

FIRST REPORT
OF
THE NINTH FINANCE COMMISSION



JULY, 1988

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CHAPTER I

INTRODUCTION

1.1 This Finance Commission, the ninth to be set up under Article 280 of the Constitution, was constituted by an Order of the President [SO No.581(E) dated 17th June,1987], which is reproduced below:-

"In pursuance of the provisions of Article 280 of the Constitution of India, and of the Finance Commission (Miscellaneous Provisions) Act, 1951 (33 of 1951), the President is pleased to constitute a Finance Commission consisting of Shri N.K.P. Salve, Member of Parliament, as the Chairman and the following four other Members, namely:-

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| 1. Shri Justice Abdus Sattar Qureshi Judge, Gujarat High Court. | <i>Member</i> |
| 2. Dr. Raja J. Chelliah Member, Planning Commission. | <i>Member</i> |
| 3. Shri Lal Thanhawla Former Chief Minister of Mizoram. | <i>Member</i> |
| 4. Shri Mahesh Prasad | <i>Member Secretary</i> |

2. The Chairman and the other Members of the Commission shall hold office from the date on which they respectively assume office upto the 30th day of June,1989.

3. The Commission shall make recommendations as to the following matters:-

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article.

4. In making its recommendations, the Commission shall-

- (i) adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre and, in doing so, keep in view the special problems of each State, if any, and the special requirements of the Centre such as defence, security, debt servicing and other committed expenditure or liabilities;
- (ii) have due regard to the need for providing adequate incentives for better resource mobilisation and financial discipline as well as closer linking of expenditure and revenue-raising decisions;

(iii) take into account the need for speed, efficiency and effectiveness of Government functioning and of delivery systems for Government programmes; and

(iv) keep in view the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment.

5. The Commission may suggest changes, if any, to be made in the principles governing the distribution among the States of -

(a) the net proceeds in any financial year of the additional duties of excise leviable under the Additional Duties of Excise (Goods of Special Importance) Act, 1957 (58 of 1957), and

(b) the grants to be made available to the States in lieu of the tax under the repealed Railway Passenger Fares Tax Act, 1957 (25 of 1957).

6. In making its recommendations on the various matters aforesaid, the Commission shall adopt the population figures of 1971 in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid.

7. The Commission may examine the feasibility of the merger of additional duties of excise in lieu of sales tax with basic duties of excise and evolve a suitable formula for allocating a part of the duties of excise in respect of the goods described in column (3) of the First Schedule to the Additional Duties of Excise (Goods of Special Importance) Act, 1957 (58 of 1957) for distribution among the States, in lieu of sales tax.

8. The Commission may make an assessment of the debt position of the States as on the 31st day of March, 1989 and suggest such corrective measures as deemed necessary keeping in view the financial requirements of the Centre. The corrective measures will be with particular reference to investments made in infrastructure projects and shall have linkage with improvements in financial and managerial efficiency.

9. The Commission may review the policy and arrangements in regard to the financing of relief expenditure by the States affected by natural calamities and suggest such modifications as it considers appropriate, in the existing arrangements, having regard, among other considerations, to the need for avoidance of wasteful expenditure. The Commission may examine, *inter alia*, the feasibility of establishing a national insurance fund to which the State Governments may contribute a percentage of their revenue receipts.

10. On the matters aforesaid, the Commission shall

make two reports, the first report covering a period of one year commencing on the 1st day of April, 1989, by the 30th June, 1988, and the second report covering a period of five years commencing on the 1st day of April, 1990, by the 30th June, 1989.

11. The Commission shall indicate the basis on which it has arrived at the findings and make available the State-wise estimates of receipts and expenditures."

1.2 Shri N.K.P. Salve, Chairman, Shri Justice A.S. Qureshi, Member, Dr. Raja J. Chelliah, Member, and Shri Lal Thanhawla, Member, are rendering part-time service. Shri Mahesh Prasad is the full time Member Secretary of the Commission.

1.3 There are certain distinctive features in the Presidential Order. Paragraph 10 of the Order requires the Commission to submit two reports, the first covering the year 1989-90 and the second, the subsequent five years. Moreover, the Presidential Order, unlike in the case of previous Commissions, does not limit the scope of the Commission to the assessment of the non-Plan side of the budget, but requires the scrutiny of the receipts and expenditures on the entire revenue account of the States and the Centre. Further, for making the assessment, the Commission has been asked to adopt a normative approach in order to provide adequate incentives for better resource mobilisation and financial discipline as well as to effect a closer linking of expenditure and revenue raising decisions. Another important feature of the Presidential Order is the emphasis placed on not merely balancing the receipts and expenditures on the revenue account but also on generating surpluses for capital investments. Other important features of the Order include examining the feasibility of the merger of additional excise duties in lieu of sales tax with basic duties of excise and exploring the feasibility of establishing a national insurance fund to meet relief expenditure on natural calamities.

1.4 The Presidential Order requires the Commission to submit the first report covering the period of one year commencing from the first day of April, 1989, by 30th June, 1988. Due to initial delays caused by circumstances beyond its control, it was not possible for the Commission to make its report within the stipulated date. The Commission, therefore, had to request the President for an extension of time upto 31st July, 1988. This request was accepted by the President in his Order dated 30th June, 1988. The Order is reproduced in Annexure I.1.

1.5 The Commission had its first meeting on 22nd June, 1987 after the Chairman and the Members had assumed charge. As many as 26 meetings were held before this report was finalised. In view of the marked departure in the terms of reference contained in the Presidential Order to the Commission and their far-reaching scope and implications, it was decided to invite views and suggestions of the cognoscenti and public at large. Accordingly, a press note was issued in all leading newspapers. The Commission also addressed individual letters to Members of Parliament, Members of State

Legislatures, Vice-Chancellors of Universities, Heads of important research institutions, Heads of Departments of Economics in various Universities, eminent economists, administrators, academicians, Chairmen and Members of the previous Commissions, former Finance Ministers and other prominent individuals. The Member Secretary of the Commission also held a press conference on 6th August, 1987. In response to this, as many as 158 memoranda were received by the Commission from various individuals and organisations. Besides, a number of associations, federations and individuals sought personal interviews with the Commission. A list of those who submitted memoranda is given in Annexure I.2 and a list of individuals and organisations which met the Commission is given in Annexure I.3.

1.6 Before the formal constitution of the Commission, the Government of India had appointed an Officer on Special Duty in the Ministry of Finance. The preparatory work done by the officer in setting up the secretariat of the Commission and requesting information and data from the States was of considerable help. In spite of this, the Commission had to overcome a number of initial handicaps before the work could be taken up in right earnest. Organising the infrastructural facilities for the Commission's secretariat and posting the necessary staff took considerable time. The States were required to submit memoranda and forecasts of receipts and expenditures by 31st October, 1987; but none were received within the prescribed time frame. The date for submission had to be extended several times and in fact, the forecasts and memoranda continued to be received right upto the end of June, 1988. Even the Central Government submitted its revised forecast for 1989-90 only on 31st May, 1988. We must mention here that due to these reasons we were severely handicapped in our task, particularly in the initial stages.

1.7 It would not be out of place to refer here to the apprehensions entertained initially in certain quarters on the form and content of the terms of reference given to the Commission. A serious view was taken of the use of the word "shall" in paragraph 4 of the Presidential Order, which was considered mandatory, almost amounting to a directive. Doubts were also expressed about the reference to a 'normative' approach. Although there was nothing objectionable about the normative approach per se, the suggestion to take account of all the requirements including committed liabilities in the case of the Centre and the absence of such a suggestion in the case of the States gave rise to misgivings that the 'guidelines' were loaded in favour of the Centre. Also, the mandate given to the Commission to examine the feasibility of the merger of additional duties of excise in lieu of sales tax with basic duties of excise and the establishment of a national insurance fund was construed as measures adverse to the financial interests of the States. The Chief Minister of Kerala wrote to the Chairman articulating these misgivings and apprehensions. To dispel these, the Chairman replied to him on 18th November, 1987 and subsequently wrote to

all the Chief Ministers on 10th December, 1987 setting out the Commission's perception of its role and obligations. He mentioned that it was the Commission's prerogative to adopt such approach and method as it considered fit and appropriate on subjects covered by (a) and (b) of article 280(3) of the Constitution. In view of the Presidential Notification, however, he clarified that the Commission would consider, *inter alia*, adopting a 'normative approach' wherever appropriate in the interest of sound finance. But in doing so, the Commission would apply a uniform, just and equitable yardstick both to the Centre and the States. With regard to the merger of additional duties of excise in lieu of sales tax with basic duties of excise, he mentioned that the Commission shall bear in mind the tax rental nature of existing arrangements and accord full weight to the views of the States. Regarding the feasibility of establishing the proposed national insurance fund, he explained that in the Commission's view, the terms of reference do not contemplate nor imply the exclusion of the Centre from participation in the fund. There was better appreciation of the situation by the States following these clarifications by the Commission and they extended full cooperation to the Commission in its work.

1.8 We have noted with interest the widespread debate on the terms of reference and the issues before the Finance Commission amongst leading economists and administrators. The Commission has welcomed the public discussions that have taken place through newspaper articles, memoranda and seminars. It has always been our endeavour to give due regard to various views and suggestions made by experts. The Commission also co-sponsored with the Planning Commission a seminar in the National Institute of Public Finance and Policy on 5th and 6th February, 1988, which was attended by a number of leading economists, administrators and constitutional experts. Maharashtra Economic Development Council, Bombay, had also organised a seminar covering the terms of reference given to the Commission. The Commission is also aware of the seminars held in the Centre for Economic and Social Studies, Hyderabad, and by Kerala State Planning Board in Trivandrum. We also received material on inter-Governmental fiscal relations and federal transfers prevailing in Australia, Switzerland, Canada, West Germany and the USA through our Missions abroad.

1.9 Since the Commission has been asked to consider the total revenue account without making a distinction between Plan and non-Plan, it was considered useful to interact with the Deputy Chairman and the Members of the Planning Commission. A meeting was held on 21.4.1988. The Planning Commission agreed that the Finance Commission would broadly determine the revenue component in the Plan of the Centre and each of the States, and that the inter-sectoral allocation would be left to the Planning Commission taking into account the Plan priorities, programmes, inter-sectoral linkages and inter-dependence between revenue and capital expenditures.

1.10 As desired in the Presidential Notification and also in view of the paramount need for fiscal discipline, the Commission decided to adopt a normative approach. Consequently, the States were asked to give their forecasts for 1989-90 on the normative basis as well, spelling out the norms that should be adopted for assessing receipts and expenditures. Since a number of States had doubts about the norms and methodology to be adopted for the forecasts, the Commission later advised them to submit their forecasts on only the traditional basis. As explained in Chapter III we thought it advisable to apply the norms selectively for the year 1989-90. The room for normative assessment would be much greater for the period 1990-95. This would be undertaken with the cooperation and understanding of the Central and the State Governments. For 1989-90, we prepared a paper proposing to estimate taxable capacities of the States using the regression approach by pooling cross-section observations over the time series in a covariance model. Some conceptual and methodological issues relating to the normative assessment of receipts and expenditures of the Centre and the States during 1990-95 were set out in another paper. Both the papers were discussed with some eminent econometricians and public finance specialists at New Delhi on 26th February, 1988 (Annexure I.4). The latter paper, duly expanded and revised, was circulated to the State Governments and the Ministry of Finance, Government of India. The Commission took the initiative to convene a meeting of the State Finance Secretaries and representatives of the Union Finance Ministry at New Delhi on 22nd April, 1988 for detailed discussions on the approach paper which was held by economic dailies and journals as an example of "glasnost". There was a broad acceptance of the approach and methodology in the meeting.

1.11 For the period 1990-95, it is our intention to make a normative assessment of revenue receipts and expenditures much more comprehensively. Toward this end, we have already commissioned some important analytical studies. While most of the studies are being carried out in-house, a study on "Estimation of Relative Taxable Capacities of the States" using the Representative Tax System Approach" has been assigned to the National Institute of Public Finance and Policy. Besides, we have retained Prof. B.2. Bhattacharya of the Institute of Economic Growth to conduct a study on government borrowing in India with special reference to States' indebtedness to the Centre. We have also requested the National Institute of Urban Affairs to conduct a study on Municipal Services and Municipal Finances.

1.12 We were able to undertake visits to the States only from April, 1988 due to delay in receiving the forecasts from the States. Although we are required to give two separate reports for the year 1989-90 and for the period 1990-95, we felt that it would be desirable to visit each of the States at least once. We have already covered the States of Madhya Pradesh, Gujarat, Kerala,

Maharashtra, Jammu and Kashmir, Haryana, Punjab and Himachal Pradesh in April and May, 1988.(Annexure I.5). We also visited Rajasthan in January, 1988 for a first hand assessment of the drought prevailing in that State. In this connection we visited a number of areas seriously affected in the districts of Barmer, Jodhpur, Jaisalmer, Bikaner and Ajmer. During the visits to the States, we had detailed discussions with the Chief Ministers, their Cabinet colleagues and the senior officers of the State Government. We also met Members of Parliament, Members of State Legislatures, representatives of Chambers of Commerce, Federation of State Employees' Associations, economists and other eminent personalities. Some of the States also arranged field visits so as to facilitate a greater understanding and appreciation of problems at first hand. These visits gave us a vivid insight into the problems which would not have been possible from a formal document. They increased our awareness of the high cost of delivering general, economic and community services in remote and inaccessible areas. The Commission also had useful rounds of discussions with the Union Secretaries in-charge of various Departments

under the Government of India. These meetings were helpful in obtaining the requisite clarifications on several issues related to the resources and expenditure needs of the Central Government. A list of the Secretaries who met the Commission is given in Annexure I.6.

1.13 Our report for the year 1989-90 should be viewed, by and large, as a continuation of the report of the last Commission. We have deliberately refrained from making radical departures so as not to upset the on-going arrangement in the terminal year of the Seventh Plan although we are quite aware of the wider scope of our work.

Most of the States that we visited made an impassioned plea for increased assistance to meet their growing requirements and to take care of the special problems which they had on hand. The Secretaries of the Ministries of Home, Defence, Finance, Food and Fertilizers, on the other hand, made very effective presentations of the Centre's expenditure needs. We are duty bound to take into account not only the needs of the States but also the capacity and commitments of the Central Government. We have tried to keep a balance in evolving a package.



THE APPROACH OF THE COMMISSION

The Federal Finance Problem

2.1 A federal or quasi-federal form of government can be said to offer a combination of the benefits of economic integration and political autonomy. By coming together to form a common nation, the regional units are able to gain collectively economic and military strength and at the same time the federal form of government yields the benefits of decentralisation which are both political and economic. Decentralisation of the provision of public services can be said to lead to greater economic efficiency because the pattern of expenditure would be more in accordance with the preferences of the people. Also, the local and regional units of government could provide services within their respective jurisdictions and raise the resources needed to meet the costs from the residents under their jurisdictions and those who benefit from the services. In this way, there will be a linking of revenue-raising and expenditure decisions which can be expected to result in economy and responsibility in the management of public funds. Decentralisation of the provision of public services also satisfies the political aspirations of the peoples of different regions for autonomous action in matters mainly affecting their welfare. There is therefore a strong case for assignment of expenditure decisions in a wide range of activities to the sub-national governments or States, even in a quasi-federal set-up.

2.2 If there could be perfect matching of the capacity to raise resources and the need for funds to provide services on an adequate scale at different levels of government and in the different regions, there would not arise what is commonly referred to as the federal finance problem. However, in reality it has been found difficult to provide sub-national governments, at the State as well as the local level, taxing powers commensurate with their expenditure needs. This is because of two important reasons: Firstly, the most productive sources of revenue have to be assigned to the Central or Federal Government in order to reap economies in collection and to avoid harmful economic effects, that would arise, if certain tax sources are assigned to sub-national governments. For example, the tax on production or excise cannot be allowed to be levied by the States, as differing rates of excises in different regions would lead to arbitrary and uneconomic location of industries, not to speak of the possibility of States having monopoly power in particular products imposing heavy burdens on the citizens of other States through high taxation.

2.3 Again, it is well known that several problems arise if the power to levy income tax is left to the States, the main one being the conflict between the principles of origin and residence. Besides, progressive income tax levied by sub-national governments could result in mobility of persons

and allocation of resources in unintended and inefficient ways. Apart from that, the cost of collection can be minimised if the Central Government is given the exclusive right to levy and collect income tax as is borne out by the experience of several other federal countries.

2.4 The second reason for limiting the taxing powers granted to the States is that there are not many taxes which can satisfy the principle that a tax levied by a given State should be borne mainly by its citizens. The incidence of most productive tax extends beyond the jurisdiction of particular States.

2.5 The asymmetry in the assignment of tax powers and expenditure responsibilities has led in all federations to the familiar problem of vertical fiscal imbalance, that is, the expenditure needs of the sub-national governments or States are far in excess of the taxes and other revenues which they themselves are able to raise, calling for a large volume of devolution of funds from the Federal or Central Government.

2.6 Federal transfers have to address another problem also. The capacity to raise resources often differs vastly across States; some State Governments cannot raise resources to provide the citizens an average standard of services, given their low revenue-raising capacity. The Central Government has, therefore, to be left with surplus funds after meeting its own needs and making general transfers to remedy vertical fiscal imbalance, in order to make redistributive transfers to the weaker States.

2.7 These considerations warrant flexibility in the conducting of inter-governmental fiscal relations. In smaller, more developed and more homogenous federations like Switzerland and West Germany, largely the extent and methods of revenue sharing are specified in the Constitution itself and any change requires an amendment of the Constitution through a referendum. While this brings in remarkable stability to fiscal policy and greater inner strength to the policy regime, it would not be operational in a large, heterogeneous, less developed country like India. Nor are the informal systems of transfers prevailing in more developed countries with a long history of cooperative federalism workable in our context.

2.8 Keeping these considerations in view and recognising the broad contours of the federal financial problem that were likely to arise, the founding fathers of the Indian Constitution introduced provisions for the sharing of certain Central taxes with the State Governments as well as for grants-in-aid of revenue to States which are in need of assistance (Articles 270, 272 and 275). The Constitution also provides for the

establishment of an independent Finance Commission at periodic intervals in order to make recommendations to the President regarding the distribution of the proceeds of the taxes that are to be or may be shared with the State Governments and on the principles on which grants-in-aid are to be given to the States in need of assistance (Article 280).

2.9 The principle of linking revenue-raising and expenditure decisions leading to economy in the use of resources and fiscal responsibility can be completely satisfied only if each level of government is fiscally self-sufficient, that is, the States can raise all the resources they need from within their own respective jurisdictions and out of their own sources of revenues. Once federal transfers are introduced, there is necessarily a weakening of the principle. However, in deciding upon the principles of transfers of funds from the Central Government to the State Governments, the Finance Commission would have to ensure that the linking of revenue and expenditure decisions and fiscal responsibility are not unduly weakened at either level of government and that higher expenditures than what is to be normally provided for on the basis of national criteria must be met out of one's own resources. While an adequate volume of assistance in the form of federal transfers must be made available to the States in the light of the respective responsibilities assigned to the Central and the State Governments under the Constitution, there should be no weakening of the basic principle that the task of balancing the budget should be the responsibility of each government concerned. This principle was clearly enunciated by the very first Finance Commission. Its report said "The principle of self help also implies that a State should utilise its existing resources to good account before it makes a claim for assistance from the Centre. We should like to emphasise here that it is not the purpose of any system of grants-in-aid to diminish the responsibility of the State Governments to balance their own budgets. The method of extending financial assistance should be such as to avoid any suggestion that the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year. If the amount of grants-in-aid were to be merely in proportion to the financial plight of a State, a direct premium might be placed on impecunious policies and a penalty imposed on financial prudence. On the other hand, if a State is eligible for a grant on other grounds, it should not be precluded from this benefit, merely because its budget is in order as a result of its sound financial management" (p.97).

