

**THE MALADY OF CONTINUING FISCAL IMBALANCE:
THE IMPOSSIBLE QUADRANGLE**

Raja J. Chelliah

The Fourth Ambirajan Memorial Lecture

February 16, 2005

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PREAMBLE

I deem it a great privilege to be invited to deliver the Fourth Ambirajan Memorial Lecture. Giving such a lecture is an elegant way of paying tribute to an eminent economist, an excellent teacher and a great soul. I had known Dr. Ambirajan for many years and had read several of his books. In the latter part of the nineties, we worked closely together in building up the Madras School of Economics. Madras School of Economics is much indebted to him.

I have chosen a subject in the area of financial management very close to some of the areas in which Dr. Ambirajan was interested.

Government of India's avowed objective is to restore overall fiscal balance by reducing the fiscal deficit of the government sector to a reasonably low percentage of GDP and eliminating the revenue deficit by the year 2008-2009. Also, the state governments are being urged to radically improve their finances such that they would, collectively and severally, soon reach a sustainable fiscal situation in which their debt will be stabilized at reasonable levels with the fiscal deficit being brought down as percentage of their respective GSDPs.

These are laudable objectives and undoubtedly several steps have been taken in recent years to moderate the financial crisis, such as the debt swap scheme for the benefit of the states, attempts to raise the tax/GDP ratio of the central government and reducing the interest on small savings loans given to the states. However, there is no sign of visible improvement in the overall fiscal situation or in the fiscal situation of most states.

* Assistance by Dr. K.R. Shanmugam in choosing and interpreting data is gratefully acknowledged.

Since 1991, two Finance Commissions have reported and given their recommendations. Their recommendations have not led to much difference to the continuing fiscal stringency. In the case of not a few states, the fiscal situation has already become unsustainable; others are moving towards a crisis.

The contention of this paper is that the root causes of the endemic fiscal crisis, especially at the level of the states, (which then affects the central fisc) are to be found in the simultaneous pursuit of fiscal objectives and policies which are in themselves incompatible.

Macroeconomists speak of the “Impossible Trinity” in the area of monetary-external sector policy. They argue convincingly that the policy of fixed exchange rate, full capital account convertibility and freedom to follow monetary and fiscal policies required by domestic circumstances cannot all be pursued simultaneously. They are incompatible and one of them will have to give way. In India, under the auspices of the central government, four major policies affecting the government finances are being pursued which are incompatible. These are: a) adoption of the “gap-filling approach”¹ by the Finance Commissions, b) the policy of the Planning Commission of extending loan “assistance” to the states according to a set of entitlement formulae with no reference to borrowing or repayment capacity or the existing level of public debt – the same criteria are used for the distribution of loans as for the distribution of grants, c) the policy of pay revision of government servants through the appointment of pay commissions periodically and the adoption of the same recommended revisions by the central government and by all the state governments, regardless of the size of the government labour force in different states, the capacity to pay of the governments of the different states, their per capita incomes and the general level of salaries in those states, and d) the pursuit of the objective of achieving fiscal health *through getting* the governments to maintain reasonably low levels of fiscal deficit, through responsible fiscal policies, that is, each government assuming responsibility for balancing its budget.

¹ Even though it is claimed that only modified or moderated gaps are attempted to be filled.

The last-mentioned is a basic objective of the central government's macroeconomic policy. However, the other three policies generate trends that make it impossible to achieve, in the medium or long-term, a state of fiscal balance. This incompatibility may be christened "the Impossible Quadrangle". The incompatibility basically arises from the fact that the policies relating to central transfers and loans to the states generate wrong incentives and violate economic considerations while the policies relating to the recruitment of government servants and their pay revisions do not take into account incentives, economic considerations or capacity to bear higher tax burden. The planning mode applied to public financial activities proceeds on the basis that finances can be managed without reference to incentives, financial capacity of sub-national governments or fiscal discipline (essentially meaning that the governmental authority undertaking an increase in public expenditure on its own volition must pay for it). Fiscal responsibility cannot be planned from above; rather such conditions and rules must be created that fiscal responsibility will have to be practised by the sub-national governments / states which have a good deal of autonomy.

The revenue expenditures of the state governments have grown at a fairly fast pace, especially since 1979-80 (Table 1). The growth rate of central government revenue expenditure has also been fast. However, the faster rate of growth of the economy during the eighties and nineties has sustained this growth of government expenditures without creating a breakdown of the public financial system. But pressures have been building up on the system. The combined fiscal deficit of the centre and the states started rising in the early eighties (as per cent of GDP) and reached nearly 10 per cent by 1986-87. While the central government could bring down its fiscal deficit to around 5.8 per cent of GDP by 1997-98 (excluding the borrowing on behalf of the states it was 4.5 per cent), the combined fiscal deficit rose to nearly 10 percent in the late nineties because of the revenue and fiscal deficits of the states rising fast after 1998-99. As of 2000-01, the combined revenue deficit of the states was 2.55 per cent and the combined fiscal deficit was 4.25 per cent (Table 2). The position in a number of individual states is of course much worse than indicated by these figures.

