheme of debt relief, which is in two parts. First, there is the relief that comes from consolidating the past debt and rescheduling it, along with interest rate reduction. The second part consists of a debt write-off, which is linked to the reduction in the absolute levels of revenue deficits. Both reliefs will be available, only if states enact appropriate legislations to bring down the revenue deficit to zero by 2008-09 and commit to reducing the fiscal deficit in a phased manner. With the relief that has been recommended, it should be possible for states to pursue their developmental goals with fiscal prudence. The condition imposed also mitigates the moral hazard problem.

Institutional Changes

The Commission has argued that important institutional changes are required to tackle some of the structural problems in managing government finances. One central change relates to the regime of government borrowing. It has recommended that states, like the centre, must decide their annual borrowing programme, within the framework of their respective fiscal responsibility legislations. In fact, as the background papers for this Conference indicate that if the state governments move on a path of fiscal correction, the market borrowing programme of the states will be sustainable and should not face difficulties in terms of eliciting the necessary subscription. There is also a need to let the states access the market directly for their borrowing requirements. Such a practice will bring in the needed fiscal discipline. The overall limit to their annual borrowing from all sources should be supervised by an independent body like a Loan Council with representatives from the Ministry of Finance, Planning Commission, Reserve Bank of India, and the state governments. This Council may, at the beginning of each year, announce borrowing limits for each state, taking into account the sustainability considerations into account. Our suggestion for de-linking grants and loans in plan assistance, as these need to be determined on different principles, is part of the reform of the borrowing regime. It is this part of the Finance Commission's recommendations dealing with the changes in the borrowing scheme that will receive detailed attention at this meeting.

Restructuring Public Finance

The scheme of restructuring envisages the fiscal deficit to be reduced to 6 per cent on the combined amount of the centre and states and revenue deficit to zero by 2008-09. This will result in an increase in the aggregate saving rate as well as an increase in government capital expenditure as a percentage of GDP. In consequence, as aggregate investment rate increases, growth is stabilized at above 7 per cent. The reduction in the revenue deficit by 4.5 percentage points is to be achieved by an increase in the total revenue receipts by 2.9 per cent and a reduction in total revenue expenditure by about 1.6 per cent.

In our plan for restructuring government finances, we expect a positive growth dividend, as revenue deficits relative to GDP progressively fall, implying a fall in government dis-savings, and an increase in the overall savings relative to GDP. A higher tax-GDP ratio combined with higher growth on a sustained basis, and fall in interest payments, create the necessary space for increasing government capital expenditure, and productivity enhancing non-interest, non-salary revenue expenditure. The virtuous cycle of reforms, robust government finances, and an equalizing system of fiscal transfers, should help establish a sound federal fiscal system in India.