2.10 It follows that not only the volume of resource transfers but also the manner in which the transfers are made, or the principles according to which they are determined, are important. After considerable deliberation, this Commission has decided to move away from what has been called "the gap filling approach". Before we delineate our approach and the basic principles on which the quantum and distribution of Central transfers would be determined by us, it may be

useful to briefly recapitulate the trends in the finances of the Central and the State Governments as well as in the financial relations between the two levels of government. As would be seen later, the emerging trends in public finances which are of high portent for the future of our economy have deeply influenced our approach and recommendations.

Trends In Central-State Finances

2.11 As in most countries, in India too, government revenues and expenditures have grown rapidly since Independence. The combined revenue receipts of the Centre and the States which formed 6-7 per cent of gross domestic product (GDP) in the early fifties have now reached the level of 20 per cent; there has been a somewhat faster growth of revenue expenditures. We are here concerned with more recent trends. We note that between 1974-75 and 1986-87, total revenue receipts of the Centre and the States have grown in real terms at 8.4 per cent per annum as against the average growth rate of 4.8 per cent in real GDP.¹ Real government expenditures within the revenue account grew at 10.3 per cent per annum. In other words, during this period, in real terms, total government revenues increased 2.5 times and total revenue expenditures 3.2 times.

2.12 In nominal terms, revenue receipts grew at an annual rate of 14.5 per cent between 1975-76 and 1986-87, while the growth rate of revenue expenditure was higher by almost 2.7 percentage points at 17.2 per cent. This outpacing of revenue growth by expenditure growth has led to the era of revenue deficits beginning from 1982-83. However, it appears it is rather the recent trends that have caused the imbalance rather than the longer term trends.

2.13 As GDP figures have been revised since 1980-81, it is difficult to trace the trends in the growth of government revenues and expenditures in terms of changes in percentage of GDP. However, it can be stated that until 1979-80, both revenue receipts and revenue expenditures increased fairly rapidly in relation to GDP; since 1980-81, while revenue expenditures as a percentage of GDP continued to accelerate, the growth of revenues slowed down: revenue expenditures increased from 17.5 per cent of GDP in 1980-81 to 23 per cent in 1986-87 whereas revenue receipts increased from 17.6 per cent to only 20.6 per cent during the same period resulting in a combined revenue deficit of the Centre and the States at 2.4 per cent of GDP (Annexure II.1)

2.14 If the Central Government's finances alone are considered, it is seen that its gross revenue receipts increased from 11.7 per cent to 14.1 per cent of GDP during 1980-81 - 1986-87, indicating quite a remarkable rate of growth. Its net revenues (i.e., gross revenues minus tax devolution to the States) increased from 9.3 per cent to

1 The growth rate of GDP mentioned here is somewhat exaggerated because of the upward revision of GDP in the later years of the period.

11.5 per cent of GDP, the ratio of the devolution to GDP remaining almost the same at the two ends. As against this, the revenue expenditures of the Central Government (including grants) increased from 9.8 per cent of GDP to 14.0 per cent during the period. Of this, grants to the States increased from 2.0 per cent of GDP to 2.6 per cent of GDP and other revenue expenditures of the Central Government increased from 7.07 per cent to 11.04 per cent of GDP. Thus Centre's own expenditures increased by 3.7 percentage points, while grants increased by 0.6 percentage point.

2.15 The own revenues of the States increased from 6.3 per cent of GDP in 1980-81 to only 7.1 per cent in 1986-87; but their total revenue receipts including devolution of taxes and grants from the Centre increased from 10.1 per cent to 12.9 per cent (total revenues increased by 2.8 percentage points, while own revenues increased by only 0.8 percentage points). Revenue expenditures of the States increased from 10.4 per cent of GDP to 12.9 per cent, i.e., by 2.5 percentage points during the period. This may be compared with the 3 percentage point increase in the own expenditures of the Centre.

2.16 The following conclusions may be drawn about fiscal trends since 1980-81:

- a. There has been a substantial growth in the revenue receipts of the Central Government.
- b. But the growth in revenue expenditures of the Centre has been much faster mainly because of the rise in its own expenditure and partly also because of the rise in the proportion of grants.
- c. The growth of own revenues of the States has not been as fast as that of Central revenues but, when supplemented by Central transfers, States' revenue receipts grew fairly fast.
- d. However, States' revenue expenditure increased faster than revenues, although not as fast as Centre's own expenditures.

2.17 Since non-Plan revenue expenditure accounts for around 20 per cent of GDP, the entire Plan revenue expenditure (at the aggregate level) has to be met out of borrowing. The non-Plan expenditure of the Centre and the States increased almost steadily from 14 per cent of GDP in 1974-75 to 19.5 per cent in 1986-87. At the Central level, until 1985-86, much the greater part of the rise in the non-Plan revenue expenditure was accounted for by increases in interest payments and subsidies. However, since 1986-87, there has also been a substantial increase in defence expenditure which has caused the ratio of non-Plan revenue expenditure to GDP to grow further. At the level of the States, the non-Plan revenue expenditure ratio grew from 7.72 per cent in 1974-75 to 10.14 per cent in 1986-87; more than half of the increase in the ratio was accounted for by increases in development expenditure. The growth in non-Plan development expenditure within the revenue account at the States' level and a good part of the increase in interest payments at the

Central level may be attributed to the successive development Plans (which leave behind increased commitments) as well as to borrowing for meeting revenue expenditure and also capital expenditure not generating adequate returns.

2.18 The combined revenue deficit of the Central and State Governments is estimated at Rs. 10,132 crore in 1987-88, which may form 3.1 per cent of GDP. Of this, the share of the Centre is Rs. 8,496 crore or 2.6 per cent of GDP. Although the total net revenue deficit of the States in that year is only Rs. 1,636 crore, the combined revenue deficit of the deficit States is around Rs. 2,205 crore. Indications are that revenue expenditures would continue to increase faster than revenue receipts and the revenue deficits would rise both absolutely and in relation to GDP. Drastic changes in fiscal policies are required if this trend is to be reversed.

2.19 Another cause for serious concern is the rapid increase in public debt, especially in recent years. The combined public debt of the Centre and the States increased from only Rs. 29,933 crore at the end of 1974-75 to Rs. 1,80,834 crore at the end of 1986-87 amounting to 61.8 per cent of GDP. It is estimated to have reached Rs. 2,10,377 crore by March 31, 1988. Until the revenue deficit emerged, public borrowing (including borrowing from the Reserve Bank of India) was resorted to for financing public investment in physical assets or for granting loans to the private sector. With a large public sector in core enterprises and the State playing an active interventionist role in promoting growth, it is inevitable that there is a large public borrowing programme. But such a borrowing programme and the consequential growth of public debt need not have resulted in a corresponding growth of interest burden on the budget itself if the investment in public enterprises as well as in financial assets had earned adequate returns. The total capital employed in the Central public enterprises (covered by The Public Enterprises Survey) amounted to about Rs. 52,000 crore at the end of 1986-87. Of these, 100 units were making losses amounting to Rs. 1,708 crore; 109 units were making after-tax profit of Rs. 3,478 crore of which Rs. 2142 crore came from the petroleum sector. Hence, the profit after-tax of enterprises in other than the petroleum sector amounted only to Rs. 1,336 crore. All in all, the rate of return on the capital of Rs. 51,931 crore amounted to 6 per cent before tax and 3.4 per cent after tax. Of course, if the petroleum sector is excluded, the rate of return would be negative. But the government has to continue to service the debt incurred for a large part of this huge investment. At the level of the States, the most important public enterprises are the State Electricity Boards and the State Road Transport Corporations. The total capital employed (net fixed assets) in State Electricity Boards amounted to Rs. 13,534 crore in 1985-86 and together they incurred a commercial loss of Rs. 1,520 crore. The State Road Transport Corporations made an aggregate loss of Rs. 226 crore on a block capital of Rs. 1,882 crore. One of the major causes for the rise in the net interest burden on the general

budget is the poor returns on the major investments of Central and the State Governments. Another cause is the creation of public debt for financing revenue expenditure which by its very nature cannot yield any direct return.

2.20 The total public debt of the Centre and the States now constitutes about 55 per cent of GDP; and the gross interest burden amounts to 3.8 per cent of GDP and the net interest burden 2.2 per cent. The total fiscal deficit (the total borrowing requirements) of the Central Government has become large amounting to nearly 9.4 per cent of GDP. This in itself is not conducive for the maintenance of monetary stability. Besides, the consequent rise in interest burden tends to enhance the revenue deficit further.

2.21 The low level of income and the fairly moderate rate of economic growth that we have been able to achieve together constrain the amount of resources that can be raised by the governments. But the resources which the governments need for providing essential public services and for performing other functions expected of them are large and rising. The problem of scarcity of resources, however, cannot be solved through increasing revenue deficits, which is tantamount to living beyond one's means. The fiscal scenario in the country has gradually worsened to an alarming extent and corrective steps are required now to reverse the deteriorating trend and to create conditions for the restoration of health to the financial system. It is in this context that we have been asked to undertake the very difficult and delicate task of assessing the requirements of the Centre and the States and making recommendations on the distribution of revenues between the two levels of governments. One of the terms of reference given to the Commission suggests that the Commission should "keep in view the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment". In our considered view, one of the major objectives of financial policy in the medium term should be the elimination of the revenue deficit. In our recommendations, we shall not only keep this objective in view but also indicate the kind of policy changes needed to achieve it. (The detailed recommendations will be given in the second report.)

2.22 As a backdrop to its work, the Commission also has to consider the recent trend in financial relations between the Centre and the States. Such an analysis would reveal which trends should be strengthened and which are to be reversed and what modifications would be needed in the distributional pattern of resources.

2.23. Annexure II.2 indicates the trends in the share of States in the total combined tax revenues of the Centre and the States. It is seen that over the years the share of total taxes accruing to the States has increased with some fluctuations. Since 1974-75 the rise has been fairly steady; the share of the States has increased from 44.8 per cent in 1974-75 to 51 per cent in 1986-87. In a similar manner, Annexure II.3 indicates the changing share of

the States in total revenue accruals. (In this table besides devolution of taxes, plan and non-plan grants from the Centre are also included in the States' share) We note that the share of revenues accruing to the States has increased from 54.3 per cent in 1974-75 to 61.2 per cent in 1986-87. In other words, as of now, as much as 61 per cent of the total revenues raised by the Centre and the States are placed at the disposal of the States although they themselves raise only 34.6 per cent of total revenues.

2.24 The dependence of the States on devolution and grants has gradually increased. While their own revenues have declined from 61.9 per cent in 1974-75 to 56.9 per cent in 1986-87, their dependence on current transfers from the Centre has correspondingly increased from 38.1 per cent to 43.6 per cent (Annexure II.4). In this connection, it is worth noting that the proportion of shared taxes in States' revenues is lower now than the high point reached in 1979-80 as a result of the application of the Seventh Finance Commission's recommendations. This decline, however, has been made up by an increase in the share of grants.

2.25 We may also consider the relative importance of shared taxes and grants in total Central revenues. Annexure II.5 indicates that the proportion of the shared taxes or tax devolution to total Central tax revenue increased from 16.6 per cent in 1974-75 to a high of 25.8 per cent in 1980-81; it declined thereafter till 1984-85. Subsequently, there has been a slight increase, the share in 1987-88 being 22.1 per cent. As against this, the proportion of total current transfers (that is shared taxes plus grants) to total Central revenues has more or less steadily increased from 27.6 per cent in 1974-75 to 38.8 per cent in 1987-88. This increase is largely attributable to grants for financing State Plans and Centrally Sponsored Schemes.

Tasks Ahead : Our Approach

2.26 As stated earlier, after some initial apprehension, all the States have extended their fullest cooperation to us, which undoubtedly bodes well for the future of cooperative federalism in India. We must, however, state in passing that for the success of Indian fiscal federalism, it is imperative that mutual suspicion between the Centre and the States and among the States *inter se* should be dispelled and a healthy federal spirit be fostered. On matters impinging on federalism, the Constitutional provisions can provide only the directions; they can be effectively implemented only in a spirit of trust and mutual understanding. Therefore, constructive attitude devoid of distrust and suspicion is essential on the part of both the Centre and the States, if we are to flourish under a healthy cooperative federation. In the interest of harmonious relations, we cannot overemphasise the need for frequent formal and informal consultation processes, and given its dominant Constitutional role in Indian federal polity, the Central Government has to take a lead role in this task. Fruitful and harmonious fiscal relations between the Centre and

the States is a prerequisite for resolving all outstanding fiscal issues. The utmost cooperation between the Centre and the States has become all the more necessary in view of the disquieting fiscal scenario of governmental dissaving in India which we have detailed.

2.27 It is important to identify the means by which the trend of rising revenue deficit at the Central and State levels could be arrested. Clearly, raising revenues to a level of over 20 per cent of GDP in a country of India's level of income and economic development is creditable. However, it would be increasingly difficult to raise the tax ratio further although some increase in it may also be necessary. We have already noted that the combined revenue ratio of the States could only rise by 0.8 percentage point in the six years since 1980-81. The States do not have many productive sources of revenue although it is possible for them to tap certain untapped sources such as taxation of land or income from land, since their tax rates are already high, it is going to be difficult for them to get increases in revenue other than through obtaining higher elasticities in response to growth in income. In this context, if the trend of increasing revenue deficit is to be arrested, substantial emphasis would have to be given to decelerating the growth of revenue expenditures of both Central and State Governments.

2.28 The growth in subsidies and interest payments has been an important cause of the fast rise in revenue expenditures at the Central level. In addition, wages and salaries have grown rapidly as a result of both an increase in government employment and a rise in wage payments due to dearness allowance and pay revisions. This factor has become more important in recent years. For the Central Government, the increase in wages and salaries has been mainly due to the revision of scales and allowances following the recommendations of the Fourth Pay Commission; in the States, however, this has come about due to both revision of salaries as well as substantial increases in employment. If the present trends continue, a growing proportion of expenditures would be incurred merely to pay salaries to government employees, which would result in increasing revenue deficits if offsetting cuts in other expenditures are not made. Many of the States have followed in the footsteps of the Central Government in revising their scales of pay without paying due regard to their capacity to raise revenues. This has a harsher impact on the weaker States. We believe that for reasons of both growth and equity, it is necessary to have a proper wages and income policy. But, this can be done only in an environment of stable prices, the maintenance of which is the primary responsibility of the Central Government and calls for proper macro-economic management in containing overall deficits and the growth in money supply¹. It is time that the Government of India paid adequate attention to these issues in order to nurse the economy back to fiscal health.

2.29 At this stage, we may refer to the statement of some observers that the Central Government is primarily

responsible for the sorry state of public finances because the revenue deficit is almost entirely on Central account (example, 1986-87). No doubt, the kind of expenditure policy followed by the Central Government has made a significant contribution to the emergence and growth of the revenue deficit but we must point out that the Centre would have a large revenue surplus before tax devolution and making grants; there would be a surplus even after tax devolution if grants were excluded. In other words, the increasing trend in Central revenue deficit is partly due to the significant increases in tax devolution and grants over the years. At an average rate of 17 per cent per year, growth of current transfers has been faster than the growth of both Central revenue receipts (14.4 per cent) as well as States' own current revenues (15.7 per cent) during the period 1975-76 to 1986-87. Therefore, the revenue deficit at the Central level is also attributable partly to the substantial increase in federal current transfers to the States.

2.30 In our analysis, we have sketched developments until 1986-87 which is the latest year for which we have firm data. The revised and budget estimates for the two years following only indicate a deterioration in the fiscal situation. The revenue deficit of the Central Government for 1988-89 is placed at Rs. 9,840 crore. As for the States, the combined revenue deficit of deficit States is likely to amount to Rs. 2,463 crore in that year. The combined revenue deficit of the Centre and the States is likely to constitute 3.3 per cent of GDP. In the light of this continuing deterioration of the fiscal situation, achieving the objective of "not only balancing the receipts and expenditures on revenue accounts of both the States and the Centre, but also generating surpluses for capital investment" placed before us in our terms of reference, can only be a distant goal, but eliminating the revenue deficits as early as possible is an absolute fiscal imperative. We shall, therefore, set before ourselves the task of phasing out the revenue deficits during the next six years so that by the end of the fiscal year 1994-95, the Centre and the States would be balancing their revenue accounts. We shall have rendered what we consider to be an important service to the nation if we succeed in persuading the Central and State Governments to work towards this objective which should not be difficult, realising that only till 1981-82, both the Centre and the States had surpluses in their revenue accounts [Annexure II.6]. We realise that even achieving balance is by no means an easy task but given high degree of fiscal discipline on the part of both the Centre and the States it is not unachievable. What is needed is political will. But it is necessary to remind ourselves that a satisfactory and enduring solution to the problem of Centre-State relations cannot be found except through sound and disciplined fiscal management. The Centre bears the larger responsibility in that it is primarily responsible for the maintenance of price stability without which the finances of the State Governments, weak as they are individually, are thrown out of gear.

2.31 In the above context, one of the terms of reference that requires the Commission to adopt a

1. Because of the strict limitation placed on overdraft facilities to the State Governments, in their case, their revenue deficits cannot lead to an overall deficit in the sense of borrowing from the Reserve Bank.

normative approach, assumes great importance. We do not consider this to be a directive to the Commission, but regard it as a salutary suggestion intended to induce sound fiscal management at the level of both the Centre and the States. We have decided to adopt a normative approach due to the inherent merit of such an approach, the adoption of which seems to be the only way for solving the problems we face and for ensuring equitable treatment to the different governments. We have indicated earlier that while an adequate volume of resources must be made available to the States for fulfilling their Constitutional obligations, the manner of resource transfer should not be such as to weaken fiscal responsibility, and must leave scope at least at the margin for linking revenue raising and expenditure decisions. It has been the contention of several professional economists and also of many States that the "gap filling" approach adopted by the Finance Commissions in the past was not conducive to encouraging economy in expenditure and rewarding of efficiency and fiscal prudence. At the same time, since gaps were taken to indicate needs, genuine needs could not be taken care of; nor was it possible to make allowances for differences in taxable capacity, leading to deficiency in capacity in particular States. On the other hand, it was possible for individual States to undertake more expenditure without raising correspondingly higher resources and pass on the burden of the increased expenditure commitments to the residents of other States via the Central budget.

2.32 This is not a matter concerning the Centre vs. States. Two principles are involved : (a) maintenance of fiscal responsibility and uncompromising commitment to economy and efficiency; and (b) inter-State equity - the genuine basic needs of all the States should be taken into account along with differences in taxable capacity. Once assistance is granted on the basis of these two principles, it would clearly be the responsibility of each government (including the Centre) to balance its revenue budget.