Though the Eleventh Finance Commission was asked by the President, in its Terms of Reference (among other things), to “review the state of the 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”, they did not put forward any such restructuring plan. They seemed to clearly understand the root of the problem. They did point out that “the mandate to suggest measures for restructuring having regard to considerations of efficiency, economy and composition of expenditure implies that revenue sharing between the Centre and the States cannot be decided in isolation but must be anchored to a macro framework defined by parameters of fiscal adjustment in the desired directions along *with incentive to induce prudent and efficient fiscal management*” (italics added) (Twelfth Finance Commission, 2003, p.94). After mentioning that transfers from national to sub-national governments are common in all federations, they went on to point out, “However, it is well recognized that, unless carefully designed, intergovernmental transfers tend to undermine accountability by de-linking spending and taxing decisions and thereby weaken fiscal discipline and efficient use of national resources” (Twelfth Finance Commission, 2003, p.103). Having said this, they did not at all recognize that one of the major causes for lax fiscal discipline and continuing fiscal crisis is the de-linking of spending and taxing decisions at the margin which underlies the system of federal fiscal transfers in India and the continuing debt relief provided to the states. In the end, they adopted the time-honoured filling the gap approach, by giving grants on non-plan revenue account to ensure that no state was left with any revenue deficit after receiving these grants. They claim to have introduced some normative elements in assessing the growth of revenues and expenditures. At the same time, they recognized that, as I have pointed out in this paper, since the Finance Commission has to start with a base year every time, most of the increases in expenditures and slow growth of revenues in the past would have been already allowed for.

Thus it is that we find that the fiscal situation in the states has not improved after the submission of the report of the Eleventh Finance Commission.

A broad overview of the trends in the fiscal indicators shows that in the sixties and seventies the policies followed in respect of plan assistance, Finance Commission transfers and employee recruitment and compensation had not resulted in any perceptible deterioration in the fiscal situation. This may be partly because the taxes levied and collected by the centre had risen from about 4 per cent of GDP in 1950-51 to 7 per cent in 1970-71 and to nearly 10 per cent in 1979-80 (Table 3). The total taxes raised by the centre and the states rose from 6.31 per cent of GDP in 1950-51 to nearly 16 per cent in 1989-90. When the central tax ratio was rising fast, it was possible for the central government to raise the percentage of the devolution of taxes to the states: devolution as per cent of gross central tax revenues increased from about 12 per cent in 1950-51 to 28.8 per cent in 1980-81 (Table 4). The central tax ratio more or less stagnated around 10 per cent of GDP after that year and declined in the nineties. Increases in central transfers to the states (devolution plus grants) thereafter started causing strain in central finances.

Several commentators have expressed the opinion that the basic factor underlying the fiscal crisis of the 1990's is the significant decline in the tax ratio of the central government. But we find that the ratio fell only about 1.5 per cent of GDP, whereas the combined revenue deficit of the states increased from less than one per cent of GDP to 2.6 per cent during the same period (1988-89 – 2000-01) (Table 2). And, furthermore, *revenues accruing to the states fell by only one percentage point of GDP between 1992-93 and 2000-01* (Table 5).²

Principles of Federal Finance

In most federal countries, the Constitution provides for much greater degree of decentralization of expenditure responsibilities than the powers to raise resources. The reason for this asymmetry, as we know, is that while expenditure decentralization is both desired and feasible, efficiency considerations lead to a considerable degree of centralization of taxing powers. (The facts that the bases of important taxes are mobile and that the centre can more efficiently collect taxes with nation wide bases are the main

² But on the other hand, revenue expenditures of the states increased by nearly 1.5 percentage points of GDP during the same period (Table 6).

considerations.) The limited decentralization of taxing powers creates the familiar problem of vertical fiscal gap.

The makers of the Indian Constitution were well aware of this and they provided for the sharing of the central tax revenues between the Union government and the states. Since there were and would continue to be disparities and unequal capacities to provide public services among the states, the Constitution makers introduced enabling provisions for the central government to make grants-in-aid to states that are judged to be “in need of assistance”. The quantum of sharing of central taxes and the principles of grants-in-aid to the states in need of assistance were to be reviewed every five years by a Finance Commission whose recommendations were to be taken into account before the President takes decisions on these matters.

Unfortunately, the Finance Commissions did not develop an approach on the basis of a consistent theoretical framework. Designing a satisfactory system of federal fiscal transfers³ is a complicated and difficult matter because in matters relating to centre-state relations one needs to carefully balance the principles of autonomy, efficiency (fiscal discipline), equity and adequacy. And these principles have to be interpreted and defined. Also, since inter-dependency is a basic feature of fiscal federal relations, one has always to keep in mind that any one action proposed would produce reactions or effects in some other parts of the system.⁴

In distributing grants among the states, equity is an important criterion, particularly in the context of economic and other relevant disparities among the states. The Constitution mentions “the states in need of assistance”. How is this need to be assessed? It is “fiscal need” that is to be assessed. Obviously, the “needs” are to be assessed in such a way that particular states would not be able to increase their eligible “needs” through suitable action. On the other hand, “needs” should not be assessed

³ In this paper the term “transfers” is always used to mean current transfers.

⁴ For example, if the central government expenditure is reduced and transfers are increased, some states will gain and others will lose; again, if central transfers are increased through raising central taxes, the scope for state taxation may be reduced and so on.

largely on the basis of expenditure priorities and tax levels determined by the centre or the grant-determining authority, as such action would militate against the autonomy of the states. Autonomy, however, implies that a state that wishes to increase expenditure under some heads on its own volition should itself raise the resources needed for it. The system of transfers should not be such as to snap this link.

Article 280 of the Constitution, which specifies the functions of the Finance Commission, stipulates that the Commission should make recommendations to the President on a) the shares of the centre and the states of the taxes that are to be, or may be, shared between them and b) the principles of grants-in-aid to be given to the states in need of assistance. From this it appears that the Constitution makers had intended that sharing of taxes was to address (largely at any rate) the problem of vertical fiscal gap and the general grants-in-aid were to be used to mitigate horizontal inequalities. The Finance Commissions did not, generally speaking, keep these two types of gaps clearly separate although the Second Commission did observe that “the gap between the ordinary revenue of a State and its normal inescapable expenditure should, as far as possible, be met by sharing of taxes. Grants-in-aid should be largely a residuary form of assistance given in the form of general and unconditional grants” (para 66). But this idea was not followed up to suggest ways of determining a “normal budget” on the basis of norms to be developed.

The Finance Commissions did not grapple with the problem of rigorously defining “needs”, “capacity”, “tax effort” or with the problem of estimating the vertical gap. They were saved this trouble by the Planning Commission introducing a distinction between plan and non-plan expenditure and desiring that the non-plan revenue account of the governments should be in surplus or balance during the next plan period so that that plan can be launched on the basis of additional resource mobilization and plan assistance. Then, filling the non-plan revenue gap became the major criterion on which to base the recommendations of the Finance Commission. It was realized that the gaps to be filled should be normative and not actual. But only one Commission (the 9th) was to adopt the normative approach. Others have proceeded on the basis of “moderating” the actual

gaps. It has been pointed out (Chelliah, 2000) that while the moderated revenues and expenditures would determine the entitlements for the next five years, the basis of projections for the subsequent five years would be the actuals for the beginning year of that period. Hence the gap filling approach would promote expenditure increases and work against raising more of a state's own resources. In this connection, see also (Anand Mukesh, Amaresh Bagchi, and Tapas K. Sen, 2003, pp. 80-101).

The impact of "the gap filling approach" on a state government is graphically described by Dr. D.K. Srivastava in the following words: "Borrow to spend in the current period. Accumulate interest liabilities. Show a record of higher expenditure. Get transfers to cover this historically attained level of expenditure. Also get transfers to meet additional interest liabilities which become a committed liability. Now borrow again. Also ask for relief on past debt liability." (Srivastava, 2000, p.72). However, it is surprising that Dr. Srivastava, comparing Canadian and Indian practices, should merely state, "Even though the modalities of equalization may appear to be different in Canada and India, the use of the distance factor in the Finance Commission formula for distribution is not very different from the way cash transfers are determined under CHST in Canada" (Rangarajan and Srivastava, 2004, p.45). In saying this, Dr. Srivastava completely ignores the fact the block transfers in Canada are not related to actual expenditures or gaps whereas in India "the gap filling" is a central mechanism. That is the basic difference. This is not brought out in the NIPFP paper.

"The gap filling approach" certainly tends to generate the wrong incentives. There could be some damage control through moderating projected expenditures. But it is not easy for the Finance Commission or any central authority to allow or disallow particular items or levels of expenditure without seriously impinging on the autonomy of the states. The terms of reference given to the Eleventh Finance Commission bring this out:

"5. In making its recommendations, the Commission shall have regard, among other considerations, to:-

- (i) the resources of the Central Government and the demands thereon, in particular, on account of expenditure on civil administration, defence and border security, debt servicing and other committed expenditure or liability;
- (ii) revenue resources of the States for the five years commencing on 1st April, 2000, on the basis of levels of taxation possible to be reached in 1998-99, targets set for additional resources mobilisation for the Plan and the potential for raising additional taxes;
- (iii) the requirement of the States for meeting the Plan and non-Plan revenue expenditure, keeping in view the need for generating surplus for capital investment and reducing fiscal deficit;
- (iv) the maintenance and upkeep of capital assets and maintenance expenditure of plan schemes to be completed by 31st March, 2000 and the norms on the basis of which specified amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;
- (v) the requirements of States for upgradation of standards in non-developmental and social sectors and services particularly of States which are backward in general administration with a view to modernise and rationalise the administrative set up in the interest of speed, efficiency and sound fiscal management.
- (vi) the need for ensuring reasonable returns on investment by the States in irrigation projects, power projects, State Transport Undertaking, departmental commercial undertakings, public sector enterprises, etc;
- (vii) such provisions for emoluments and terminal benefits of Government employees including teachers and other employees of aided institutions as obtaining on a specified date as the Commission deems it proper and with reference to appropriate objective criteria rather than in terms of actual increases that may have been given effect to;

(viii) the scope for better fiscal management consistent with efficiency and economy in expenditure including the incentives that need to be provided for better realisations of tax and non tax revenue” (Twelfth Finance Commission, 2003, pp.38-39).

If the Commission had tried to comply with all of the suggestions made in the above quoted Terms of Reference, it would not only have interfered with the autonomy of the state but also would have found the task well-nigh impossible.

The Commission had to estimate the requirements of the state for meeting the plan and non-plan revenue expenditures “keeping in view the need for generating surplus for capital investment and reducing fiscal deficit”. How would the Commission estimate the magnitude of surplus to be generated in each state for capital investment? Again, is this not a matter to be left to the states? Secondly, how would a Finance Commission correctly arrive at the requirements of states for upgradation of standards in non-development and social sectors and services? And how would one identify states which are backward in general administration or decide on the amount of help to be given to rationalize the administrative set-up in the interest of “speed, efficiency and sound fiscal management”. Thirdly, the Commission was to keep in mind the scope for better fiscal management consistent with efficiency and economy in expenditure including the incentives that need to be provided for better realisation of tax and non-tax revenues. If the Commission were to evolve detailed instructions in this regard, the states would be reduced to mere administrative units implementing policies laid down by the central government. But, in any case, it is impossible to objectively design “better fiscal management consistent with efficiency and economy”.

It would be best to leave the states to manage their own finances and link the amounts of grants-in-aid to be given to such factors as taxable capacity, tax effort and cost disadvantages.

International experience indicates that the transfers should not be linked to or decided on the basis of actual expenditures or revenues (Ehtisham Ahmad (ed.),1997).

Certainly, the sharing formula could be reviewed once in ten or 15 years and may be changed if the responsibilities of the centre and the states have significantly changed. Each state should manage its finances largely on its own, given the devolution of taxes. However, the relative lack of fiscal capacity or the lower fiscal capacity of the weaker states should be compensated for. Hence the rule applied should be: every citizen should be entitled to receive some of the basic services (provided by the states) at the average or designated minimum standard at an average tax price.