2.33 It would, of course, not be correct to state that the previous Finance Commissions did not adopt any norms in re-assessing revenue receipts and non-Plan expenditures of the States and the Centre. For example, certain normative rates of return on investments in public enterprises were assumed while projecting revenue receipts. On the expenditure side, certain items of expenditure were wholly or partially disallowed. Again, maintenance expenditures on irrigation, buildings and public works were projected on the basis of certain engineering norms. But norms were only selectively applied. In general, except for occasional disallowances, all other commitments made by the different States and the Centre as on a particular date were accepted and norms were brought in only to determine the rates of growth of expenditure items that were to be allowed. Similarly, on the revenue side, the level of revenues existing in the "base year" were taken as given and were projected at normative rates of growth. This meant that almost all expenditure commitments (the scale or volume of different services and the actual costs thereof

regardless of extravagance or economy) were considered justifiable. Furthermore, the approach implied that it did not matter to a State if it disregarded the normative rates of growth prescribed by a Finance Commission because the next Commission would in any case accept all existing commitments regardless of the actual past rates of growth.

2.34 The basic departure that we shall be making in the assessment of revenues and expenditures is that, at least in respect of the five-year period (1990-95), we shall not take for granted the base year figures either on the revenue or the expenditure side as the "right" figures on which to proceed. We shall endeavour a normative assessment of capacities and needs so that each State would be expected to raise what it can, given its capacity, and will be allowed expenditure levels commensurate with its normatively determined needs. It follows that "base year" figures cannot be taken without modification in the case of the Centre also.

2.35 Some basic considerations have to be kept in mind while adopting a normative approach. First, the distribution of revenues between the Centre and the States must be made in such a way that the two layers of government are enabled to fulfil their respective obligations satisfactorily as enjoined in the Constitution. The norms applied should not be discriminatory as between the Centre and the States. Second, the distribution of revenues among the States should be equitable so that every State is enabled over time to provide a specified minimum standard of basic public services. That is, the States with less capacity should be able to improve their relative standards in respect of essential services. Third, the assessment of revenues and expenditures should be done in such a manner that incentives for greater revenue effort and economy in spending are not curtailed. Fourth, the States should be free to provide more public services and defray their costs through additional levies on their respective citizens. Finally, the norms adopted should be consistent with our overall objective of balancing the revenue accounts of the Centre and the States.

2.36 Another major issue pertains to the suggestion in the terms of reference that the Plan and non-Plan sides of the revenue accounts should be considered together in assessing receipts and expenditures of the Centre and the States. This brings to the fore the controversy about the role and authority of the Finance Commission vis-a-vis the Planning Commission and the scope of Article 275 of the Constitution vis-a-vis Article 282. The issue has been debated in the media as also in the various seminars organised to discuss the tasks before us. Some State Governments have also raised these issues in their memoranda. We have obtained the opinions of the top constitutional experts in the country and are examining the matter. We shall advert to it in our second report. Meanwhile, as indicated in our terms of reference, we have proceeded to assess total revenue receipts of the Centre and the States including additional

resource mobilisation. Likewise, we have also assessed the revenue expenditure of the Centre and the States in its totality both on the Plan and non-Plan sides. For the purpose of our assessment of the Central revenue expenditure, we have included conventional non-Plan grants; grants for State Plan Schemes and externally aided projects; and grants for Central Sector and Centrally Sponsored Schemes.

2.37 The compartmentalisation of government revenue budgets into Plan and non-Plan, particularly on the expenditure side, has led to a situation in which only part of the budget is considered at a time - the Plan side by the Planning Commission and the non-Plan side by the Finance Commission. It has generally been assumed by the Planning Commission and the States that all new committed expenditures arising out of Plan programmes will be taken care of by the Finance Commission. On this assumption many programmes have been undertaken without taking into account the long-term implications for the revenue budget. On the other hand, if the Finance Commission confines itself to the non-Plan side, a normative approach cannot be applied since total capacities and needs have to be considered in the context of such an approach. Further, if the total revenue expenditures, Plan and non-Plan, are not assessed by one body, there is a tendency on the part of Ministries at the Centre and Departments in the States to put forward proposals for new expenditures in the course of a Plan with the result that there is no effective control on the growth of total revenue expenditures. We have already noted that the Constitution does not restrict the Finance Commission's jurisdiction to merely the non-Plan side of the budgets of the Central and State Governments. The implication in the terms of reference given to us that the total revenues and revenue expenditure should be assessed without making a distinction between Plan and non-Plan, conforms to this Constitutional position. In considering the Plan component of the revenue budget, the Finance Commission would have to work in collaboration with the Planning Commission. We have already initiated discussions with the Planning Commission both at the level of officers and that of Members. Though the Finance Commission has therefore to assess both Plan and non-Plan expenditure, it was our decision made at an initial stage that the Finance Commission shall not disturb or weaken the planning process; economic planning must continue to be the prerogative of the Planning Commission.

2.38 The adoption of a normative approach and incorporation of the Plan side of the revenue account, however, gives rise to some important operational difficulties. As comprehensive norms have to be developed for Central and the State Governments for the first time, several conceptual and methodological issues have to be resolved. We are also aware that the norms prescribed by the Finance Commission would have to be realistic so as to be capable of being adhered to by the Central and the State Governments. In undertaking this task, it is also necessary that the existing institutions and

the developmental process initiated through the planned programme should not be hampered in any way, but instead, that a conducive fiscal environment should be created for economic planning.

The Approach for 1989-90 Assessments

2.39 The normative approach that we fashion should not only satisfy the criteria that we have outlined earlier regarding equity, efficiency and fiscal responsibility, but should also lead to the phasing out of the revenue deficits and then in due course to the generation of surplus for capital investment. The detailed working out of this approach and its translation into a practicable plan would take considerable time. It would not, therefore, be feasible to adopt this approach in making recommendations for the first report for the year 1989-90.

Besides, since the new approach would mark a radical departure from the basis on which Finance Commissions have been operating, it would not be fair to the parties concerned to adopt it without giving them sufficient notice. Moreover, if any radical changes are made in the criteria for the *inter se* distribution of resources among the States in the last year of the Seventh Five Year Plan, it would upset the calculations already incorporated in the Plan. Keeping these factors in view, for making our recommendations for the year 1989-90, we have opted for a selective adoption of norms in the assessment of revenues and expenditures.

2.40 Even for the first report for the year 1989-90, we have assessed the revenue receipts normatively. On the expenditure side, however, we have made the assessment largely on the basis of the assumptions made by the Eighth Finance Commission. The methodology of assessing revenue receipts and expenditures of the States is detailed in Chapter 3. Central receipts and expenditures also have been reassessed by adopting normative rates of growth. Wherever comparable, uniform norms have been adopted in the assessment of Centre and States. The methodology adopted to assess the Central revenue receipts and expenditures are discussed in Chapter IV.

The Approach for the Period 1990-91 to 1994-95

2.41 For the five year period from 1990-91 to 1994-95, the normative assessment of revenue and expenditures has to be carried out in two stages. In the first stage, the revenues and expenditures of each State would be normatively assessed with reference to average performance. This is to be done in order to place different States in the "right place" in a relative scale of performance and needs. This kind of assessment is mainly intended to ensure fairness of treatment in regard to distribution of revenue.

2.42 Normative assessment of revenue receipts involves the estimation of taxable capacity and non-tax revenue capacity. Taxable capacity will be estimated on the basis of an appropriate method such as the representative tax system approach or the regression approach. Non-tax revenue capacities will be

determined by applying normative rates of return on investments and normative earnings from such sources as forests and mines. Also, reasonable levels of user charges would be assumed in respect of services provided by the governments. The normative estimates of revenues, based on capacities, for the latest year for which the required data are available would be then projected for the recommendation period on the basis of normative growth rates.

2.43 In making a normative assessment of non-Plan revenue expenditures of the States, a distinction has to be made between non-developmental and developmental heads. Expenditure needs under the head of 'administrative and general services' would be assessed on the basis of the justifiable costs of providing an average standard of these services in the different States. In respect of social and economic services, expenditure would be estimated on the basis of providing physical standards of services already attained in the different States at justifiable costs. As regards various welfare programmes and subsidies, a view will be taken as to which expenditures are to be disallowed, partially or fully, by applying uniform criteria. Central tax revenues would also be projected at normative rates of growth for the five-year period. As regards non-tax revenues, normative yields will be estimated by applying yardsticks similar to those applied in the case of the States with suitable modifications. Again, the major items of Central non-Plan revenue expenditure, other than interest and defence, would be assessed on a normative basis after examining needs and possible ways of achieving economy.

2.44 Before commencing the second stage of assessment, we shall tentatively work out the quantum and pattern of devolution of taxes, as well as grants-in-aid. The Commission would derive, in collaboration with the Planning Commission, minimum levels of revenue Plan expenditure that should be provided (part of this could be

used for equalisation purposes).

2.45 In the second stage of assessment, on the basis of the estimated revenues and expenditures and the devolution of Central taxes tentatively decided upon revenue balances for the Central and individual State Governments will be worked out. Most likely, the estimated revenue and expenditure figures would result in revenue deficits for some governments as well as a net aggregate deficit, because on the revenue side, the aggregate of normative estimates would not differ significantly from the actuals of the base year. In order to complete the normative assessment, we shall target the rates of growth of revenues and expenditures so as to eliminate the revenue deficits by the end of 1994-95. The revenue deficit is to be phased out partly by bringing down the revenue expenditure ratio (to GDP) through decelerating non-Plan revenue expenditure growth, and partly by increasing the revenue ratio. The contribution to additional revenue growth and to reduction in non-Plan revenue expenditure growth, to be made by different governments, would have to be determined keeping in view such factors as levels of expenditure in relation to the average and relative taxable capacities. Should some governments be left with deficits even after this exercise, some modifications would be needed in the amount of Central transfers. In any change to be made in resource transfer, the importance of maintaining the viability of Central finances would be kept in view.

2.46 What we have described above indicates the broad approach we intend to adopt in making our recommendations for the five-year period. The details will be worked out as we proceed with the exercise. We felt it was only fair that sufficient notice should be given about the change in approach so that the Centre and the State Governments might start adopting adjustment policies forthwith.

REASSESSMENT OF THE FORECASTS OF STATES' REVENUE RECEIPTS AND EXPENDITURES

3.1 As we have indicated in Chapter II, although the application of norms to both revenue receipts and expenditures is desirable, 1989-90 being the last year of the Seventh Plan, a sudden departure from the approach adopted by the last Commission would tend to nullify the assumptions on the financing of the Plan and dislocate the planning process already initiated. Keeping this in view, and considering that our exercise for 1989-90 provides an opportunity for working out a gradual transition to a more rigorous application of the normative approach, we have adopted the norms selectively in our assessment of revenue receipts and revenue expenditures of the Centre and of the States for the year 1989-90.

3.2 Normative assessment of revenue receipts involves the estimation of revenue capacity, which in turn requires the estimation of taxable and non-tax revenue capacities. While the non-tax revenue capacity was assessed normatively even in the past, tax revenues have generally been assessed by previous Commissions on the basis of historical trends or some assumed growth rates over the base year. In this process, the levels of relative under-taxation and over-taxation by the different States was not taken into account.

Projection of Tax Revenues

3.3 There are two main approaches to estimating the relative taxable capacities of the States. The "Representative Tax System" approach estimates the taxable capacity by applying a "standard tax system" to the tax bases in the different States. The standard (or representative) tax system is built up by working out the average effective tax rates which are ratios of the sums of the actual revenue from the different taxes levied by the States to the sums of their respective estimated bases. By aggregating the capacities in respect of individual taxes levied by a State, the total taxable capacity of that State is derived. Estimating taxable capacities on the basis of this method requires compilation of voluminous data on tax bases and their proxies, and therefore, cannot be completed in a short period. We have, therefore, entrusted this study to the National Institute of Public Finance and Policy, the results of which would be available only for our second report covering the period 1990-95.

3.4 An alternative method of estimating taxable capacity is the regression approach. Given that differences in tax revenues among the States are attributable to differences in factors affecting taxable capacity on the one hand, and differences in tax effort on the other, taxable capacity is estimated by regressing per capita tax revenues or tax-SDP ratios of different States on taxable capacity variables. By substituting the actual values of the capacity variables in the equation, the

estimate of taxable capacity is obtained. In this, the differences in tax revenues among the States due to tax effort factors are taken to be represented by the residual. In other words, the relative taxable capacity is the amount of revenue a State can raise if it uses its capacity to an "average" extent.¹ The major problem with this approach is that variation in tax revenue on account of tax effort factors cannot be separated from the variance due to random errors.

3.5 We have estimated taxable capacity for the 14 major States using the regression approach with some modifications. (For the methodology applied to other States, see, para 3.10) Specifically, to overcome the bias arising from taking 'effort' as a residual, we have pooled the cross-section observations with time-series from 1980-81 to 1984-85, and endogenised the effort factors by specifying dummy variables for each of the States. The shifts in the tax function over time have been quantified by specifying time dummy variables. In order to standardise the dummy variables specified for the States, their coefficients were restricted to sum up to unity. The States are not all structurally homogeneous, being at different levels of development. It is therefore necessary to evolve separate norms for groups of structurally homogeneous States. For this purpose, we have grouped the 14 major States into three categories - high income, middle income and low income, on the basis of their average per capita income levels during the triennium 1982-83 to 1984-85. The detailed methodology employed to estimate taxable capacities of the States is set out in Appendix I.

3.6 After experimenting with a number of taxable capacity variables, we finally included in the equations the per capita SDP, the proportion of non-primary sectoral SDP to total SDP and the Lorenz ratios of consumer expenditure distribution, computed on the basis of NSS consumer expenditure data for the 32nd Round (1977-78) and 38th Round (1983-84), interpolated for the relevant years in the equations. Of the various specifications, the log-linear form provided the best fit for all the three categories of States. Also, the regression coefficients had the expected signs, and there was no significant serial correlation. We have, therefore, preferred to base our normative projections of tax revenues on the basis of these equations.

3.7 By substituting the actual values of the explanatory variables for the year 1984-85 and the average values of the States' dummies ($1/n$), where n represents the total number of States in the group, an estimate of taxable capacity was derived for the year

¹ The average here refers to the average behaviour as revealed by the regression equation.

1984-85. Taking this as the base, projections were made for 1989-90. For this purpose, the growth rate of tax revenues for each of the States was derived by multiplying the income elasticity of tax revenues computed for the relevant group of States with the rate of growth of GDP in the State concerned. Elasticities estimated for the period from 1974-75 to 1984-85 were 1.10 for high income and middle income States and 0.92 for the low income States.

3.8 The tax revenue projections thus derived are at 1984-85 tax rates.¹ Estimates of revenues at current tax rates were derived by adding the revenue effect of discretionary measures undertaken between 1985-86 and 1989-90 to the projected normative estimates. However, information on the yield of discretionary measures was available only for the first three years of the Seventh Plan. To estimate the additional resource mobilisation (ARM) to be undertaken through taxes for the entire Plan period, the proportion of (ARM) through tax measures actually undertaken to total ARM in the first three years of the Plan, was applied to the targetted total ARM for the Plan period. The same proportion was applied on the targets for 1988-89. In respect of the States which have already fulfilled the targets in 1984-85 prices, the actual revenue effect of the tax measures undertaken from 1985-86 to 1988-89 was taken for 1989-90. In the case of States falling short of the targetted ARM through taxes, the difference subject to a maximum of 10 per cent of the target was added to the estimated 1989-90 yield of ARM measures undertaken upto 1988-89.

3.9 The comparison of the normative estimates with trend estimates indicates the magnitude of relative undertaxation and overtaxation in different States. We find that in the case of some States, there is relatively substantial undertaxation and it would be too difficult for them to "catch up" in one year. To be realistic, and to mitigate the harshness arising from the sudden adoption of normative approach, we have moderated the normative estimates. Thus, in cases where the normative estimates are higher than the trend estimates, we have moderated the normative estimates by adding 50 per cent of the shortfall, subject to a maximum of 15 per cent of the trend estimates. Correspondingly, we have moderated the estimates even for the States whose normative estimates are lower than the trend estimates by adding only 50 per cent of the difference (Annexure III.1). Thus, these States are provided with the reward for their better tax performance by way of 50 per cent of the difference between the normative estimates and the trend estimates. At the same time, we must state categorically that States must take note of their shortfalls and adopt appropriate remedial measures to reach performance levels on par with the average of the States in their group.

3.10 The above analysis has been carried out for the 14 major States in the Indian Union, i.e. leaving aside the

1. This is not true for each individual State, but for the States as a whole.

special category States and the newly-formed States. The reasons for leaving out these States are that essentially these are heterogeneous in character, detailed reliable data on the explanatory variables are not available for them and in some cases, as the States have recently been formed, it would not be appropriate to judge them on the same yardsticks as applied to the major States. In the case of these States, therefore, we have applied normative rates of growth of tax revenues and have not attempted to estimate the levels of under-taxation or over-taxation in the base year. The moderated rates of growth of tax revenues for these States have been derived by multiplying the "group" income elasticity of taxes with the rates of growth of GDP. The estimated elasticity in these States was 0.9. To be consistent with the projections made for the major States we derived the estimates at 1984-85 rates of taxes. Therefore, the rates of growth were applied on the estimated base year figures of 1986-87 at 1984-85 rates, which was derived by deducting the ARM for the two years 1985-86 and 1986-87. The rate of growth of GDP upto 1986-87 was estimated from the States' estimates of GDP and for subsequent years, the trend rate of growth of GDP was taken. To this was added the estimated yield in 1989-90 of the ARM tax measures introduced subsequent to 1984-85 to arrive at projections for 1989-90 at current rates of taxes. The results are presented in Annexure III.2.

3.11 The normative assessment of tax revenues of the States raises the issue of revenue loss arising from the prohibition policy on the consumption of liquor. We have thus far normatively estimated the tax revenues by making relative comparisons among the States, without taking into account any loss of revenue resulting from prohibition policy. The issue is relevant in the case of Gujarat, where there is total prohibition, and Tamil Nadu, where partial prohibition on the sale of country liquor was introduced last year (1987-88).

3.12 Prohibition policy has adverse ramifications on the finances of the State Governments. Imposition of prohibition, in the short run, results in the direct reduction in revenue receipts. Even in the long run, it is argued, the increased collection of other taxes may not entirely compensate the loss of revenue from State excise duties, for the money not spent on the consumption of liquor may be either saved or spent on commodities that are tax exempt or taxed at lower rates. But as against that, the tax bases could be expected to be higher because of the faster increase in income due to larger investment and higher productivity. However that may be, it would be reasonable to expect that there would be loss of revenue in the short run.

3.13 While the adverse financial implications of prohibition policy are clear, it is up to the State Governments to decide what policies they should follow. The issue, however, is whether the Centre should bear the cost of prohibition in the States, and if so, for how long and to what extent. As the past Commissions adopted historical growth rates to project tax revenues, they

implicitly excluded receipts from State excise duties in the States enforcing prohibition. But, as we have normatively assessed total tax revenues, the potential revenue from State excise duties are implicitly included even in the case of States where prohibition is in force.