It would help much to put the system of federal transfers on a rational basis and to move towards fiscal balance if the distinction between plan and non-plan is removed and the Planning Commission confines itself mainly to matters relating government investment as far as expenditures are concerned.

Central Assistance for Plan Expenditures

Until 1968, central assistance to the states for plan implementation was linked to schemes and projects. As the schemes multiplied and the pattern of assistance differed from scheme to scheme, the whole system of plan assistance became extremely complicated. Hence a switch was made in the sixties to aggregate, formula-based assistance. It was decided that for the larger states plan assistance would consist of 30 per cent grant and 70 per cent loans. The amount of assistance given to each state (out of the total negotiated between the Ministry of Finance and Planning Commission) was determined on the basis of some criteria which have been changed from time to time. Now, the principles applied are:

In proportion to 1971 population	60 per cent
Inversely proportional to per capita income (20 per cent is shared exclusively by States with below national average per capital income)	25 per cent
Performance (include tax effort, expenditure management, achievement of literacy, population control, land reforms and absorption of external aid)	7.5 per cent
Special problems	7.5 per cent

Total	100 per cent

An important point to be noted about the system is that the same principles or criteria were and are used to distribute or make available grants as well as loans. This means plan loans are given to the states on the basis of entitlements without regard to capacity to repay, the existing level of debt, the level of GSDP and the level of revenue. This is bad enough – no sound financier will have recommended that. But, additionally, each state was (and is being) allotted an amount of loan equal to a major part of the small saving raised/ collected within its jurisdiction! Most small saving schemes carry higher rates of interest than available in the market and enjoy tax concessions. And hence their collections have grown fast. The indebtedness of the states has also grown fast. The states (and of course the centre also) have been using a substantial part of their borrowing for meeting revenue expenditure. There has been no official frowning upon this, but the loan funds flow in increasing quantities under extant central rules. Most of the borrowing by the states is not market determined.

The expected then happened. The central government had then to ask the Finance Commissions to review the state of indebtedness of the states and suggest ways of reducing the burden and improving the finances including giving relief. All the Finance Commissions beginning with the Sixth were asked in their terms of reference to perform this task.

If the basic policies had been sound, such corrective measures and reliefs suggested by the Finance Commissions would have restored equilibrium on a longer term basis. Since the basic manner of extending loans to the states and allocating capital resources was not in consonance with the principles of capital finance, high indebtedness, with the attendant high interest liabilities, out of proportion to the basic capacity to service debt would result. And, as we know, they have become an endemic feature of state finances. The relief measures would give only temporary relief.

The debt to GSDP ratios of the 14 major states in selected years from 1980-81 to 2000-01 are shown in Table 7. We find how the debt/GSDP ratio has been rapidly built up. These ratios have become quite high in recent years in the poorer states, whose

capacity to service the debt and/or to repay except out of fresh borrowing is low (Punjab seems to have a high debt/GSDP ratio because of special reasons).

The figures in Table 7 show clearly that the policies relating to states' borrowing and the approach of the Finance Commissions are basically wrong. And the remedies suggested are quite inadequate to bring about a turnaround.

As (The World Bank, 2005) puts it: "In summary, the states are disciplined neither by the credit markets nor by the central government; consequently, neither the hierarchical nor the market based controls advocated by the literature on sub-national borrowing are well developed" (pp.63-64).

We need to note that just like the "gap filling approach" of the Finance Commissions, the periodic partial interest write-off, re-scheduling of repayments of loans and loan waivers serve to weaken fiscal discipline and induce sub-national governments to borrow beyond their capacity and use the proceeds with less caution about productivity than required by fiscal sustainability and optimum use of national resources. And of course, in both cases, the tax payers in states that are more stringent in observing financial rules stand to lose by paying taxes in order to bail out the states that have been less financially prudent.

(The World Bank, 2005) has pointed out that the total bail out via the Finance Commissions over the last 30 years has not been much (just 7 per cent of GDP) (p.62). However, it is not just the size of the bail out that is important but also the wrong incentives it gives. Moreover, "the gap filling approach" ensures that most of the actual interest payments are included in the revenue expenditures used to calculate the gap.

Government Employment Policy and Pay Commissions

The adoption of a federal structure of government implies that, basically, each sub-national government would build and maintain a governmental structure, and adopt levels of remuneration, in line with *its* general economic conditions and its willingness to tax.

Since there will be inter-state economic disparities, the federal government, as noted earlier, would/should extend grants-in-aid to states with less than average taxable capacity to compensate for the shortfall. Even though such a grants-in-aid may be received, a state government will have to formulate its policies on government employment, levels of employee remuneration, the relative size of government expenditure, etc., keeping its own economic conditions in view, such as per capita incomes, per capita tax revenues and the general level of wages in the private sector in the state. Since the numbers to be employed are decided by the individual states, the federal government cannot underwrite equal salary levels in the government sector across the country.

The real level of wages of government servants in a state must bear close relationship to the general level of wages there and its relative level of per capita income. The equalisation grant given to a state (as discussed earlier) would strengthen its capacity to pay wages. With that help, the state should decide on the level of wages and the numbers to be employed.⁵

The central government in India has no systematic policy of controlling or regulating the size of its work force. But it follows the policy of raising upward, periodically, the real wages of its employees. This is done on the basis of the recommendations of a Pay Commission appointed at intervals of 10 to 15 years. It is of course necessary that the real wages of government employees have to be increased with the growth of the economy and the rise in per capita income. Also the level of remuneration has to be fixed for new skills to be hired. But it is a moot question if this important matter is to be left to be decided independently by a group of civil servants and experts in a rather “ad hoc” fashion at intervals of some years, so that lumpy increases are called for. Besides, the general level of wages in the government sector is an important price in the economy and several agencies such as the Planning Commission, the

⁵ There are of course other considerations, such as the need to pay higher emoluments to highly skilled labour.