3.14 We have estimated the loss of revenue arising from the introduction of prohibition policy. For this purpose, the revenues from State excise duties, averaged for the period 1982- 1985, have been related to per capita SDP, proportion of non- primary sectoral SDP and consumption distribution as measured by the Lorenz ratios, in a log-linear regression model. Only 12 major States where prohibition policy has not been in force were included. The resulting estimated parameter values are used to project the excise duty revenue that would have accrued in 1984- 85 given the economic structure of Gujarat. This was projected for 1989-90 by multiplying the group-specific buoyancy of State excise duty with the rate of growth of SDP in Gujarat reckoned on the basis of the past trend. The total loss thus estimated for Gujarat in 1989-90 works out to Rs.237.58 crores. In the case of Tamil Nadu, we have merely extrapolated the past trends to obtain the estimate of revenue from country liquor that would have accrued had prohibition not been introduced. The amount of revenue thus estimated works out to Rs.388 crores.

3.15 While in principle, the States following a prohibition policy should be expected to bear its costs, a sudden departure from the past approach could result in severe financial hardship to these States. In order to soften this, we have partially taken into account the loss of revenue on account of prohibition policy and adjusted our normative estimates. In the case of Gujarat, considering that prohibition has been in force for a long time and that the loss in revenue would have been partially made up by this time, we have taken into consideration only 40 per cent of the loss and accordingly reduced our normative estimate of tax revenue by Rs.95 crores. In the case of Tamil Nadu, given the shorter time span the policy has been in force, we have allowed for 50 per cent of the loss and have adjusted the normative tax revenues by Rs.194 crores. In this connection, however, we should state that the cost of prohibition, to the extent not compensated by increase in other revenues, in the years to come will have to be borne by the States themselves without any assistance from the Centre.

Projection of Non-Tax Revenues

3.16 The major source of non-tax revenues are interest receipts and dividends, receipts from forests, mines and minerals, return on irrigation works and receipts from departmentally-run undertakings.

(i) *Interest receipts:* The Eighth Finance Commission, while estimating interest receipts on loans advanced (excluding the loans to commercial undertakings), stated that the recovery of interest by the States has been much less than that expected by the Seventh Finance Commission. On the basis of the rates

of interest levied on the different categories of loans by the State Government (excluding loans to the public sector undertakings), and by taking into account the arrears, the Commission reckoned interest receipts at an average rate of 6 per cent on the outstanding loans advanced by the end of 1983-84. We do not see any reason to alter this norm and accordingly have reckoned interest receipts at 6 per cent on the loans estimated to be outstanding at the end of 1988-89.

(ii) *Dividends :* The number of public sector undertakings run by the States has grown rapidly over the years. They vary widely in regard to size, activity and financial performance. The share capital investment of States in as many as 827 undertakings (other than State Electricity Boards and State Road Transport Corporations) is estimated at Rs.5164 crores at the end of 1988- 89. A statement giving the State-wise break-up of enterprises and investments is given in Annexure III.3.

Many of these public enterprises continue to make losses and invoke sizeable budgetary support from the governments. It is necessary to realise that investments in these enterprises are made by drawals from household savings which could otherwise have gone into productive investments in other areas and therefore, it is necessary that they should generate reasonable returns. While the enterprises in core areas and those of a promotional nature cannot be expected to yield commercial returns, our analysis shows that a large number of non-core and non-promotional enterprises have been making losses year after year. We suggest that the State Governments evolve a concrete programme of restructuring the enterprises to check the drain on the exchequer. Those units which could be made commercially viable by financial restructuring could, if required, even be assisted by injecting some capital on a one time basis. At the same time, those units which are inherently unsound must be phased out. We are fully conscious of several complex issues, including the human ones, involved in this exercise. But the situation is far too serious to warrant any complacency. One cannot countenance this kind of wastage of resources which are badly needed for the provision of basic services like water supply, primary education and health care for all the people of the States. To the extent a State Government is unwilling to cut these losses, they would have to be largely borne by the citizens of that State themselves. Perennial budgetary support for undertakings in the non-core, non-promotional areas undermines our capacity to fulfil the national commitment to ensuring social justice.

We are aware of the fact that in a developing economy like ours, sizable investments, not only in core areas but also in promotional ventures, are imperative. In fact, the States have been investing in a large number of enterprises with the primary objective of encouraging various traditional crafts such as handlooms, carpet weaving, wood carving, leather goods, bronzeware and gems and jewellery making. These activities serve an important social purpose and should not be viewed

purely commercially. Nevertheless, the commercial elements in these operations should be adequate to break even. Similarly, financial enterprises have promotional elements and therefore cannot be expected to generate returns at commercial rates. Considering this, we find ourselves in agreement with the norms adopted by the last Commission. Consequently, like the last Commission, we have classified investments into three categories - namely, promotional, financial and commercial - and have worked out dividends at zero, 3 per cent and 5 per cent, respectively, for the three categories.

With regard to investments in cooperatives also we have followed the approach of the last Commission. Thus, investment in Cooperative Banks (including land developmental banks), Credit Societies, Sugar Mills, Spinning Mills and other Industrial Cooperatives have been reckoned to generate returns at the rate of 5 per cent. Cooperatives engaged in processing, warehousing, marketing and housing activities and consumer societies are reckoned to yield a return of 3 per cent. No dividend has been taken into account from the investments in dairy farming, fishermen societies, labour and cooperatives organised as part of the programme on Tribal Areas Sub-Plan. However, in the case of cooperatives which could not be fitted into any of the three categories for want of information, we have adopted 3 per cent return in our calculations. The amount of dividend estimated for the year 1989-90 is shown in Annexure III.4.

(iii) *Revenue from forests*: Estimation of revenue receipts from forests poses some serious policy issues. The conservation of forests to maintain ecological balance and prevent environmental degradation has, in recent years, assumed an important policy perspective. Undoubtedly, the nation's forest wealth has been subject to rapid depletion due to indiscriminate felling of trees, thefts and extractions. In fact, the Government of Madhya Pradesh has drawn our attention to a resolution adopted in the 22nd meeting of Central Board of Forestry held on December 7-8, 1987 and attended by the State Forest Ministers, suggesting that felling of trees should be banned and the Finance Commission should compensate the States for the loss of revenue. We recognise the merit in this argument. However, in our estimation, some legitimate felling of trees would continue and hence we have projected the revenue receipts at the levels prevailing in 1988-89 as indicated in the budget estimates of the States.

(iv) *Mines and minerals*: As regards royalty from mines and minerals, we have adopted the estimates made by the last Commission suitably adjusted for price increases. In the case of Gujarat and Assam, the receipts from royalty on crude oil as indicated in their budget estimates of 1988-89 have been taken. As regards cesses on minerals, we have projected the receipts at the levels prevailing in 1988-89 as indicated in their budget estimates. For the next report we should be able to independently work out the estimates on the basis of

relevant data on minerals yet to be received from the States.

(v) *Irrigation receipts*: An important area, which requires greater attention in the near future, is cost recovery in irrigation. The large investments in irrigation have not been yielding positive returns and have proven to be a major drain on the States' exchequer. On the one hand, overprogramming and non-sequential planning has resulted in spreading resources thinly on several projects with delays in project completion and consequent cost over-runs. On the other hand, water charges have not even covered working expenses, leave alone generating positive returns on these investments. At a stage when further investments in irrigation are required, subsidies of this magnitude cannot be sustained. In fact, even the assumption of the previous Commission that the water rates would at least cover the operational and maintenance costs by 1988-89 has been belied. Keeping this in view, we have not considered any improvement in the norm for 1989-90, but have assumed, like the last Commission, that the working expenses would be fully covered by user charges in 1989-90 except in the case of hill States where the cost of maintenance works is higher. However, some actions have to be initiated to recover higher returns on these investments during the period of the Eighth Five Year Plan.

(vi) *Receipts from Departmental Schemes*: In some States water supply schemes and milk supply schemes are run departmentally. In the case of these schemes, too, we have retained the norms prescribed by the Eighth Finance Commission. The last Commission had assumed that the losses in 1982-83 would be reduced to 50 per cent by the end of 1988-89. We too have assumed this amount of loss and suitably adjusted it for increases in prices. With regard to milk supply schemes, we have assumed that the receipts would be adequate to cover the expenses and no losses would be incurred. As regards the industrial units run departmentally, we have reckoned a return on capital at the rate of 5 per cent.

(vii) *Other receipts*: All other receipts were projected on the basis of the Eighth Commission's norms. The last Commission had assumed 5 per cent growth of revenues in real terms. Their estimates for 1988-89 were adjusted for price increases and projected to 1989-90 assuming 5 per cent growth in real terms and a price increase of 6 per cent.

Return on Investments in Power Projects

3.17 An activity in which the State Governments have invested heavily is power generation. The total outstanding loans to Electricity Boards and direct investment in Electricity Departments as on 31.3.1989 is estimated at Rs.23639.78 crores. Most of the Boards, however, have been incurring heavy commercial losses (gross operating surplus less depreciation less interest due) year after year. The Planning Commission had projected the commercial losses of the Boards for the Seventh Plan period at a staggering Rs.11,757 crores

(excluding subsidies) at 1984-85 rates. During the first four years of the current Plan the losses are reported to be Rs.7,519 crores, at current rates. In 1988-89, only two SEBs, those of Andhra Pradesh and Maharashtra, are expected to show any commercial profit. (Annexure III.5)

Many reasons have been cited for the poor performance of State Electricity Boards. An important reason is the low operating efficiency and heavy transmission and distribution losses. Apart from this, unrealistic and uneconomic tariff structure which is much below the cost, has also been cited as an important factor. It is essential that a rational pricing policy be pursued to improve the financial results and eliminate the subsidisation of unintended consumers.

These large investments cannot be permitted to continually yield such high negative returns. For, this affects not only their viability, but also the overall availability of resources which are required to be generated for the Plan programmes.

3.18 In fact, the latest amendment (1983) to the Electricity (Supply) Act, 1948 stipulates that the Board shall leave a surplus of at least 3 per cent on its net fixed assets in service after meeting its depreciation and interest liabilities. The Venkataraman Committee (1964) had recommended a return of 11 per cent consisting of 6 per cent as interest on capital, 3 per cent as net profit, 1/2 per cent as appropriation to reserves and a notional 1-1/2 per cent on account of electricity duty. The Rajadhyaksha Committee (1980) recommended that the annual rate of return on the average capital base should be 15 per cent after providing for operating expenses and depreciation.

3.19 Considering the imperative need for generating surpluses from these investments, we, like the Eighth Finance Commission, have assumed that State Electricity Boards would yield a return at the rate of 7 per cent on the estimated outstanding loans (investments) at the end of 1988-89 advanced by the State Governments. In doing so, we have excluded the investments on works-in-progress, and the portion of loans attributable to rural electrification. At the same time, we have also given credit to the sums realised by the State Governments by way of electricity duty. The estimated returns on the investments in power projects by different States are shown in Annexure III.6.

Returns on Investments In Road Transport Undertakings

3.20 State Governments have also made large investments in Road Transport Undertakings. Section 22 of the Road Transport Corporation Act, 1950 states that a Corporation in carrying out its activities shall "act on business principles". The National Transport Policy Committee (1980) suggested that the earnings must at least equal the cost of operations. The Rail Tariff Enquiry Committee (1980) expressed the view that the transport undertakings should yield a reasonable rate of return on capital. The Planning Commission has also stated that the

Road Transport Corporation should yield a return on the capital invested by the State Governments at the rate of 6.5 per cent.

3.21 However, many of the undertakings are not able to recover even their operating expenses, leave alone yielding returns on the investments. Only the Corporations in the States of Andhra Pradesh, Haryana and Rajasthan had any positive surplus after providing for depreciation and interest. (Annexure III.7). The aggregate losses in 1986-87, after providing for depreciation and interest, amounted to more than Rs.170 crores.

3.22 Increasing expenditures have been attributed to the functioning on uneconomic routes, allowing concessional fares to various categories of passengers and providing facilities like shelters on the road side, waiting halls and other civic amenities at bus terminals

3.23 While we fully recognise the above facts, it would not be correct to attribute them to be the principal reasons for the mounting losses. Our examination of the operational ratios indicate that there is tremendous scope for improvement in terms of increasing the fleet utilisation rate and occupancy ratio. Further, the staff-bus ratio in the undertakings ranges from 4 to 24. Overmanning appears to be one of the major causes of the financial plight in some of these undertakings. (Annexure III.8). In spite of successive Finance Commissions pointing this out in their Reports, the performance of the undertakings has not improved, rather has deteriorated.

3.24 Taking into account the fact that these undertakings should be operated commercially but given the reality of their poor financial performance, the Eighth Finance Commission assessed the return on investments made by the State Governments in the Road Transport Undertakings at 3 per cent, after providing for depreciation. In the case of hill States, the State Road Transport Undertakings were required to cover fully their operating costs and interest payments to creditors other than State Governments, after providing for depreciation. We are of the opinion that these norms are reasonable and feasible. The returns on investments have been estimated accordingly for the year 1989-90 (Annexure III.9).

Assessment of Non-Plan Expenditures

3.25 While the revenue receipts are assessed on a normative basis, we cannot introduce much innovation in our assessment of non-Plan expenditures for 1989-90. For reasons already explained, for the year 1989-90, we will have to be satisfied with applying the norms selectively.

3.26 We have, earlier in the report, stressed the desirability of introducing an element of reward and penalty for adherence or otherwise to the norms adopted by the Eighth Finance Commission. Accordingly, we have projected the non-Plan revenue expenditures of the States on the basis of the norms applied by the Eighth

Finance Commission. The Eighth Finance Commission had made the projections of different items of non-Plan expenditures of the States by applying reasonable rates of growth (sometimes quite liberal). Thus, in real terms, expenditure on police services was estimated to grow at 6.5 per cent, on education at 7 per cent and on pensions at 5 per cent.

3.27 Assessment of non-Plan expenditures by applying the Eighth Finance Commission's methodology, however, involves several steps. The base year figures of 1983-84 taken by the Eighth Finance Commission for making projections, in many cases were themselves estimates derived from the revised estimates of 1982-83. The first step, therefore, was to compare these with the actuals of 1983-84, and adjust the estimates for estimational errors in the base year figures. Secondly, the projections made by the Eighth Finance Commission for 1988-89 were in 1983-84 prices and had to be adjusted for price changes. The salary and non-salary portions of expenditures under each of the major expenditure heads were separately adjusted for price changes on the basis of increases in the consumer price index and the wholesale price index, respectively, upto 1987-88. For 1988-89, we have assumed price increases of the order of 6 per cent and converted the Eighth Finance Commission's estimates for 1988-89 into current prices. In applying the price increases for the salary component, an increase in consumer price index over 520, which was the index neutralised by the last Commission has been computed. Then taking the Eighth Finance Commission's projection for 1988-89 at current prices as the base, projections for 1989-90 have been made by assuming a price increase of 6 per cent and increase in expenditures of 3 per cent in real terms. It is here that we would like to state unequivocally that, against the grim fiscal scenario in the country, a concerted effort must be made to contain non-Plan expenditures. New commitments should not be undertaken in the next year and employment on the non-Plan side should be frozen at existing levels, if it cannot be reduced. The creation of any post found absolutely necessary should be accompanied by reduction elsewhere or redeployment from a low priority activity. Every attempt should be made to economise by introducing zero-based budgeting wherever applicable. We consider that the 3 per cent growth in real terms should be adequate to take care of the higher emoluments due to increments and promotions. Expenditures in respect of all items excluding debt servicing, elections, pensions and maintenance of capital assets such as irrigation works, flood control works, roads and buildings and social welfare schemes have been projected for 1989-90 by following the above method.

3.28 It is necessary to mention here that adjustment for price increase has been made on the assumption that for every one per cent increase in the price index, expenditures will increase by 0.75 per cent. In our opinion, this is a reasonable assumption because dearness allowance payments to meet increases in the cost of living do not completely neutralise them for all categories of

employees. Further, neutralisation is limited to basic pay. In fact, the implicit price deflator computed from the estimates of wages and salaries component of public expenditures of the States in India, estimated by the Central Statistical Organisation over the period 1974-75 to 1984-85, shows an increase of 0.75 per cent for every one percent increase in the wholesale price index. Given that salary payments form a very large proportion of non-Plan expenditures of the States, the response of expenditures to price increases assumed by us may be considered realistic. Besides, many items of non-salary expenditures are contractual and do not increase proportionately to increases in prices. It is also necessary to point out that our estimates of expenditures for 1989-90 compare very well with the budget estimates for 1988-89 for most of the States. Considering that the rates of growth of expenditures in real terms allowed by the Eighth Finance Commission were liberal, the adjustment for price increases allowed by us in our assessment would, in our opinion, be adequate.

3.29 An important issue that is usually considered while making the projections is the standardisation of the rates of emoluments and dearness allowances. However, in the case of our projections, as we are taking the Eighth Finance Commission's norms, this issue is relevant only indirectly. In other words, the revision of emoluments and payment of additional dearness allowances by the States enter into our calculations automatically while making adjustments for price increases. As we have accounted for increases in the consumer price index while adjusting the salary component of expenditures, the effect of salary revision and additional dearness allowance payments get subsumed in our exercise. Again, the implicit norms thus adopted by us in respect of emoluments are not discriminatory between the States. We, therefore, do not think it necessary to make any additional provision for emoluments and dearness allowance payments in our projections for 1989-90.

3.30 While major items of non-Plan expenditure can be assessed on the basis of the above methodology, certain items of expenditure, however, require a different basis for projections. Thus, we have projected expenditure on conducting elections in the States where assembly elections are due, on the basis of past expenses per electorate adjusted for price changes. Regular establishment expenditure on the elections has, however, been projected on the basis of the norms laid down by the last Commission as described earlier. The estimated pension payments for 1989-90 have been separately worked out taking into account the liberalisation of pension payments made consequent to the Supreme Court decision and dearness relief given to neutralise price increases. Interest payments have been estimated on the basis of the outstanding loans (excluding overdraft loans), estimated as on 31st March, 1989 and the average rate of interest chargeable thereon. The expenditure incurred under the major head, "Appropriation for Reduction and Avoidance of Debt", has been disallowed.

Maintenance of Capital Assets

3.31 An area requiring urgent attention by the State Governments is the maintenance of capital assets. In the past, emphasis has largely been on creating new assets rather than maintaining the existing assets properly. In fact, maintenance of major, medium and minor irrigation works, flood control works, roads, bridges and buildings has been largely neglected. Money meant for the maintenance was diverted to other purposes resulting in deterioration of capital assets. This has in turn resulted in the under-utilisation of capacity, declining productivity in the economy and eventually, deceleration in economic growth. To translate potential returns into actual returns from these investments, it is essential that adequate attention is paid to this.

3.32 In our opinion, the norms adopted by the last Commission are realistic. Therefore, we have adopted these norms with some adjustments. First, the previous Commission took into account the assets created upto 1983-84. As the Plan ended in 1984-85, we have to take account of additional assets generated in 1984-85, the maintenance of which becomes a part of the non-Plan expenditures in 1989-90. But, since we do not have information on these additional assets, we have assumed that the maintenance expenditure in 1985-86 would increase by the same percentage as the investment in 1984-85 bears to the total of cumulative investment upto the end of 1983-84. Accordingly, we have adjusted the total volume of assets in providing for maintenance expenditure. Second, the normative rate of maintenance expenditure has been adjusted for price increases using the wholesale price index. As in the case of the last Commission, we have provided an additional 30 per cent to the hill States for maintaining their assets in order to neutralise the cost disability.

3.33 Another important area where expenditures have expanded phenomenally in recent years is the realm of social security and welfare schemes. In fact, many of the States have been expanding social security schemes such as old-age pensions, pensions for destitutes and widows and benefits for the unemployed. While not detracting from the merit of these schemes and their usefulness to society in cases where the family as an institution has failed to accommodate the old and the needy, we consider that the States themselves should raise the resources to pursue such schemes. In other words, it would not be appropriate for a State to export the burden of financing such schemes to the residents of other States. Expenditures on such schemes should necessarily be linked to the revenue-raising decisions of the State itself. However, in order not to break continuity, we have allowed expenditures on all the schemes admitted by the last Commission. But increased coverage of existing schemes or any new scheme subsequent to the last Commission's recommendation has not been taken into account by us. For assessing expenditures on these items for the next 5 years, however, it is necessary to state that a fresh look will have

to be taken, in keeping with the application of the normative approach more rigorously.

3.34 In addition to the various social security and welfare schemes, some of the States have been providing food subsidies over and above the subsidy provided for in the Central budget. In some cases, these are merely subsidies for transporting supplies from the central point to far-flung areas. We have taken into account in our reckoning the expenditure on this transport subsidy. However, in the case of special additional subsidisation of food grains, we, like the last Commission, consider that the burden of this should be borne by the respective States themselves and therefore, have not taken it into account in our projections.

3.35 In their assessment of expenditures, the Eighth Finance Commission took into account the committed liability of the Sixth Plan schemes undertaken upto the end of 1983-84. This meant that the liabilities arising from the schemes undertaken during the last year of the Sixth Plan, i.e. 1984-85 had not been taken into account. We have, therefore, provided for the additional committed liability. This has been done by taking into account 30 per cent of the expenditure incurred in 1984-85 and enhancing it at the rate of 6 per cent per year upto 1988-89. This projected additional liability has been added in the place of committed liability estimated by the Eighth Finance Commission for 1988-89. This again has been adjusted for increases in prices by assuming that the salary component of additional committed liability is about 80 per cent of the total committed liability.

Assessment of Revenue Plan Expenditure and Determination of Plan Grants

3.36 Another important issue that we are required to address is the assessment of the revenue component of Plan expenditures and the determination of the Plan grants to the States. The Planning Commission has not yet finalised the size of the Plan for 1989-90 and, therefore, the revenue component of Plan expenditure is not available. We have, therefore, only attempted to put forward a rough estimate of Plan revenue component of individual States. For this purpose, we obtained information from the States on the size of the Plan and its revenue component for the year 1988-89. While we received information on the size of the Plan for all the States, we could not obtain the size of the revenue component for some States. Therefore, for these States, we broke up the total Plan amount for 1988-89 into revenue and capital components on the basis of the proportions available for the previous year, i.e. 1987-88. Having thus estimated the revenue component of the Plan for 1988-89, we have increased it by 10 per cent to arrive at estimates for 1989-90, after detailed consultation with the Financial Resources Division of the Planning Commission. The figure of revenue Plan thus arrived at may be looked upon as the desirable minima.

3.37 Besides broadly estimating the revenue component of the Plan, we are also required to determine

the amount of Plan grants the individual States would receive in 1989-90 in order to arrive at the broad picture of revenue deficit in the States. We estimated Plan grants to individual States after detailed discussions with the Planning Commission. For this purpose, we obtained the allocation of Central assistance to each of the States for the Seventh Plan period at 1984-85 prices and the approved Plan assistance during the first four years of the Plan from the Planning Commission. After suitably adjusting the approved Plan assistance for price increases, we determined the balance of assistance available to the individual States for 1989-90. The balance of assistance thus estimated, was broken up into grant and loan components. Of the grant portion thus computed, we have set apart 5 per cent for the Planning Commission to take care of the special problems of the States when the annual Plans of the States are finalised.

3.38 Our analysis showed that the assistance received by Arunachal Pradesh, Goa and Mizoram (which till 1986-87 were Union Territories) in the first four years of the Plan was more than the originally allocated amount. As they have virtually no resources of their own and as developmental effort in these States should continue, we have taken Central assistance equal to their Plan size and worked out the grant portion of the assistance therefrom.

3.39 With regard to externally aided projects, given the fluctuating nature of assistance and wide inter-State

variations from year to year, we have not ventured to determine the size of assistance and its allocation among the States. This leaves the job of determining the size and allocation of external assistance to the Planning Commission and the Ministry of Finance, thereby imparting an element of flexibility to the operations of the Planning Commission in relation to the financing of State Plans. Similarly, in the case of Centrally sponsored schemes and Special Area Development Plans, we have only taken the total assistance as reflected in the expenditure estimates of the Central Government as given in the forecast of the Ministry of Finance. We have not made State-wise allocation of these figures, leaving this task to the Planning Commission. On our part, we have assumed external assistance at the level of Rs.1000 crores and set off the grant portion of the same against the revenue deficit of deficit States, for the purpose of targeting revenue deficit.

3.39 Before closing this chapter, it is necessary to point out the special adjustments in debt servicing and repayment of loans we have made for some States affected by manmade and natural calamities. In particular, we have made adjustments in our estimates for the relief recommended elsewhere in the report, by way of moratorium on interest payments and loan repayments in the case of advance Plan assistance given to drought affected States, loan given to Madhya Pradesh to provide relief to the people affected by the Bhopal gas tragedy and the special loans given to Punjab to meet the emergent situation in the State.



REASSESSMENT OF THE FORECAST OF THE CENTRAL GOVERNMENT

4.1 In paragraph 4(i) of our terms of reference, we have been called upon to adopt a normative approach in assessing the receipts and expenditures on the revenue account of the Centre and, in doing so, to keep in view its special requirements such as defence, security, debt servicing and other committed expenditure or liabilities.

4.2 In this context, the Ministry of Finance was requested to furnish the Centre's forecast of receipts and expenditures on the revenue account and the capital account for the financial year 1989-90. The forecast was received by us on January 22, 1988. The forecast submitted by the Ministry of Finance was essentially based on the mid-term appraisal of the Seventh Five Year Plan. The forecast for 1988-89 and 1989-90 was related to the base level figure of 1986-87 (RE) and 1987-88 (BE) with the basic assumption of a 5 per cent increase in GDP and a 5 per cent price rise.

4.3 The annual budget of the Central Government for 1988-89 was presented after we had received the forecast from the Ministry of Finance. We found substantial variation between the forecast and the actuals of 1986-87, and revised estimates and budget estimates of 1987-88 and 1988-89 respectively. At our request, the Ministry of Finance submitted a revised forecast for 1989-90, which was essentially based on the budget estimates of 1988-89. This was received by us in the last week of May, 1988.

4.4 For proper appreciation of the estimates given in the forecast we held useful discussions with the Union Finance Secretary and Secretaries of other Departments in that Ministry as also the concerned members of the two Boards in the Department of Revenue handling forecast of direct and indirect taxes. Our discussions with a few other Secretaries including Secretaries in charge of the Ministries of Defence and Home and Departments of Food and Fertilizers were also very useful. These discussions gave us a better insight into the resource constraints and expenditure requirements of the Central Government.

Tax Revenues

4.5 While in the case of the States, revenue receipts can be normatively assessed by making relative comparisons, in the case of the Central Government such comparisons are not possible. Given the vast differences in economic conditions between countries, international comparisons to arrive at normative tax-income ratios also would not be appropriate.

4.6 Although for the individual States the normative estimates have been derived by judging relative performance on the basis of the covariance

model, given that these norms are behavioural, the normative estimates for 1984-85 for the States as a whole approximate the actuals for the year. The rate of growth used by us for assessing the States' tax revenues in 1989-90 is even lower than the trend, as the moderation carried out to the norm, for the undertaxing States has limited normative estimates to the maximum of 15 per cent over the trend estimates. Therefore, we have thought it fair to assess the Central tax revenues largely on the basis of the past trends.

4.7 As already mentioned, the forecast of revenue and expenditure for 1989-90 has been worked out by the Ministry of Finance on the basic assumption of 5 per cent annual growth in both real GDP and prices. Specifically, except for Union excise duties, the forecast of individual taxes was made assuming the growth rates taken in the Mid-Term Appraisal of the Seventh Plan. Thus, the projections assumed a growth rate of 10.5 per cent in respect of income tax, 10 per cent for corporation tax and 12 per cent for customs duties. In the case of Union excise duties, the forecast assumed a growth rate of 8.35 per cent as against 9 per cent taken for the mid-term appraisal of the Seventh Plan. Against these, the long term trend rates of growth for the period 1974-75 to 1986-87 are 8.5 per cent for income tax, 13.09 per cent for corporation tax, 13.14 per cent for Union excise duties and 20.34 per cent for customs duties. Accordingly, the tax receipts for 1989-90 have been reassessed by applying these trend rates of growth on the base of 1987-88 (RE). In doing so care has been taken to see that the growth rate of 15 per cent was achieved for the aggregate tax revenues for 1989-90 as compared to long term growth rate of 14.5 per cent. After adjusting our estimated figures of Central excise and custom revenues on the basis of anticipated outgoes from these taxes in 1989-90, their reassessed estimate for that year came to Rs. 20,670 crore and Rs. 18,529 crore, respectively as against Finance Ministry's forecast of Rs. 19,675 crore and Rs. 17,501 crore. In respect of income tax and corporation tax, the estimate given in the forecast implied gross receipts of Rs. 4,045 crore and Rs. 4,509 crore, respectively, as against Rs. 3,915 crore and Rs. 4,630 crore reassessed by us. In the aggregate, the reassessed total tax revenues work out to Rs. 49,000 crore, as against the estimate of Rs. 46,874 crore given in the forecast of the Ministry of Finance.

Non Tax Revenues

4.8 Interest receipts on the loans advanced by the Central Government, dividends from public sector enterprises and profits from other bodies like Reserve Bank of India, the nationalised banks and Life Insurance Corporation of India are the most important items of non-tax revenue. Interest receipts come mainly from the

railways, telecommunications, public sector enterprises and government employees. The Ministry of Finance has forecast the aggregate interest receipts at Rs.7,906 crore. This estimate is consistent with the norm of 7 per cent rate of interest prescribed by the Eighth Finance Commission on the loans outstanding to the public sector enterprises. We have elsewhere recommended to grant moratorium on the interest payments by some States on loans given as a part of advance Plan assistance for drought relief, special loans given to Punjab and interest waiver loans given to Madhya Pradesh to provide relief to Bhopal gas victims. The estimated amount of interest on which there will be a moratorium/waiver is Rs. 244 crore. Therefore, we have adjusted downward our reassessed interest receipts by the Centre by this amount. Accordingly, we have taken the figure of interest receipts for 1989-90 as Rs.7,662 crore.

4.9 We have reassessed income from dividends and profits at Rs.2,133 crore, against the forecast of Rs.629 crore given by the Ministry of Finance. The major upward revision is in respect of dividends from public sector enterprises. In this connection, we may recall that the Eighth Finance Commission considered all Central enterprises together for estimating dividends on Centre's equity investments though they classified the public sector undertakings of the States into promotional, financial and commercial undertakings and assumed different rates of return from them. The Eighth Finance Commission had also decided that the investment in public sector enterprises should yield a minimum dividend of 6 per cent. The Eighth Finance Commission's estimate of 6 per cent was made in the backdrop of the Seventh Finance Commission's norm of 7.5 per cent and the rate of return envisaged in the pattern of financing the Sixth Plan of 8 per cent rising to 10 per cent. Accordingly, in our reassessment, we have assumed 6 per cent rate of return on the outstanding investments made in the public sector enterprises. On this basis, in the reassessment, receipts from dividends and profits excluding investments in enterprises under construction have been taken at Rs. 2,133 crore as compared to the estimates of Rs. 629 crore in the forecast. The officials of the Ministry of Finance have tried to impress upon us that it would be unrealistic to adopt the rate of return assumed by the Eighth Finance Commission for 1989-90, because, in the short run, performance of these enterprises cannot be improved to yield this return. However, we are unable to agree with this view because the Eighth Finance Commission had fixed these norms more than four years ago. Moreover, in our reassessment of States' resources we have, by and large gone by the norms fixed by the Eighth Finance Commission.

4.10 The vast investments made in the public enterprises by the Government of India should yield a reasonable return by way of interest and dividends. The public enterprises should generate surpluses and contribute to the mainstream of development. We view profit making by the public enterprises as quite consistent with their social purposes. In this context, we cannot but

express our deep concern about the low returns on the huge investments made in public sector enterprises. We believe that financial profitability should be an important yard-stick for evaluating the enterprises. The public sector is required to be an engine of growth, rather than a drag on government resources. The present profile of the public sector which is marked by low, quite often negative, return is untenable. A hard look at some of these undertakings, particularly those in the non-core sector with unenviable financial track-records, is long overdue. The government cannot afford to keep these unproductive units for long without seriously impairing its own financial interests. The government should seriously consider withdrawing from non-profit making activities in non-priority areas so as to concentrate on the basic functions in the core sector. The government's responsibility and budgetary support should, by and large, be restricted to the core enterprises. Possibilities should be pursued for restructuring and phasing out loss making enterprises in the non-core sector by an appropriate package of measures.

Revenue Expenditure

4.11 Most of the items of non-Plan expenditure have been projected by the Ministry of Finance by assuming 10 per cent growth rate over the budget estimates of 1988-89. Against this, in our reassessment, we have estimated non-Plan revenue expenditure by applying long term growth rates worked out for the period 1974-75 to 1986-87 over the base level figures of 1987-88 (RE) to arrive at the estimates for 1988-89. The projections for 1989-90 have been made by applying a growth rate of 9 per cent to the estimates of expenditure arrived at for 1988-89 (3 per cent real growth rate plus 6 per cent annual increase in prices). This method has been followed in respect of different items of non-Plan revenue expenditure except in the case of interest payments and subsidies.

4.12 Defence expenditure constitutes an important item of revenue expenditure, next only to interest payments. While applying the long term rate of growth to reassess the expenditure on defence, we have also kept in view our discussions with the Finance Secretary, the Defence Secretary and senior Service Officers. The reassessed figure of Rs. 10,824 crore arrived at by us is lower than the forecast of the Ministry of Finance by Rs. 37 crore only.

4.13 Interest payments constitute another important item of non-Plan revenue expenditure. The forecast of the Ministry of Finance for this item is Rs. 17,000 crore. The Ministry's officials have explained to us that interest payments have been growing at an accelerated rate and in recent years the rate of growth has been more than 20 per cent. We have, therefore, accepted the forecast of interest payments given by them at Rs. 17,000 crore. We cannot leave this subject without observing that gross interest payments have been climbing rapidly and in 1989-90 they would constitute around 35 per cent of the non-Plan expenditure assessed by us. This reflects both the

growing indebtedness and the high cost of borrowing and deserves to be avoided in the interest of sound finance.

4.14 We consider that the expenditure on subsidies must be contained if any dent is to be made on Centre's revenue deficit in 1989-90. Though separate estimates for subsidies are not given in the forecast submitted by the Ministry of Finance, on the basis of their projections, the total expenditure on subsidies in 1989-90 would be of the order of Rs. 8,048 crore. In this connection, it is pertinent to refer to the observations of some of the previous Finance Commissions in respect of different subsidies. The Seventh Finance Commission had assumed a progressive decrease in fertiliser subsidy reducing it to nil by 1983-84. The Eighth Finance Commission had noted that these expectations had not materialised. It had projected an increase in the quantum of fertiliser subsidy taking into account the likely increase in production in the period of the award but it did not make any provision for increase in the quantum of subsidy due to further increase in the production costs of fertilisers. The Commission suggested that any such increase should be suitably absorbed by the issue price of fertilisers. We find that the Ministry of Finance forecast of fertiliser subsidy for 1989-90 is Rs. 3,300 crore against the 1988-89 budget estimate of Rs.3,000 crore. Thus, the Central Government has not been able to adhere to the recommendation of the Finance Commissions and the targets set out in the Long Term Fiscal Policy. We discussed with the Secretary, Department of Fertilisers the possibilities of containing fertiliser subsidy. We have received a number of suggestions from him in this regard. Some of these are indexation of issue price of fertilisers with the rise in the cost of production, supply of inputs like gas, petroleum products and coal at concessional prices, revision of the method of calculation of depreciation allowance while determining the retention price, refixation of the capacity utilization norms taking into consideration the factors of feed-stock and vintage, and reduction of customs and excise duties on machinery for fertiliser projects and on fertiliser inputs. We can see that some of these suggestions, if accepted, will have an adverse impact on Centre's resources, offsetting the savings made in the quantum of fertiliser subsidy. Even then, we are of the view that these suggestions should be carefully considered by the Central Government as a policy package. We are quite convinced that a stage has come when any further growth in the fertiliser subsidies should be severely restricted. We shall consider this question in our second report. For the present, we are not allowing any growth in the expenditure on this item for 1989-90. Accordingly, we have limited the expenditure on this item in 1989-90 to the level of Rs.3,000 crore which is the budget estimate for 1988-89.

4.15 As regards food subsidy, the Seventh Finance Commission had assumed that it would be reduced by 25 per cent in 1983-84 below the levels existing in 1979-80. As in the case of fertiliser subsidy, the Eighth Commission had noted that this had actually not

happened. During our meeting with Secretary, Food, we drew his attention to the fact that while the Eighth Finance Commission had envisaged a growth rate of 2 per cent in the expenditure on food subsidy, the growth between 1984-85 and 1988-89 is seen to have been of the order of 22 per cent per annum in nominal terms. While appreciating the need for containing the expenditure on food subsidy, Secretary, Food urged us to consider the question of food subsidy in the light of the government's declared policy relating to procurement of foodgrains and their supply at subsidised prices. As a matter of fact, the policy was to bring more and more people within the subsidy scheme and therefore the amount of subsidy was bound to go up. We were also informed that it was not feasible to reduce food subsidy by denying the benefit of the scheme to certain sections of the people by fixing the eligibility criterion on the basis of income. If the income level was kept low, it would exclude a very large section of the people including Group D employees and increase the expenditure on dearness allowance on account of increase in the cost of living. If income level was kept high, the exclusion gains would be outweighed by higher administrative costs of implementation and enforcement. We had discussed this matter with the Union Finance Secretary also. But our impression from all these discussions is that the Central Government does not have any immediate policy plan which could help it to contain the food subsidy in 1989-90. We are, however, of the view that the best way to contain food subsidy during 1989-90 would be to apply the Eighth Finance Commission norm of allowing the subsidy to grow by 2 per cent in real terms. We expect that here administrative efficiency, supplemented by upward adjustment in issue price to the extent absolutely necessary would absorb cost increases due to price rise. This should broadly take care of the incremental expenditure on food subsidy. The reassessed figure of expenditure on this basis comes to Rs. 2,346 crore against a forecast of Rs.2,530 crore.

4.16 As regards export subsidy, the forecast of the Ministry of Finance is based on a 10 per cent step-up over the budget estimate of Rs. 1,091 crore in 1988-89. Keeping in view the imperative need to encourage our export efforts, we consider the figure of Rs. 1,200 crore estimated by the Ministry of Finance as reasonable and therefore we accept it. For other subsidies, we do not propose to allow any growth over the budget estimate for 1988-89. This would mean an expenditure of Rs. 925 crore in 1989-90 against the Finance Ministry forecast of Rs.1,018 crore.