Ministry of Finance, the Ministry of Labour and some state level organisations would also have to be involved in determining that, if a *de novo* revision is to be undertaken.

May be the revision of wages in the government sector and changes in the structure of employment could be divided into two segments. The first will be concerned only with the general revision in real wages in keeping with the rise in per capita income; the second will relate to changes in structure and new types of staff. The later may be considered at intervals of 10 years or so. The general revision can be linked to a proportion (say, 1/4th) of rise in real per capita income and be effected every three or four years. Thus lumpy increases at intervals will be avoided and wage revision will be aligned with growth in national income. In each state, this wage revision will be linked to the rise in state per capita GSDP.

This is only a broad suggestion. I have not worked out the details or all the considerations to be taken into account. The major point I wish to make in this connection is that in a federation there cannot be one uniform or even near-uniform pay scale for all government servants and that each sub-national government will have to fix the level and structure of its government servants' wages keeping in line with the per capita income of the state, the level of wages in the private sector in the state (organised and unorganised) and its fiscal capacity and willingness to tax. Imposition of the relatively high scale of wages adopted by the central government on all states is to force them to bear burdens beyond their capacity. And if the "excess" burden is to be a part of the "gap" to be filled by the Finance Commission, then a dichotomy arises between the authority who decides on the number of employees and the one who is to pay for it or at least a part of the cost. This in turn leads to inter-state inequity. (I, resident of state A, will be paying tax to the central government to enable it to pay (through gap filling) part of the salary of government servants in state B, C, ... whose numbers will be decided by those states.)

The people of all the states that have lower than average income will suffer because the wages of PSU's in those states also will go up to the central level and the

prices charged by those PSU's will have to be raised. Then there is a rise in the burden on the people. If the PSU prices are not raised and they start making losses, then the people of the state will pay for that in some other way.

Thus one finds that the application of central pay scales across the country to government servants in all the states will not only tend to perpetuate fiscal imbalance but will also entail imposing unjustified burdens on the population of the poorer states. Additionally, so long as the "gap filling" approach is followed by the Finance Commissions, there will be an additional violation of rule that at least at the margin the authority which spends must be the one that pays for the expenditure.

I hope that I have shown that, taken together, "the gap filling approach", extending loans to the states without out any reference to capacity, but as a matter of entitlement, bringing about lumpy wages and salary increases in government servants' emoluments on the basis of the recommendations of Pay Commissions and favouring the adoption of more or less the same revisions at the centre and all the states – all of these will perpetuate the fiscal imbalances.

Much of the blame for it must be laid at the door of the central government. Even the "gap filling approach" is implicit in the Terms of Reference given to the Finance Commissions.

A New Approach

It will not be easy to bring about changes in the existing policies. Short-term compulsions will encourage adoption of remedies (like the debt swap scheme and debt relief) that will give only short-term relief.

Certain basic policy decisions will have to be taken. First, the states should be treated as autonomous units and they should be allowed to determine for themselves levels of revenues and expenditure. They will have the primary responsibility to maintain fiscal balance in their respective jurisdictions. Second, the percentage share of central

taxes going to the states must remain constant for at least 15 years. Third, block grants should be aimed at making up deficiency in fiscal capacity. “Need” must be defined as deficiency in fiscal capacity. Cost disadvantages could also be compensated. The proportion of block grants to devolution should rise. Fourth, the distinction between plan and non-plan expenditure should be done away with, at least as far as revenue expenditure is concerned. The Planning Commission should deal with only capital expenditure. Fifth, while loans could be extended to states by the centre to a limited extent, states should be required to borrow from the market within the limits set by the centre⁶. The centre could subsidise a small part of the interest (to differing extent) in respect of states that have less than average taxable capacity. Concurrently, in the place of plan loans, some capital grant assistance should be given with higher per capita amounts for the states with lower capacity. Collections of small savings should go into a fund as of now, and the states should negotiate loans (within the cap) with the fund, the lending rate of interest being determined by the borrowing rate and the credit worthiness of the states concerned.

When this new approach is adopted, it may be necessary to write-off 50 per cent of the debt which the states are now holding in order to enable the states to cope with the new situation (only that part of the debt which consists of central loans and market borrowing). But this will be on the understanding that there will be no more debt relief.⁷ With this new approach, our federal fiscal policy would become more rational, equitable and efficient and fiscal balance will be gradually restored.

I commend this new approach for discussion and consideration by academics and policy makers.

⁶ The cap for each state can be decided on the basis of its GSDP.

⁷ The short-term implication for the central finances would be that 50 per cent of the interest payments on the written-off debt would have to be borne by the central exchequer. In course of time, of course, the debt has to be paid off. Central Bank credit could be availed of to some extent for this purpose.