4.17 The forecast for other items of non-plan revenue expenditure in 1989-90 is Rs. 24,414 crore against the 1988-89 budget estimate of Rs. 20,629 crore. The rate of growth assumed in the forecast thus works out to 18.35 per cent. As already indicated in our reassessment of items of non-Plan revenue expenditure other than interest payments and subsidies, we have applied long term growth rates (1974-75 to 1986-87) to 1987-88 (RE) to arrive at estimates for 1988-89. A further

growth rate of 9 per cent has been applied to them to project the same to 1989-90. On this basis, the reassessed estimate of revenue expenditure in respect of items other than interest and subsidies works out to Rs. 23,361 crore. The estimate so worked out also provides for the anticipated price increase in 1989-90. We have, therefore, felt it necessary to deduct from this an amount of Rs. 800 crore which we have separately provided for meeting additional dearness allowance expenditure in 1989-90. Therefore, the revenue expenditure on various items other than interest, subsidies and provision for dearness allowance is reassessed at Rs. 22,561 crore. A certain amount of belt-tightening and economy through a more rigorous application of zero-base budgeting and efficiency and productivity parameters is implicit in the real rate of growth of 3 per cent in the non-Plan expenditure assumed by us. It is imperative to follow this discipline if the revenue deficit has to be brought down.

Non-Plan Revenue Surplus

4.18 On the basis of the reassessment of Centre's resources made by us on the lines indicated above, both in respect of revenue receipts and revenue expenditure, non-Plan revenue surplus for 1989-90 works out to Rs. 16,868 crore as against Rs. 9,757 crore implied in the estimates given in the forecast by the Ministry of Finance.

4.19 Our terms of reference enjoins us to examine and reassess the expenditure on Centre's Plan revenue account also. Centre's Plan expenditure on revenue account includes expenditure on its own Plan, expenditure for providing grants for States' own plans and grants for Central Sector Schemes as well as Centrally Sponsored Schemes undertaken by them.

4.20 While reassessing the Plan expenditure on revenue account for 1989-90, we have been guided by the objective of bringing down the deficit on revenue account to zero by 1994-95. As per our terms of reference, we should also try to generate surplus in the revenue account for capital investment. As this objective cannot be achieved in 1989-90, we propose to go into this aspect in our second report. We, however, believe that a modest beginning should be made in this direction in 1989-90. We have recommended elsewhere in our report

a total devolution of Rs. 11,785 crore and grants amounting to Rs. 1,878 crore for 1989-90. The Ministry of Finance in their forecast have proposed a figure of Rs. 11,774 crore for Plan expenditure on revenue account. This is based on a 10 per cent step-up over the annual Plan provision in 1988-89. This includes Rs. 8,303 crore for grants to States and Union Territories for their own plans and for Central Sector and Centrally Sponsored Schemes. We have allowed the step-up proposed by the Ministry of Finance except that we have provided for Rs. 7,728 crore for grants to States and Union Territories. We have discussed the details of our estimation under the chapter dealing with the reassessment of the States' forecasts. On this basis, the overall revenue deficit of the Central Government in 1989-90 is estimated to be Rs. 7,994 crore constituting 1.92 per cent of the projected GDP of Rs. 41,685 crore in that year.

4.21 Before leaving the subject we would like to stress that one of the areas where revenue expenditure on the Plan side can be reduced is Centrally Sponsored Schemes. The Centrally Sponsored Schemes have grown in volume and number over the years. As of April, 1985, the schemes under implementation were as many as 262. The outlay of Rs. 18,000 crore approximately on these schemes accounted for about 80 per cent of Central assistance provided for the State Plans during the Seventh Five Year Plan. This has happened in spite of States' objection to their proliferation and the decision of NDC in 1979 to roll them back to the level of 1/6th of Central assistance for States' Plans by hacking away schemes costing a total of Rs. 2,000 crore. More recently, the National Development Council (NDC) after considering the Ramamurti Committee Report in November, 1985, had set up a Committee headed by the then Union Minister for Human Resources Development to go into this matter. This Committee had, in turn, constituted a group of officials whose recommendations favour retention of most of the schemes. We feel that while preserving the schemes of national importance and those contributing to human resources development such as poverty alleviation and family planning, it is possible to achieve economy in expenditure in 1989-90, of almost Rs. 500 crore, by reducing some of the schemes and/or by dropping some others altogether.

INCOME TAX

5.1 Paragraph 3 (a) of the Presidential Order requires us to make recommendations on "the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds". Taxes on income other than agricultural income are levied and collected by the Government of India and are compulsorily shareable between the Union and the States under Article 270(1) of the Constitution. The proceeds attributable to Union Territories, taxes payable in respect of Union emoluments, corporation tax and the surcharge levied for purposes of the Union are kept out of the divisible pool by virtue of the provisions contained in clauses (2), (3) and (4) of Article 270 and Article 271 of the Constitution. Article 270, read with Article 280(3) of the Constitution requires the Finance Commission to make recommendations on the following matters relating to income tax :

- (a) the percentage of 'net proceeds' of income tax to be assigned to the States;
- (b) the allocation of shares of each of the States in the divisible pool;
- (c) the percentage of the 'net proceeds' which shall represent the proceeds attributable to Union Territories.

5.2 This report relates to the year 1989-90 which is the terminal year of the Seventh Five Year Plan. We would like to reiterate that our approach and recommendations for the year 1989-90, however, should not be construed as determining our approach and methodology or the likely conclusions for the five year period in our second report.

5.3 We summarise below the State Governments' submissions to us through memoranda and oral representations. First, there was a universal demand for sharing corporation tax revenues, by amending the Constitution, if necessary. It was pleaded forcefully that corporation tax is nothing but an income tax on corporate entities which was shareable until a change in definition was made by an amendment to the Income Tax Act in 1959. The States also argued that corporation tax has proved to be a far more buoyant source of revenue; its sharing has been favoured by successive Finance Commissions; that its denial has become an irritant in Centre-State fiscal relations; and that, pending amendment of the Constitution, the Finance Commission should recommend grants to the States corresponding to their shares. There was also a pointed reference to the recommendation of the Commission on Centre-State Relations (Sarkaria Commission) on this matter. While

taking note of the intensity of feeling of the States in the matter, we would like to recall that the States were compensated for the loss arising from the amendment to the Income Tax Act in 1959 by means of annual grants of Rs.3.46 crore, Rs.24.15 crore and Rs.20.18 crore in the years 1959-60, 1960-61 and 1961-62 respectively, as noted by the Third Finance Commission. Further, in consideration of the shrinkage of the divisible pool as a result of the amendment to the Income Tax Act, the share of the States was raised from 60 per cent to 66 2/3 per cent by that Commission and excise devolution was also enhanced. We can go into this question only when it is referred to us by the President under Article 280(3)(c) of the Constitution and it has not been so referred. The sharing could be considered with a view to diversifying and broadening the base of the taxes to be shared with the States in order to even out fluctuations and to provide a more assured and predictable basis for States' revenue receipts. However, the sharing of corporation tax would not automatically mean an enlargement of the divisible pool since the size of the pool would be determined by the ability and need of both the Centre and the States assessed normatively. It may in fact result in a reduction in the existing percentage of devolution of income tax and excise duties. We propose to return to this matter in greater depth in our second report.

5.4 The second point relates to the levy of surcharge, which the Central Government withdrew in 1985-86 in deference to the recommendations of the last Commission. The State Governments contend that the surcharge, which was reintroduced in 1987-88, benefits only the Central Government although it is intended to raise resources for meeting the additional expenditure liability arising out of drought. Several State Governments argued that as they themselves are required to provide relief and bear the additional financial burden, they should be given a share of the proceeds of the surcharge on income tax. The Governments of Madhya Pradesh, Maharashtra and Uttar Pradesh pleaded that the surcharge, if continued beyond drought conditions, should be merged with the basic tax. Some States suggested appropriate amendments to the Constitution to make the surcharge shareable. We share the view of the previous Commission that a surcharge continued indefinitely could well be called an additional income tax and, therefore, becomes shareable with the rest of the proceeds of income tax.

5.5 Several State Governments have pleaded before us that the tax on Union emoluments should also be shared. The Government of Maharashtra has argued that keeping this portion outside the divisible pool is not only flawed but also unjust. If the rationale underlying this is taken to its logical conclusion, the tax payable in respect of

different State emoluments should also revert to the respective State as a first charge on the proceeds. As this is quite cumbersome to do, the State Government pointed out that the tax attributable to Union emoluments should form part of the net distributable proceeds by amending the Constitution.

5.6 The Government of Tamil Nadu brought before us an interesting and a relatively recent development in income tax law. It said that the Government of India has recently acquired powers to make pre-emptive purchase of properties in major cities. The transactions relating to the pre-emptive purchase of immovable properties are booked under Major Head No.4059 - Capital Outlay on Public Works as net of recoveries. Thus the receipts on account of sales of the acquired properties by the government are also adjusted under the same head as reduction of expenditure. The budget provision envisaged an expenditure of Rs.30 crore net of recoveries in 1987-88. The State Government feels that the Centre is reckoning the pre-emptive purchase and sale of acquired properties as a continuous transaction under the capital account. It is indeed so, as would appear from the fact that the Central Government proposes to extend the scheme to more cities. As the pre-emptive purchase and sale of each property is bound to result in net savings to the Central Government, the capital account in respect of this transaction would only show a *minus* debit and not a *net* debit. The receipts from the sales represent accretions to capital gains, though the beneficiary may be the Central Government. Since capital gains tax forms part of the divisible pool of income tax, the State Government has suggested that the Finance Commission recommend accounting the net proceeds from the transactions under capital gains tax for sharing purposes. We consider that the Comptroller and Auditor General of India is the designated authority to advise the President on the correctness of classification of accounts, in terms of Article 150 of the Constitution. It is only appropriate that he should be consulted on the method of accounting to be adopted. In any event, as the Comptroller and Auditor General is vested with the right to certify, as final authority, the 'net proceeds' of income tax by virtue of Article 279 of the Constitution, we would leave it to him to prescribe the correct procedure in this matter.

5.7 Some State Governments expressed dissatisfaction with the apportionment of cost of collection between income tax and corporation tax in the ratio of 7:1. Following the suggestion of the last Commission that the method of allocating the cost of collection be reviewed by an Expert Committee, the Government of India set up such a Committee in 1985, with the Deputy Comptroller & Auditor General of India as the Chairman. The Expert Committee consisted of Finance Secretaries of certain States and officers of the Ministry of Finance. The Committee submitted its report in February, 1986. The Expert Committee concluded that the existing ratio of 7:1 between income tax and corporation tax is reasonable and should be continued.

5.8 Several State Governments have questioned this conclusion as also the manner in which this Committee went about its work. We have considered this matter. It would appear from the report of the Committee that it did not have access to certain factual data relating to the work load in tax assessment and had to use proxies. Besides, the findings of the Committee have become somewhat dated now by developments such as the introduction of summary assessment which should significantly reduce the work load of individual assessments. One has also to keep in view the relative complexity in assessing the returns relating to corporation tax which involve greater work load on account of stricter scrutiny and interpretation of several exemption provisions. We, therefore, feel that there is need to re-examine the entire matter taking into account factors such as new simplified procedures of assessment and the nature and complexity of the cases involved under the respective taxes.

5.9 The Eighth Finance Commission recommended that receipts from 'penalties' and 'interest recoveries' under the head 'Miscellaneous Receipts' should be included in the divisible pool of income tax. The Government of India has not accepted this recommendation. On pursuing this and other recommendations of the previous Commission, we were informed that the Ministry of Law, to which a reference was made by the Ministry of Finance, reiterated its earlier stand taken in February, 1979 that although interest and penalty are payable under the Income Tax Act, they are distinct from income tax. We are not in agreement with this approach. We are concerned that the recommendation of the Eighth Commission in this regard has not even been laid before each House of Parliament together with an explanatory memorandum as required under Article 281 on the plea that only major operative recommendations of the Finance Commission are placed before the Parliament. Article 281 does not make any distinction as to the nature of the recommendation of the Finance Commission. The Commission examined the matter *de novo*. We found that the contention of the Law Ministry on this point that 'penalties' and 'interest recoveries' were distinct from income tax was not tenable in view of the clear pronouncements by the Supreme Court.^{1/} The Supreme Court held in the case of Anwar Ali that "there was no essential difference between tax and penalty because the liability for payment of both was imposed as a part of the machinery of assessment and the penalty was merely an additional tax imposed in certain circumstances on account of assessee's conduct." The true nature of penalty has been held to be additional tax in the case of C.A. Abraham also. The Supreme Court also regarded "penalty as an additional tax imposed upon a person in view of his dishonest or contumacious conduct" in the case of Bhikaji Dadabhai and Co. The Commission had also

1/ (i) C.A. Abraham 1961 (41) ITR 425 SC.

(ii) Bhikaji Dadabhai & Co. 1961 (42) ITR 123. SC.

(iii) Anwar² Ali 1970 (76) ITR 696. SC.

addressed a letter (Annexure V.1) in February, 1988 to Ministry of Finance in which the legal status of 'penalty' was spelt out in detail. The Commission did not receive any reply to this communication. After detailed examination of all the relevant matters, we are of the considered view that it would be unfair to deny the States their legitimate share in 'penalties' and 'interest recoveries' on the *ipse dixit* of the Law Ministry. We, therefore, reiterate the last Commission's recommendation that receipts on account of 'penalties' and 'interest' recoveries should form part of the divisible pool of income tax.

5.10 Under Article 270(3) of the Constitution the share of Union Territories has to be prescribed. The last few Commissions have been treating the Union Territories as though they were one State and allocating a share to them accordingly. Since the last Commission, the number of Union Territories has come down with Arunachal Pradesh and Mizoram getting full Statehood. Of the Union Territory of Goa, Daman and Diu, Goa has become a State. Thus when the last Commission gave its report, there were 22 States and 9 Union Territories. Now there are 25 States and 7 Union Territories.

5.11 Following the principle adopted by the earlier Commissions, we also propose to treat the 7 Union Territories as one unit for the purposes of our scheme of devolution. We notice that the Government of Nagaland has stated in its memorandum that setting apart a certain percentage of net proceeds of income tax for Union Territories be discontinued or the percentage be lowered in view of the fact that Union Territories draw funds from the Consolidated Fund of India. The Government of Nagaland seems to have made a similar representation to the last Commission as well. As the Constitution enjoins that a share be given to Union Territories, it is necessary that we prescribe a share of the net proceeds to Union Territories. For this purpose, we have taken all the Union Territories notionally together as a unit, and on this basis, we prescribe the share of Union Territories at 1.044 per cent.

5.12 Sikkim is a State to which the Income Tax Act, 1961 does not apply. It is, therefore, not entitled to any share in the net proceeds of income tax. However, if, at a later stage, the State desires to fall in line with the rest of India, it will have to be assigned a share. Therefore, the State-wise allocations are required to be made on two considerations: (i) with Sikkim included, and (ii) with Sikkim excluded. This will take care of the contingency in case the Income Tax Act, 1961 is extended to Sikkim during the period covered under this report.

5.13 Almost all State Governments have asked for enlargement of the States' share beyond the present level of 85 per cent which was prescribed by the Seventh Finance Commission and retained by the Eighth Finance Commission. In fact, the Government of Nagaland has argued that if the proceeds from corporation tax are not shared, then it is just and fair that the entire net proceeds of income tax are given to the States and no portion be kept

with the Centre. On the other hand, the Governments of Gujarat and Arunachal Pradesh have suggested retention of the States' share at 85 per cent. The Government of Maharashtra has argued that in order to sustain the interest of the Central Government in income tax, the States' share could be reduced to 75 per cent. At the same time, the State Government has demanded that the Constitution be amended so that 20 per cent of the receipts from corporation tax could be assigned to the States in addition to 75 per cent of income tax. However, the State Government has pointed out that, pending amendment of the Constitution, the share might be retained at 85 per cent. The State Governments of Uttar Pradesh and Madhya Pradesh have argued for raising the level of States' share to 95 per cent, the former stating that the balance of 5 per cent is sufficient for the Centre to hold its interest in the collection of the tax. The Governments of Bihar, Andhra Pradesh and Tamil Nadu have suggested raising the share to 90 per cent. Each State Government has given its reasons in support of the suggestion. The Government of Bihar has observed that the various measures taken by the Central Government have had the effect of limiting the yield of income tax. Indeed, the Government of Maharashtra has demanded that the State Governments should be taken into confidence before granting any tax concession since their interests are vitally affected.

5.14 Before we discuss the matter of the devolution of income tax, we should like to deal with the general principles of devolution of taxes. The principles of devolution of income tax and Union excise duties have gradually evolved over the years as a result of the recommendations of successive Finance Commissions. Each Commission has tried to respond to changing needs to improve the manner of distribution in the light of experience.

5.15 Three major questions have to be decided in relation to devolution of taxes. First, what should be the percentage shares of income tax and Union excise duties that should be devolved on the States? Second, should the same or different principles be applied for the distribution of the shared portion of the two taxes among the States? And third, what should be the principles of distribution?

5.16 The percentage share of the divisible pool has been gradually rising over the years in respect of both taxes. The divisible pool of income tax had already reached 85 per cent under the recommendations of the Seventh Finance Commission (1979-80 - 1983-84). It is generally felt that it would be counter-productive to increase the States' share beyond 85 per cent as ever now, the very small percentage share accruing to the Central Government gives it little incentive to raise additional revenues from this source. As regards Union excise duties, 40 per cent of the duties are included in the general devolution formula and an additional 5 per cent is being distributed to the deficit States in proportion to their assessed revenue deficits under the recommendations of

the Eighth Finance Commission. As mentioned above, almost all the State Governments have asked for enlargement of the States' share beyond the present level of 85 per cent prescribed by the Eighth Finance Commission. In considering this matter, we have to keep in view the legitimate needs of the Centre and also take a decision on whether any increase in the volume of transfers that may be considered necessary, should take the form of additional devolution of taxes or increased grants-in-aid. These questions require detailed consideration which we shall undertake in our next report. Since 1989-90 is the last year of the Seventh Five Year Plan, we would not like to recommend any increase or decrease in the proportion of resources transferred by way of devolution of taxes. We, therefore, recommend that the States' share of income tax be retained at the prevailing level of 85 per cent of the net proceeds of income tax for 1989-90.

5.17 Next we come to the question of prescribing the criteria for determining the shares of States *inter se*. Traditionally, the proceeds of income tax have been distributed among the States on the twin criteria of 'population' and 'contribution'. The weightage given to contribution varied between 10 per cent and 20 per cent and that for population between 80 per cent and 90 per cent. The last Commission made a major departure and injected progressivity into the devolution scheme for income tax. The criteria adopted by the last Commission provided a pronounced weightage in favour of backwardness and unified the formulae for distribution of excise duties and income tax.

5.18 The States have suggested various factors to be considered with diverse mix of weightage. The Government of Gujarat has argued in favour of raising the weightage for 'contribution' to 20 per cent while the Government of Maharashtra has proposed that it be taken upto 45 per cent. Madhya Pradesh and Rajasthan would like us to assign high weightage to geographical area for determining the shares of the States, and the poorer States like Bihar, Orissa and Uttar Pradesh require us to allocate significant weightage to economic backwardness.

5.19 On our part, for reasons stated earlier, we do not want to make any radical departure for 1989-90. We, therefore, intend to follow the general pattern prescribed by the Eighth Finance Commission reserving only 10 per cent of the tax to be distributed on the basis of contribution and the rest of the share of income tax and Union excise duties being distributed on the basis of uniform criteria. The factor of contribution would take into account the assessment of income tax for the years 1982-83 to 1984-85. The State-wise data obtained by us from the Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, is shown in Annexure V.2.

5.20 The portion of the divisible pool of income tax remaining after the distribution of 10 per cent on the basis of contribution and the 40 per cent share of Union excise duties are, according to the recommendations of the

Eighth Finance Commission, being distributed in the following manner:

- (i) 25 per cent on the basis of population in 1971;
- (ii) 50 per cent on the basis of distance of the per capita income of the State from the highest per capita income State multiplied by the 1971 population of the concerned State; and
- (iii) 25 per cent on the basis of inverse of per capita income of the State multiplied by 1971 population (income adjusted total population formula).

5.21 It was the general feeling of the Commission that the per capita SDP of a State by itself does not adequately reflect the capacity and financial needs of that State. Although per capita income may be the best summary measure for judging the relative positions of the different States, the use of some supplementary norm might enable us to capture other relevant factors and thus achieve greater equity *inter se* in the allocation of shared taxes.

5.22. The Fifth Finance Commission took into account five different factors to represent backwardness which was used as a criterion along with population for the distribution of Union excise duties. The Seventh Finance Commission, assigned equal weights to four factors, namely, population of the State in 1971; the proportion of poor people in a State to total population of the poor in the country, the inverse of per capita income multiplied by the population of the State in 1971, and a revenue equalisation formula. The Eighth Finance Commission did not continue the use of the proportion of people below poverty line as one of the criteria partly because it had been pointed out that State-wise data on the proportion of the poor were not reliable. Apart from that, it was their view that the use of this criterion was inappropriate. Their argument is reproduced below:

"We have scrutinised the estimates of the poor in each State by using the formula of the Seventh Finance Commission and those made by the Planning Commission for the purposes of the 1980-85 Plan. A peculiar feature of these estimates is that in the hill States and the States like Rajasthan which are undoubtedly poor and backward, the percentage of poor is relatively small. To what extent the policies of the State Governments resulting in maldistribution of incomes are responsible for accentuation of poverty conditions particularly in the case of States which have a high per capita income, is another important question which is to be considered in this connection. More important is the fact that the estimates of the poor can vary depending on the concept of poverty used. It is, therefore, not surprising that many States have expressed doubts about the reliability of data and the methodology used for the estimation of these poverty ratios." (Para 6.33)

The Eighth Finance Commission also pointed out that

a majority of States, including some of the backward and poor States, did not favour the use of this criterion.

5.23 Although there are limitations to the available data on the distribution of poor among the States, we understand that the estimates in this regard made by the Planning Commission are being used for the allocation of the major part of funds to the States for financing anti-poverty programmes.

5.24 While there is weight in the arguments advanced by the Eighth Finance Commission, the consensus in this Commission is that the exclusive use of per capita income in addition to population would also not be appropriate because this measure does not adequately capture or reflect the state of well-being or otherwise among the majority of population of the States. It is true that a State with high per capita income does have the potential to mitigate the poverty of its less fortunate citizens and persistence of poverty could be traced partly to lack of will or inefficiency on the part of the State Government concerned. However, the incomes of the rich residents of various States are also subject to Central taxes and the States' capacity to tax them gets accordingly limited.

5.25 It could well be argued that if a criterion in addition to per capita income and population should be used, it should be some other appropriate indicator of backwardness and not the relative number of poor people in a State. However, we do not have any other composite index of backwardness readily available for use in our first report. We propose to have a dialogue with the State Governments on this matter and also consult leading economists and other experts who can advise us. We hope to be able to evolve a suitable index which could be considered for use in making our recommendations for the five year period (if ultimately we are led to use the proportion of poor people, we should then have to strengthen the data base). For the year 1989-90, for want of a better index, we have decided to use the proportion of people below poverty line as an additional criterion. However, since we have not had full round of discussions with all the States and apprehensions have been expressed about the reliability of the data on inter-State distribution of the poor, we have decided to assign only a small weight to this criterion. We recommend that 90 per cent of the shareable proceeds of income tax and 40 per cent of the net proceeds of Union excise duties be distributed among the States in the following manner:

- (i) 25 per cent on the basis of population in 1971;
- (ii) 50 per cent on the basis of distance of the per capita income of a State from the highest per capita income State multiplied by the 1971 population of the State concerned;
- (iii) 12-1/2 per cent on the basis of inverse of per capita income of a State multiplied by 1971 population; and
- (iv) 12-1/2 per cent on the basis of proportion of poor people in the State to the total number of poor

people according to the estimates for 1983-84 made by the Planning Commission. (Annexure V.3).

5.26 Several State Governments represented before us, as they did before our predecessors, that use of 1971 Census data by the Commission where population is a factor in determining the devolution of taxes and duties and grants-in-aid, is inappropriate now as it does not fully take into account the present needs of the States.

5.27 We have given careful consideration to this observation of the State Governments. While examining this matter, we cannot ignore the fact that some States have made good progress in implementation of the family planning programme between 1971 and 1981. Besides, we consider that promoting family welfare measures, including planned parenthood and small family norms, is a matter of paramount national importance. We are of the view that this desirable national objective should be accorded due recognition and encouragement. If we were to take 1981 Census figures instead of 1971 population data, the respective shares of the States will change (within the same overall quantum of devolution) to the detriment of the States that have been more successful in implementing the family planning programme. We are accordingly adopting the 1971 Census figures in our devolution package.

5.28 While working out the distance of per capita income, our methodology would be the same as given by the last Commission, except for the following modifications:

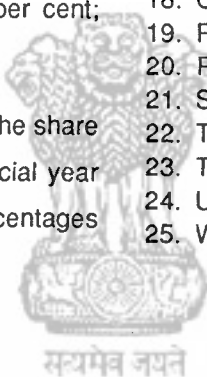
- (i) the per capita income would be computed by taking the material for the latest three years, namely, 1982-83 to 1984-85 for which comparable State Domestic Product data are available;
- (ii) according to the statistical data on State Domestic Product, Goa emerges as the State with the highest per capita income. We, however, do not consider Goa as a representative State for the purposes of measuring the distance of per capita income among the States, since it is too small in area and population. Besides, the data for State Domestic Product for Goa are available for only two years. Taking all the relevant factors into consideration, we have adopted Punjab, which has the second highest per capita income, as the highest per capita income State for purposes of measuring the distance factor. At the same time, in order to protect the interests of both Goa as well as Punjab, we have adopted the distance of the next highest income State which, in the present reckoning, is Maharashtra, for measuring the notional distance. Thus, the income distance of the three States, namely, Goa, Punjab and Maharashtra would be at par *inter se*. Two statements showing the comparative per capita SDP for the three-year period from 1982-83 to 1984-85 are given in Annexures V.4 and V.5.

5.29 On this basis we give in the Table below the recommended State-wise allocation of income tax revenue from the divisible pool for the year 1989-90. Based on the data made available by the Government of India and as assessed by us, the States are likely to receive in 1989-90 a total sum of Rs.2990.38 crores.

5.30 To conclude, we recommend that for the financial year 1989-90 :-

- (i) Out of the net proceeds a sum equal to 1.044 per cent thereof shall be deemed to represent the proceeds attributable to Union Territories;
- (ii) the share of net income tax proceeds, except the portion representing the proceeds attributable to Union Territories and Union emoluments, to be assigned to the States should be 85 per cent; and
- (iii) the distribution amongst the States of the share assigned to them in respect of the financial year 1989-90 should be on the basis of percentages shown in the Table below :-

| State | (In percentage) | |
|----------------------|----------------------|----------------|
| | With Sikkim included | Without Sikkim |
| 1. Andhra Pradesh | 7.344 | 7.346 |
| 2. Arunachal Pradesh | 0.066 | 0.066 |
| 3. Assam | 2.507 | 2.507 |
| 4. Bihar | 12.314 | 12.318 |
| 5. Goa | 0.090 | 0.091 |
| 6. Gujarat | 4.232 | 4.233 |
| 7. Haryana | 1.048 | 1.049 |
| 8. Himachal Pradesh | 0.505 | 0.505 |
| 9. Jammu & Kashmir | 0.682 | 0.682 |
| 10. Karnataka | 4.937 | 4.938 |
| 11. Kerala | 3.553 | 3.554 |
| 12. Madhya Pradesh | 8.000 | 8.003 |
| 13. Maharashtra | 10.110 | 10.112 |
| 14. Manipur | 0.181 | 0.181 |
| 15. Meghalaya | 0.183 | 0.183 |
| 16. Mizoram | 0.059 | 0.059 |
| 17. Nagaland | 0.064 | 0.064 |
| 18. Orissa | 4.054 | 4.055 |
| 19. Punjab | 1.522 | 1.522 |
| 20. Rajasthan | 4.773 | 4.775 |
| 21. Sikkim | 0.028 | - |
| 22. Tamil Nadu | 7.614 | 7.616 |
| 23. Tripura | 0.269 | 0.269 |
| 24. Uttar Pradesh | 18.326 | 18.331 |
| 25. West Bengal | 7.539 | 7.541 |
| Total | 100.000 | 100.000 |



UNION EXCISE DUTY

6.1 Article 272 of the Constitution states that the Union duties of excise other than those on medicinal and toilet preparations shall be levied and collected by the Government of India, but, if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the States to which the law imposing the duty extends sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among the States in accordance with such principles of distribution, as may be formulated by such law. Under para 3(a) of the Presidential Order we are required to make recommendations in regard to the distribution, between the Union and the States, of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds. Union excise duties come under the category of Central taxes which may be divided between the Centre and the States.

6.2 Union excise duties although not compulsorily shareable have been shared between the Centre and the States right from 1952. Under the award of the First Finance Commission, 40 per cent of the net proceeds of excise duties on three commodities viz., matches, tobacco (including manufactured tobacco) and vegetable products were distributed among the States in proportion to population. Since then, the coverage of Union excise duties and the percentage share of the States and also the principles governing the *inter se* distribution have received increasing emphasis under successive Finance Commissions. Over the years, excise duties have become the largest source of tax revenue and successive Finance Commissions have increasingly relied on them to meet the requirements of the States.

6.3 The Second Finance Commission expanded the list to include duties on five more commodities, but keeping in view their overall scheme of devolutions reduced the share of distributable net proceeds to 25 per cent. The Third Finance Commission recommended sharing of the net proceeds of all the dutiable commodities except motor spirit and those which yielded less than Rs. 50 lakhs annually. But it reduced the share of the States to 20 per cent of the net proceeds. In addition, the Commission separately distributed Rs.36 crores being about 20 per cent of the yield from motor spirit, for maintenance and improvement of communications. This principle of distribution was maintained until the Seventh Finance Commission raised the States' share to 40 per cent.

6.4 The Fourth Finance Commission recommended that in addition to the duties levied at that time, those that might be imposed during the five year period of their report

should also be shared with the States. It, however, did not favour sharing of the revenue from special excise duties. It was for the Fifth Finance Commission to bring the proceeds of special excise duties within the scope of the divisible pool from the year 1972-73. The Sixth Finance Commission enlarged the scope of the divisible pool further but kept out the revenues from earmarked levies. The Seventh Finance Commission increased the share of the States in the divisible pool to 40 per cent and kept out of it revenues from additional excise duties on textiles and textile articles and the cesses levied for special purposes.

6.5 The Eighth Finance Commission aimed at minimising financial imbalances among the States without jeopardising the interests of the developed States. The Commission felt that the recommendations of the previous Commissions had made a number of States dependent on grants-in-aid which was an inelastic source. Therefore, the Commission wanted a scheme of devolution that would be not only progressive and simple but would also deal with the revenue deficits of the States. The Commission increased the States' share from 40 per cent to 45 per cent of the net proceeds of shareable excise duties excluding receipts from electricity duty but set apart this additional 5 per cent to be distributed among the deficit States. The *inter se* distribution was based on the proportion of the deficit of each State to the deficits of all States as assessed by the Commission. As regards the 40 per cent, they recommended that 25 per cent of this should be distributed among the States on the basis of the 1971 population figure. Another 25 per cent was to be distributed on the basis of income adjusted total population. The remaining 50 per cent was distributed on the basis of distance of average per capita income of any State during the years 1976-77 to 1978-79 from the highest per capita income State (Punjab at the relevant time) multiplied by its 1971 population.

6.6 Let us now turn to the views of the States. They touch upon many points including whether any duty of excise may be kept out of the divisible pool, inclusion of net proceeds of earmarked cesses and the effects on the States of frequent increase in administered prices by the Central Government. The scheme of sharing the divisible pool of Union excise duties between the Centre and the States including the formula of *inter se* distribution of the States' share are also the issues on which the States have given their suggestions.

6.7 We first consider whether any of the excise duties should be kept out of the divisible pool. Most of the States have demanded that all excise duties, including earmarked cesses and the additional excise duties on textiles and textile articles under Additional Duties of

Excise (Textiles and Textile Articles) Act, 1978, should be brought under the scope of the divisible pool. Bihar, Gujarat and Tamil Nadu have argued that if cesses are levied at all, they should be for a limited period. If they continue longer, they should be merged with Union excise duties. We agree that earmarked levies reduce the size of the divisible pool. An impost like cess on crude oil could have sizeably increased the States' share of the divisible pool.

6.8 We find that there are a large number of items like tea, sugar, bidi, textiles, paper, jute manufactures and automobiles on which regular excise duties as well as cesses are leviable. There are other types of cesses on iron ore, coal, etc. on which no excise duty is leviable. Additional excise duties on textiles and textile articles are nothing but earmarked levies as their proceeds are spent for financing the Controlled Cloth and the Janata Cloth Schemes. The Eighth Finance Commission had considered the question of inclusion of cesses in the divisible pool. However, it did not go beyond observing that earmarked levies should be kept to the minimum. While expressing the same views, we would urge the Centre to reduce the number of cesses to the extent feasible as indicated in the Long Term Fiscal Policy.

6.9 Having said this, we recommend that the divisible pool of excise duties should include net proceeds of all excise duties including special excise duty but exclude duties collected under the Additional Duties of Excise (Textiles and Textile Articles) Act, 1978 and the earmarked cesses.

6.10 Increases in administered prices is another issue to which our attention has been drawn by the States.

Most of them are against the Centre's use of administered prices to raise resources. They contend that the Centre is enriching itself by increasing administered prices without bothering about the impact on the States' budgets. The Centre should raise resources by increasing excise duties instead of administered prices so that the States may also share the resources so raised.

If it is not possible to stop resorting to administered price increases, it has been suggested, the Finance Commission should devise a mechanism by which the States can be suitably compensated on an automatic basis. On this issue the Eighth Finance Commission observed that while there was justification for increasing administered prices when there were increases in the cost of production, if revenue-raising was the sole consideration, excise duty increase should be preferred. The Ministry of Finance did not agree with this approach when we sought their views on this subject. We were informed by the Union Finance Secretary that if the resources raised from the hike in administered prices were to be made shareable, the extent of the hikes would have to be much higher depending on the current scheme of sharing of net proceeds of excise duties and this would impose undue burden on the economy. While we have given serious thought to the views of the Ministry of Finance we are unable to accept them. We endorse the

view of the Eighth Finance Commission that if the main purpose is resource raising for the government, it should be done through excise duty increase so that the States also get a share out of it notwithstanding the fact that the extent of increase would be higher in such cases.

6.11 Coming to the issue regarding the share of the States in the net proceeds of Union excise duties, a number of States have advocated that the size of the States' share should be increased. Jammu and Kashmir, Himachal Pradesh, Maharashtra, Orissa and Sikkim have pleaded for increasing the States' share to 50 per cent. Andhra Pradesh, Assam, Gujarat, Haryana, Rajasthan, Karnataka, Tamil Nadu, Uttar Pradesh and West Bengal have asked for a increase in the States' share to 60 per cent, while Kerala, Punjab and Tripura have argued for 75 per cent. Nagaland has submitted that the share of the divisible pool should be increased to cover the assessed deficits of the States before devolution.

6.12 We have carefully considered these suggestions. While we agree that the States need more resources, the formula of devolution must also take into account the overall resource position. As stated in the previous Chapter, we shall consider the question of the role and relative magnitude of devolution in detail in the second report. For 1989-90, we propose to recommend the continuation of the existing arrangement whereby 40 + 5 per cent of the net proceeds of the shareable excise duties is distributed among the States. We find that, according to our normative assessment, the States' needs would be reasonably met through this volume of devolution of excise taken together with the volume of income tax recommended to be shared, topped up by grants-in-aid that we recommend.

6.13 We next consider the formula of distribution of Union excise duties, taking first the distribution of the 40 per cent of Union excise duties. The States have suggested diverse criteria. The States of Orissa, Sikkim and Goa have favoured continuation of the Eighth Finance Commission formula. Tripura and Manipur have supported the existing formula with some minor modifications. Haryana and Punjab consider that population should be the criterion for distribution of the States' shares. Andhra Pradesh, Kerala and Mizoram have suggested that a common formula should be adopted for the distribution of the States' share of income tax and Union excise duties. Andhra Pradesh and Karnataka have suggested equal weightage for population and distance of the States' per capita SDP from the per capita SDP of the richest State. Kerala has proposed a combination of population with distance of per capita income, inverse of per capita cumulative plan outlay and Central investments, tax effort and allocational efficiency as measured by the ratio of development expenditure to total revenue expenditure. Madhya Pradesh has proposed that 15 per cent of the net proceeds of Union excise duties should be distributed on the basis of area or area adjusted total population, 35 per

cent on the basis of inverse of per capita income and 50 per cent on the basis of distance of per capita income. Uttar Pradesh suggests that the divisible pool of Union excise duties be distributed among the States on the following pattern : 50 per cent on the basis of population, 25 per cent on the basis of the inverse ratio of per capita income of the States multiplied by population and the remaining 25 per cent to the States whose per capita income is below all States' average. Bihar has urged that 50 per cent should be distributed on the basis of inverse of per capita income multiplied by rural population, and the other 50 per cent on the basis of the distance of the per capita income of the State from the highest per capita income State multiplied by the rural population of the concerned State. Formulations suggested by Gujarat and Rajasthan are quite elaborate and they take note of several factors. Tamil Nadu has observed that the proceeds of Union excise duties should be distributed entirely on the basis of the equalisation factor calculated by multiplying the tax income ratio by distance adjusted to 1971 population as per the recommendations of the Eighth Finance Commission. Arunachal Pradesh wants the population factor to be moderated by giving appropriate weightage for area. Assam has suggested that out of the States' share of 60 per cent, 50 per cent may be distributed to all States and 10 per cent to backward revenue deficit States. Himachal Pradesh has urged that 40 per cent of the net proceeds be distributed with 25 per cent weightage to population, 25 per cent weightage to ensure an equal proportion of revenue surplus to all deficit States and 50 per cent weightage on the basis of the Development Index prepared by the Centre for Monitoring Indian Economy. Another 10 per cent of the net proceeds should be kept aside for Hill States. Maharashtra has suggested a detailed formula incorporating the factors of contribution to excise revenue, economic and fiscal backwardness, fiscal discipline, administrative efficiency etc. Mizoram has proposed that 25 per cent should be kept apart on the basis of population, 40 per cent on the basis of backwardness and 25 per cent for ensuring surplus to all States equal to 25 per cent of their revenue expenditure and 10 per cent reserved for hill States to ensure a surplus equal to at least 50 per cent of their revenue expenditure.