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Table 1
Annual Growth Rates of Major Variables of the Budgets
of the Centre and the States (%)

Variables	1960-61 to 1970-71	1970-71 to 1980-81	1979-80 to 1984-85	1985-86 to 1990-91	1991-92 to 2001-02
<i>Current Prices</i>					
Revenue Raised by the Centre	11.55	15.96	14.88	14.55	12.24
Revenue Raised by the States	13.16	15.01	15.86	14.68	12.87
Revenue Accruing to the Centre	11.13	14.53	15.80	15.63	13.31
Revenue Accruing to the States	13.43	15.89	15.00	14.33	12.09
Revenue Accrual (Combined)	12.38	15.32	15.30	14.85	12.51
Revenue Expenditure of the Centre	12.15	15.51	18.63	17.87	15.28
Revenue Expenditure of the States	13.71	14.32	18.22	16.58	14.43
Revenue Expenditure (Combined)	13.04	14.82	18.38	17.16	14.80
<i>Constant Prices</i>					
Revenue Raised by the Centre	4.22	6.96	5.33	5.45	4.76
Revenue Raised by the States	5.72	7.00	6.24	5.59	5.36
Revenue Accruing to the Centre	3.82	5.65	6.18	6.45	5.76
Revenue Accruing to the States	5.97	6.90	5.45	5.26	4.61
Revenue Accrual (Combined)	4.99	6.41	5.73	5.75	5.01
Gross Taxes of the Centre	5.43	6.22	5.27	6.24	4.49
Own Taxes of the States	5.82	7.27	7.13	6.55	6.26
Total Taxes (Combined)	5.55	6.55	5.89	6.34	5.13
Taxes Accruing to the Centre	4.74	5.90	6.52	6.50	4.34
Taxes Accruing to the States	6.53	7.19	5.30	6.18	5.78
Revenue Expenditure of the Centre	4.78	6.56	8.76	8.51	7.61
Revenue Expenditure of the States	6.25	5.54	8.40	7.34	6.80
Revenue Expenditure (Combined)	5.61	5.91	8.55	7.87	7.14
Shared Taxes	8.30	6.89	1.91	5.47	4.76
Central Grants to the States	4.70	7.19	7.19	2.05	2.03
Transfers From the Centre	6.42	7.14	4.21	3.94	3.53
GDP (Real)	3.74	3.32	5.55	6.48	6.13

Computed using GDP data from the CSO (website) and budgetary data from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

Table 2
Fiscal Deficit (FD) and Revenue Deficit (RD) of the Centre and States
(Rs. Crore)

Years	Centre		States		Combined	
	FD	RD	FD	RD	FD	RD
1980-81	8299 (5.77)	2037 (1.42)	3713 (2.58)	-1486 (-1.03)	10780 (7.50)	551 (0.38)
1981-82	8666 (5.14)	392 (0.23)	4063 (2.41)	-1379 (-0.82)	10608 (6.29)	-987 (-0.59)
1982-83	10627 (5.64)	1308 (0.69)	4986 (2.65)	-888 (-0.47)	11116 (5.90)	420 (0.22)
1983-84	13030 (5.94)	2540 (1.16)	6359 (2.90)	-210 (-0.10)	15971 (7.28)	2330 (1.06)
1984-85	17416 (7.09)	4225 (1.72)	8199 (3.34)	923 (0.38)	22013 (8.97)	5148 (2.10)
1985-86	21858 (7.86)	5889 (2.12)	7521 (2.71)	-654 (-0.24)	22174 (7.98)	5235 (1.88)
1986-87	26342 (8.47)	7777 (2.50)	9269 (2.98)	-170 (-0.05)	30789 (9.89)	7607 (2.44)
1987-88	27044 (7.63)	9137 (2.58)	11219 (3.17)	1088 (0.31)	32432 (9.15)	10225 (2.89)
1988-89	30923 (7.34)	10515 (2.49)	11672 (2.77)	1807 (0.43)	35887 (8.51)	12322 (2.92)
1989-90	35632 (7.33)	11914 (2.45)	15433 (3.17)	3682 (0.76)	43135 (8.87)	15596 (3.21)
1990-91	44632 (7.85)	18562 (3.26)	18787 (3.30)	5309 (0.93)	53580 (9.42)	23871 (4.20)
1991-92	36325 (5.56)	16261 (2.49)	18900 (2.89)	5651 (0.87)	45850 (7.02)	21912 (3.35)
1992-93	40173 (5.37)	18574 (2.48)	20891 (2.79)	5114 (0.68)	52404 (7.00)	23688 (3.17)
1993-94	60257 (7.01)	32716 (3.81)	20596 (2.40)	3813 (0.44)	70952 (8.26)	36529 (4.25)
1994-95	57703 (5.70)	31029 (3.06)	27697 (2.73)	6156 (0.61)	71639 (7.07)	37185 (3.67)
1995-96	60243 (5.07)	29731 (2.50)	31426 (2.65)	8201 (0.69)	77671 (6.54)	37932 (3.19)
1996-97	66733 (4.88)	32654 (2.39)	37251 (2.72)	16114 (1.18)	87244 (6.38)	48768 (3.56)
1997-98	88937 (5.84)	46449 (3.05)	44200 (2.90)	16333 (1.07)	110743 (7.27)	62782 (4.12)
1998-99	113349 (6.51)	66976 (3.85)	74254 (4.27)	43642 (2.51)	157053 (9.02)	110618 (6.35)
1999-00	104717 (5.41)	67596 (3.49)	91480 (4.72)	53797 (2.78)	184826 (9.54)	121393 (6.27)
2000-01	118816 (5.65)	85234 (4.05)	89532 (4.25)	53569 (2.55)	199852 (9.50)	138803 (6.60)
2001-02*	140955 (6.14)	100162 (4.36)	95994 (4.21)	59188 (2.59)	226425 (9.92)	159350 (6.98)

(Figures in parentheses are percentages of GDP)

Source: CSO (website) for the GDP data and *Handbook of Statistics on the Indian Economy* (RBI), 2003-04 for the deficit figures.

*GDP provisional figure is used

Table 3
Tax Revenues of the Centre and the States: Raised and Accruals
(Percentages)

Year	Gross Tax Revenue of the Centre		Own Tax Revenue of the States		Taxes Accruing to the Centre		Taxes Accruing to the States		Total Taxes as % of GDP
	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	
1950-51	4.08	64.59	2.23	35.41	3.59	56.94	2.72	43.06	6.31
1955-56	4.46	63.15	2.60	36.85	3.78	53.52	3.28	46.48	7.06
1960-61	5.21	66.30	2.65	33.70	4.25	54.07	3.61	45.93	7.86
1965-66	7.45	70.53	3.11	29.47	6.45	61.09	4.11	38.91	10.56
1970-71	7.02	67.47	3.38	32.53	5.37	51.58	5.04	48.42	10.40
1975-76	9.14	68.05	4.29	31.95	7.22	53.75	6.21	46.25	13.43
1979-80	9.91	67.71	4.72	32.29	7.09	48.45	7.54	51.55	14.63
1980-81	9.17	66.41	4.64	33.59	6.53	47.31	7.27	52.69	13.80
1981-82	9.40	65.64	4.92	34.36	6.86	47.94	7.45	52.06	14.32
1982-83	9.40	64.96	5.07	35.04	6.94	47.93	7.54	52.07	14.47
1983-84	9.44	65.73	4.92	34.27	7.05	49.09	7.31	50.91	14.36
1984-85	9.56	65.54	5.03	34.46	7.21	49.41	7.38	50.59	14.59
1985-86	10.31	66.26	5.25	33.74	7.62	48.95	7.95	51.05	15.56
1986-87	10.55	66.29	5.37	33.71	7.83	49.18	8.09	50.82	15.92
1987-88	10.63	66.11	5.45	33.89	7.92	49.26	8.16	50.74	16.08
1988-89	10.55	66.45	5.33	33.55	8.02	50.51	7.86	49.49	15.88
1989-90	10.62	66.46	5.36	33.54	7.90	49.43	8.08	50.57	15.98
1990-91	10.12	65.64	5.30	34.36	7.57	49.07	7.86	50.93	15.43
1991-92	10.31	65.27	5.49	34.73	7.68	48.61	8.12	51.39	15.80
1992-93	9.97	65.37	5.28	34.63	7.23	47.40	8.02	52.60	15.26
1993-94	8.82	62.10	5.38	37.90	6.23	43.87	7.97	56.13	14.19
1994-95	9.11	62.43	5.49	37.57	6.66	45.62	7.94	54.38	14.60
1995-96	9.36	63.46	5.39	36.54	6.90	46.75	7.86	53.25	14.75
1996-97	9.48	64.54	5.21	35.46	6.92	47.10	7.77	52.90	14.69
1997-98	9.14	63.09	5.35	36.91	6.28	43.36	8.21	56.64	14.49
1998-99	8.26	61.71	5.12	38.29	6.01	44.91	7.37	55.09	13.38
1999-00	8.87	62.55	5.31	37.45	6.62	46.71	7.55	53.29	14.18
2000-01	9.03	61.77	5.59	38.23	6.54	44.76	8.07	55.24	14.61
2001-02*	8.20	59.47	5.59	40.53	5.86	42.50	7.93	57.50	13.78

Computed using GDP figures from the CSO (website) and data on Tax Revenues from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

* GDP provisional figure is used.

Table 4
Proportion of Tax Devolution in Gross Taxes of the Centre and Total Transfers in the Gross Revenues of the Centre

Year	Tax Devolution as % of Gross Taxes of the Centre	Central Transfers as % of Revenue Raised by the Centre
1950-51	11.85	13.59
1960-61	18.44	37.42
1970-71	23.55	38.52
1980-81	28.77	42.82
1990-91	25.24	43.24
2000-01	27.54	41.15

Source: Computed using the data on GDP from CSO (website) and data on revenue and transfers from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

Table 5
Revenues of the Centre and the States: Raised and Accruals

(Percentages)

Year	Revenue Raised by the Centre		Revenue Raised by the States		Revenue Accruals of the Centre		Revenue Accruals of the States		Total Revenue (Centre & States) as % of GDP
	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	
1950-51	4.74	60.15	3.14	39.85	4.13	52.16	3.78	47.84	7.91
1955-56	5.67	61.27	3.59	38.73	4.21	44.60	5.23	55.40	9.45
1960-61	6.27	62.80	3.72	37.20	4.26	41.29	6.06	58.71	10.33
1965-66	8.35	65.01	4.49	34.99	6.64	49.60	6.75	50.40	13.39
1970-71	7.77	63.33	4.50	36.67	5.34	41.63	7.49	58.37	12.84
1975-76	10.38	65.33	5.51	34.67	7.46	45.39	8.98	54.61	16.44
1979-80	11.56	64.85	6.27	35.15	6.75	38.43	10.81	61.57	17.55
1980-81	10.70	64.09	6.00	35.91	6.12	36.92	10.46	63.08	16.58
1981-82	10.98	63.79	6.23	36.21	6.75	39.39	10.38	60.61	17.13
1982-83	11.22	63.34	6.49	36.66	6.82	38.82	10.75	61.18	17.57
1983-84	10.80	63.59	6.18	36.41	6.40	38.02	10.44	61.98	16.84
1984-85	11.29	63.86	6.39	36.14	6.83	39.01	10.68	60.99	17.51
1985-86	12.11	65.04	6.51	34.96	6.87	37.45	11.48	62.55	18.35
1986-87	12.43	65.33	6.59	34.67	7.22	38.42	11.56	61.58	18.78
1987-88	12.27	64.15	6.86	35.85	6.96	36.91	11.90	63.09	18.86
1988-89	11.98	64.79	6.51	35.21	7.06	38.37	11.33	61.63	18.39
1989-90	12.53	65.85	6.50	34.15	8.01	42.22	10.97	57.78	18.98
1990-91	11.32	64.40	6.26	35.60	6.42	36.79	11.04	63.21	17.46
1991-92	11.75	62.76	6.97	37.24	6.68	35.90	11.94	64.10	18.62
1992-93	11.60	64.01	6.52	35.99	6.46	35.69	11.64	64.31	18.10
1993-94	10.30	60.17	6.81	39.83	5.27	30.75	11.87	69.25	17.14
1994-95	10.37	58.88	7.24	41.12	5.91	33.61	11.67	66.39	17.58
1995-96	10.63	60.78	6.86	39.22	6.35	36.40	11.09	63.60	17.44
1996-97	10.75	62.46	6.46	37.54	6.39	37.36	10.72	62.64	17.11
1997-98	10.48	62.20	6.37	37.80	6.12	36.13	10.82	63.87	16.94
1998-99	9.61	60.47	6.28	39.53	5.88	37.25	9.90	62.75	15.78
1999-00	10.29	61.08	6.56	38.92	6.50	38.52	10.38	61.48	16.89
2000-01	10.42	62.25	6.32	37.75	6.13	36.63	10.61	63.37	16.75
2001-02*	9.94	59.77	6.69	40.23	5.73	34.50	10.89	65.50	16.62

Computed using GDP data from the CSO (website) and data on revenues and taxes are from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

* GDP provisional figure is used.

Table 6
Revenue Expenditures of the Central and the State Governments (at current prices)

Year	Revenue Expenditure of the Centre			Revenue Expenditure of the States			Combined Revenue Expenditure	
	Rs. Crore	As % of GDP	% of Combined Revenue Expenditure	Rs. Crore	As % of GDP	% of Combined Revenue Expenditure	Rs. Crore	As % of GDP
1950-51	357	3.59	48.84	374	3.76	51.16	731	7.36
1955-56	416	3.83	40.39	614	5.65	59.61	1030	9.47
1960-61	682	3.97	40.16	1016	5.92	59.84	1698	9.89
1965-66	1517	5.48	44.38	1901	6.87	55.62	3418	12.35
1970-71	2277	4.99	39.83	3440	7.53	60.17	5717	12.52
1975-76	5325	6.39	44.95	6522	7.83	55.05	11847	14.23
1979-80	8844	7.32	43.45	11512	9.53	56.55	20356	16.85
1980-81	9474	6.59	39.96	14237	9.90	60.04	23711	16.49
1981-82	11671	6.92	41.89	16193	9.60	58.11	27864	16.53
1982-83	14097	7.49	42.14	19354	10.28	57.86	33451	17.77
1983-84	16448	7.49	42.02	22691	10.34	57.98	39139	17.83
1984-85	20211	8.23	42.70	27118	11.05	57.30	47329	19.28
1985-86	24669	8.87	44.03	31362	11.28	55.97	56031	20.16
1986-87	30229	9.71	45.67	35960	11.56	54.33	66189	21.27
1987-88	33809	9.54	43.90	43205	12.19	56.10	77014	21.73
1988-89	40259	9.55	44.81	49592	11.76	55.19	89851	21.31
1989-90	50873	10.46	47.23	56831	11.69	52.77	107704	22.15
1990-91	55090	9.69	44.81	67860	11.93	55.19	122950	21.62
1991-92	59924	9.18	41.75	83611	12.80	58.25	143535	21.98
1992-93	66906	8.94	42.06	92150	12.31	57.94	159056	21.25
1993-94	77986	9.08	42.52	105440	12.27	57.48	183426	21.35
1994-95	90866	8.97	42.34	123749	12.22	57.66	214615	21.19
1995-96	105136	8.85	42.80	140499	11.83	57.20	245635	20.68
1996-97	119802	8.76	42.37	162977	11.91	57.63	282779	20.67
1997-98	139665	9.17	43.49	181479	11.92	56.51	321144	21.09
1998-99	169331	9.73	43.94	215994	12.41	56.06	385325	22.13
1999-00	193587	10.00	43.17	254858	13.16	56.83	448445	23.15
2000-01	213422	10.21	43.97	271966	13.02	56.03	485388	23.23
2001-02*	231033	10.12	43.06	305443	13.38	56.94	536476	23.51

Source: CSO (website) for the GDP data and *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues) for the Revenue - Expenditure figures.

* GDP provisional figure is used.

Table 7
Public Debt of Major States as Percentage of GSDP

States	1980-81	1985-86	1990-91	1995-96	2000-01*
Andhra Pradesh	20.47	21.70	19.05	18.99	25.44
Bihar	25.71	30.50	33.06	37.45	44.19
Gujarat	14.55	18.04	20.41	15.48	26.69
Haryana	17.50	20.48	19.18	19.40	23.94
Karnataka	17.82	20.12	18.51	17.60	21.21
Kerela	20.12	25.44	26.95	26.09	34.28
Madhya Pradesh	17.51	20.42	18.33	18.95	26.70
Maharastra	12.72	16.48	14.81	11.58	18.73
Orissa	30.35	32.38	39.76	34.61	56.85
Punjab	17.85	26.81	37.28	35.30	42.01
Rajasthan	29.53	30.68	23.97	25.77	38.64
Tamil Nadu	15.80	14.64	15.84	16.05	20.33
Uttar Pradesh	20.29	23.84	24.86	26.36	35.74
West Bengal	18.92	21.27	20.97	20.85	33.78

Source: Data on GSDP for the years 1995-96 and 2000-01 from the CSO Website, and for 1980-81, 1985-85 and 1990-91 from EPW Research Foundation; Data on Public Debt from "*Handbook of Statistics on State Government Finances*" (RBI Website).

* In 2000 - 01, data for Bihar, Madhya Pradesh and Uttar Pradesh include the data for Jharkhand, Chattisgarh and Uttaranchal.

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