6.14 After carefully considering the above submissions and taking into account the fact that 1989-90 is the terminal year of the Seventh Five Year Plan and that it is not desirable that the scheme of distribution during this year should differ drastically from the current one, we consider it appropriate to continue the Eighth Finance Commission's devolution formula for 40 per cent of the net proceeds of excise duties for 1989-90 as well with some modification. For the reasons stated in the previous chapter, we consider that it is necessary to supplement per capita income with another appropriate indicator of backwardness. For want of a better alternative, we have decided to use the proportion of people below poverty line as an additional criterion, but in view of the doubtful

reliability of data on poverty, we have assigned only small weight to this factor.

6.15 The Eighth Commission had recommended that five per cent of the net proceeds of excise duties excluding the same on electricity, should be set aside and distributed to the States which had deficits after devolution of all taxes and duties and grants in lieu of the repealed tax on railway passenger fares, but excluding their shares of estate duty and grants on account of wealth tax on agricultural property. The *inter s* distribution was based on the proportion of the deficit of each State to the deficits of all States as estimated by the Commission. In the memoranda presented to us Rajasthan, Jammu and Kashmir, Arunachal Pradesh, Assam, Goa, Meghalaya and Sikkim have asked for continuation of this scheme for the deficit States, with a few modifications. Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh and Tamil Nadu have, however, opposed this arrangement on the ground that if this scheme was to be continued there would be no need to give additional grants-in-aid to the deficit States. They feel any earmarking to cover the revenue gaps should be financed from the general revenues of the Centre, and not out of the divisible pool.

6.16 We agree with the Eighth Finance Commission that a scheme of devolution should *inter alia* deal with the revenue deficits of the States. Moreover, any scheme of devolution we adopt should not unduly disturb the existing arrangements for financing the Seventh Plan. Therefore, we propose to continue for 1989-90, the present system of setting aside 5 per cent of the net proceeds of Union excise duties for the deficit States.

6.17 Accordingly, we recommend that the distribution among the States in 1989-90 of 40 per cent should be in the following manner :

- (a) 40 per cent of the net proceeds of excise duties which are shareable should be distributed among all the States in the following manner:
 - (i) 25 per cent should be distributed among the States on the basis of 1971 population.
 - (ii) 12.5 per cent should be distributed among the States on the basis of Income Adjusted Total Population (IATP). For calculating IATP, 1971 population of the States should be weighted with the inverse of the average per capita income for the triennium 1982-83 to 1984-85. The share of a State is to be determined by the percentage of the income adjusted total population of that State to the aggregate of the income adjusted total population of all States.
 - (iii) 12.5 per cent should be distributed on the basis of poverty ratio i.e. the proportion of the number of people below the poverty line in a State as

computed by the Planning Commission for 1983-84 to the total of such population in all States.

- (iv) The remaining 50 per cent should be distributed on the basis of distance of per capita income of any State during the triennium 1982-83 to 1984-85 to that of the State having the highest per capita income i.e. Punjab as decided by us multiplied by its 1971 population. The shares of Punjab and Goa will be determined with reference to the distance of the next State i.e., Maharashtra from Punjab.

- (b) The remaining 5 per cent of the net proceeds of shareable excise duties is to be distributed among the States with deficits, after taking into account their shares from the devolution of all taxes and duties, including the shares of excise duties under clause (a) above as also the grants in lieu of the repealed tax on railway passenger fares. Distribution should take place on the basis of the proportion of deficit of each State to the total of all States' deficits worked out by us.

6.18 As regards 40 per cent of the net proceeds of shareable excise duties, the percentage share of each State has been worked out and the same is given in the table below:

Table 1

Percentage Share of States In 40 per cent of the net proceeds of excise duties for the year 1989-90.

| Name of the State | Percentage share |
|----------------------|------------------|
| 1. Andhra Pradesh | 7.858 |
| 2. Arunachal Pradesh | 0.070 |
| 3. Assam | 2.707 |
| 4. Bihar | 13.573 |
| 5. Goa | 0.074 |
| 6. Gujarat | 3.109 |
| 7. Haryana | 1.077 |
| 8. Himachal Pradesh | 0.549 |
| 9. Jammu and Kashmir | 0.713 |
| 10. Karnataka | 5.092 |
| 11. Kerala | 3.707 |
| 12. Madhya Pradesh | 8.726 |
| 13. Maharashtra | 5.635 |
| 14. Manipur | 0.197 |
| 15. Meghalaya | 0.199 |
| 16. Mizoram | 0.065 |
| 17. Nagaland | 0.070 |
| 18. Orissa | 4.454 |
| 19. Punjab | 1.310 |
| 20. Rajasthan | 5.097 |
| 21. Sikkim | 0.032 |
| 22. Tamil Nadu | 7.785 |
| 23. Tripura | 0.295 |
| 24. Uttar Pradesh | 19.877 |
| 25. West Bengal | 7.729 |
| Total | 100.000 |

6.19 We have also worked out for 1989-90 the percentage shares of the deficit States in the 5 per cent of the net proceeds of the shareable excise duties. These are shown in the table below:

Table 2

Shares of Deficit States In 5 per cent of the net proceeds of excise duties.

| Name of the State | Percentage Share |
|----------------------|------------------|
| 1. Andhra Pradesh | - |
| 2. Arunachal Pradesh | 7.158 |
| 3. Assam | 14.233 |
| 4. Bihar | - |
| 5. Goa | 1.695 |
| 6. Gujarat | - |
| 7. Haryana | - |
| 8. Himachal Pradesh | 10.031 |
| 9. Jammu and Kashmir | 19.499 |
| 10. Karnataka | - |
| 11. Kerala | - |
| 12. Madhya Pradesh | - |
| 13. Maharashtra | - |
| 14. Manipur | 6.787 |
| 15. Meghalaya | 4.837 |
| 16. Mizoram | 8.199 |
| 17. Nagaland | 8.108 |
| 18. Orissa | 5.806 |
| 19. Punjab | - |
| 20. Rajasthan | 3.946 |
| 21. Sikkim | 1.408 |
| 22. Tamil Nadu | - |
| 23. Tripura | 8.293 |
| 24. Uttar Pradesh | - |
| 25. West Bengal | - |
| Total: | 100.000 |

ADDITIONAL DUTIES OF EXCISE AND THEIR MERGER WITH BASIC DUTIES OF EXCISE

7.1 Additional duties of excise in lieu of sales tax were introduced in 1957 in pursuance of a decision of the National Development Council in December, 1956. The decision reads as follows:

"The National Development Council agreed unanimously that sales tax levied in States on mill-made textiles, tobacco including manufactured tobacco, and sugar should be replaced by a surcharge on the Central excise duties on these articles, the income derived therefrom being distributed among States on the basis of consumption, subject to the present income derived by States being assured. The method of sharing and distribution should be referred to the Finance Commission".

7.2 Additional duties of excise have been levied and collected since then by the Centre, and the entire net proceeds from the three commodity groups viz. special varieties of fabrics, tobacco including manufactured tobacco and sugar (excluding the proceeds attributable to the Union territories) have been distributed to the States in the manner recommended by the respective Finance Commissions. As observed by the various Commissions, the present practice of levying additional duties of excise in lieu of sales tax is in the nature of a tax rental arrangement. Unless there is a specific dispensation from the Central Government, a State stands to lose its share from the additional duties of excise if it imposes sales tax on any of the commodities attracting this levy.

7.3 Previous Finance Commissions, starting from the Second, were called upon to give their recommendations on the principles of *inter se* distribution of the net proceeds of additional duties of excise among the States. We are also required to give our recommendations on this subject according to paragraph 5(a) of our terms of reference. Paragraph 7 breaks new ground by asking us also to give our recommendations on the merger of additional duties of excise with the basic duties of excise. We are further required, in the same para, to evolve a suitable formula for allocating a part of the merged duties of excise for the three commodity groups for distribution among the States.

7.4 We first take up the merger issue. Merger of additional duties of excise with basic duties of excise was mooted in the paper on Long Term Fiscal Policy of December, 1985 as a measure of tax simplification and administrative streamlining. It was, however, mentioned in the policy paper that the matter would be referred to the next Finance Commission for the determination of a suitable formula of distribution of the merged duties among the States. We are also of the view that a decision on this complex matter should be taken only after consulting the

States and after an indepth examination of the desirability and feasibility of the suggested merger. All the more so as we find from the Memoranda submitted to us that many of the States like West Bengal, Maharashtra, Haryana, Kerala are opposed to the tax rental arrangement itself. We consider it imperative to complete our discussions with the States, many of which we have yet to visit, before we finalise our views on this matter. Accordingly, we defer our recommendation on the merger issue until our second report. In the meantime, we are suggesting elsewhere in this chapter that the Central Government should look into certain aspects of the operation of the tax rental arrangement which are acting as irritants to the States and remove their misgivings, to the extent possible, on a time bound basis. We hope that by the time we are due to finalise our views on the merger issue for our second report the apprehensions and misgivings of the State Governments relating to the tax rental arrangement would have been redressed. This would help create an atmosphere conducive to an objective and dispassionate approach to the question.

7.5 Now we take up the other part of our terms of reference relating to the distribution of net proceeds of additional duties of excise. Since these additional duties are levied in lieu of sales tax which itself is a tax on consumption, the successive Finance Commissions have sought to approximate the shares of various States to the growth pattern of their sales tax revenues or to their share in consumption. Further, since direct and reliable estimates of State-wise consumption of these commodities are not available, proxies have been used. The Second Finance Commission, which was the first to go into this question since the coming into force of the arrangement in 1957, sought to make good the deficiency in the consumption data by using population as a corrective factor. The Third Finance Commission recommended that the amount of additional duties of excise in excess of the guaranteed amount should be distributed among the States partly according to the percentage increase in the collection of sales tax in each State since 1957-58 and partly on the basis of population. The formula of the Fourth Finance Commission was based entirely on sales tax revenues of individual States. The Fifth Finance Commission made a departure in that while the sales tax collections were taken as an important factor, the inter-State sales tax revenue was excluded. Population was also taken as a factor for working out the shares of the States. Equal weights were given to sales tax collections and population.

7.6 The Sixth Finance Commission felt that sales tax was levied on a host of products ranging from luxuries to raw materials and, therefore, sales tax revenue could

hardly be relied upon to arrive at the consumption figures of the relevant commodities. That Commission thought it more logical to relate the consumption of these items to the levels of income. Accordingly, it took State Domestic Product (SDP) as one of the factors in determining distribution, and population as the other factor. Ultimately the Sixth Finance Commission's recommendations relating to distribution of net proceeds of additional duties of excise were based on three factors viz., population, SDP and production, the last one representing that part of production which get exported to other States. The weights given were 70 per cent, 20 per cent and 10 per cent, respectively.

7.7 The search of the Seventh Finance Commission for consumption figures took it to the National Sample Survey Organisation (NSSO) data specially compiled for them. That Commission noted that the NSSO consumer expenditure surveys did not entirely capture the expenditure incurred by the higher income groups. Therefore, these were not expected to provide acceptable estimates of consumption of the higher varieties of tobacco items and textiles, which were important from the revenue angle. Further, NSSO surveys covered only household expenditure but in the case of sugar and textiles, non-household consumption was quite significant. The NSSO data were also somewhat out of date being based on 1972-73 figures. For these reasons that Commission had to look for some other way to calculate the consumption figures. It finally adopted two separate bases, one for sugar and the other for textiles and tobacco. In the case of sugar, the Commission took the average quantities of despatches to individual States during the three years ending 1976-77 to work out the State-wise consumption figures. In respect of textiles and tobacco the Commission went by the logic of higher income levels leading to higher consumption. The percentage shares of these products for each State in the corresponding all-States' total figure were worked out by multiplying the average per capita SDP of each State for three years ending 1975-76 by the population of the State as per the 1971 Census.

7.8 The attempts of the Eighth Finance Commission to find a reliable estimate of consumption of the three commodity groups did not produce much results. It did not accept the estimates of consumption in different States based on the 32nd Round of NSSO survey (July, 1977 to June, 1978) for reasons stated by the Seventh Commission. It was not inclined to determine the State-wise consumption of sugar on the basis of despatches to different States. The Commission rightly felt that such a method did not take note of the simple fact that sometimes the markets of one State met the requirements of other States. It did not also consider that the State-wise production figures of the relevant items or the sales tax revenue of each State could provide reliable State-wise consumption figures of these items. That Commission finally went by the logic that the consumption of sugar, textiles and tobacco would be higher where the State income was higher. On this basis,

it took SDP as one of the factors in the formula of distribution. The Commission, however, felt that SDP alone could not provide a correct indicator of the consumption of the relevant items and accordingly, considered it appropriate to give adequate weightage to population also in the formula of distribution. The final recommendation of the Commission was that for the purpose of distribution of the net proceeds of additional duties of excise, equal weightage should be given to SDP of the States (1976-77 to 1978-79) and the population figures from the 1971 Census.

7.9 Let us now turn to the views of the States. Andhra Pradesh and Assam have supported the formula adopted by the Eighth Commission. Tripura, Goa and Orissa have also supported the Eighth Commission formula with some modifications. Tripura wants the proportion of Scheduled Tribes population in the State to be given suitable weightage in addition to SDP and population. Against this, Goa, a new State, has suggested that 25 per cent of the net proceeds should be pre-empted for the deficit States and the balance distributed on the basis of the Eighth Finance Commission formula. Orissa would like the weights in the Eighth Commission formula to be raised to 75 per cent for population and 25 per cent for SDP. Kerala favours equal weightage to population and consumption based on NSSO data. Rajasthan has supported distribution on the basis of population and the SDP per capita only if reliable consumption data cannot be found. Haryana considers that the distribution should give equal weightage to SDP and per capita SDP. Punjab would like the Seventh Commission formula of taking the product of per capita SDP and population to be applied to all three commodities, in the absence of reliable consumption data.

7.10 Bihar, Madhya Pradesh, Uttar Pradesh, Gujarat, Maharashtra, Karnataka, Tamil Nadu and Himachal Pradesh are against the Eighth Finance Commission formula. While Bihar is quite clear that population is the best indicator for distribution, Madhya Pradesh is in favour of such a scheme only if no reliable consumption data are available. Uttar Pradesh has asked that the guaranteed amount for each State should be set apart first for distribution and the remainder distributed on the basis of population or in the proportions of the guaranteed amounts of the States to the total guaranteed amount. Gujarat considers that the distribution should be in proportion to the guaranteed amounts as worked out by the Second Finance Commission. Maharashtra, Karnataka, Tamil Nadu and Himachal Pradesh have urged that the distribution should be on the basis of the sales tax collections of the States.

7.11 As regards the remaining States, Sikkim and Manipur have suggested that for both Union excise duty and additional duties of excise, the same formula should be adopted. The formula suggested by them is that of the Eighth Finance Commission for distribution of Union excise duties with a minor modification suggested by Manipur. Arunachal Pradesh and Mizoram are both new States and they have requested that they should also be

given a share of the additional duties of excise since they are not levying sales tax on sugar, tobacco and textiles. While Arunachal Pradesh has not suggested any formula for distribution, Mizoram favours adoption of the Eighth Finance Commission's formula. Nagaland is of the view that 20 per cent of the net proceeds from additional duties of excise should be earmarked for the hill States and the balance 80 per cent distributed among all the States on the basis of population and SDP in the ratio of 75 per cent and 25 per cent, respectively.

7.12 We have carefully considered the submissions of the States. That consumption alone should be the criterion for distribution appears to be unexceptionable to us. In fact, this was also the decision of the National Development Council in 1956. But the problem is that of arriving at the State-wise consumption data of the three commodity groups.

7.13 Like our predecessors, we tried to get the required information from the NSSO. We were given to understand that the relevant data from the 38th Round (January to December, 1983) are not yet available and when available, they would suffer from the same infirmities as the data from the 32nd Round. The description of the items in the 38th Round is the same as in the 32nd Round which means that the same discrepancies between the description of the articles on which additional duties of excise are leviable and those included in the survey would continue. The data from the 38th Round would also not fully capture the expenditures made by the higher income groups on the items attracting additional duties of excise. The 43rd Round is still in preliminary stages and its data would not be available before two years. The National Accounts Statistics also offer no help in arriving at the State-wise consumption figures of the three commodity groups. Under these circumstances we are left with no alternative but to rely on the proxies for the consumption of the three commodity groups. After careful consideration, we are inclined to agree with the proxies employed by the Eighth Finance Commission, namely, SDP and population. The SDP and consumption of the three commodities have a positive relationship though the exact nexus is not known. However, as observed by the Eighth Commission, SDP alone does not take account of variation among the States in climatic conditions, tastes and preferences in a large country like ours. This can be captured, albeit partially, by assigning significant weight to population, besides SDP. We have, therefore, decided to follow the approach of the last Commission and assigned equal weight to SDP and population in determining the shares of individual States in the net proceeds of additional duties of excise. For this, we have used the latest available comparable estimates of SDP averaged for the three years 1982-83 to 1984-85. (Annexure VII.1). As regards population, we have taken the 1971 Census figures.

7.14 As regards the share of the Union Territories, they should be treated as one unit and their share determined on the same basis as applicable to the States. The share of the Union Territories amounting to 2.023 per cent should be retained by the Central Government. The

balance should be distributed among the States in accordance with the percentages given below :-

| State | Percentage |
|--------------------------|----------------|
| 1. Andhra Pradesh | 7.933 |
| 2. Arunachal Pradesh | 0.100 |
| 3. Assam | 2.711 |
| 4. Bihar | 8.519 |
| 5. Goa | 0.230 |
| 6. Gujarat | 6.094 |
| 7. Haryana | 2.358 |
| 8. Himachal Pradesh | 0.652 |
| 9. Jammu and Kashmir | 0.916 |
| 10. Karnataka | 5.581 |
| 11. Kerala | 3.834 |
| 12. Madhya Pradesh | 7.070 |
| 13. Maharashtra | 11.763 |
| 14. Manipur | 0.192 |
| 15. Meghalaya | 0.179 |
| 16. Mizoram | 0.061 |
| 17. Nagaland | 0.127 |
| 18. Orissa | 3.680 |
| 19. Punjab | 3.478 |
| 20. Rajasthan | 4.636 |
| 21. Sikkim | 0.048 |
| 22. Tamil Nadu | 7.120 |
| 23. Tripura | 0.279 |
| 24. Uttar Pradesh | 14.109 |
| 25. West Bengal | 8.330 |
| Total (25 States) | 100.000 |

7.15 We would now revert to some of the issues of the tax rental arrangement on which the States have been feeling aggrieved. One of them is the commitment made by the Central Government in the meeting of the National Development Council held in December, 1970 that the incidence of additional duties of excise would be raised to 10.8 per cent of the value of goods cleared. A Standing Review Committee was also formed as per the decision of the NDC to review the working of the tax rental scheme. The Committee which met for the first time only in February, 1981 after a gap of over ten years, appointed a Sub-Committee which recommended that the incidence of 10.8 per cent should be achieved in three stages i.e. 8.5 per cent by 1984-85, 9.75 per cent by 1987-88 and 10.8 per cent by 1989-90. The States have a grievance that the delay in implementing the decision of the NDC amounts to a breach of faith and has caused them financial loss. Some have even gone to the extent of quantifying the loss for retroactive compensation. We have been informed by the Union Finance Ministry that the *ad valorem* incidence achieved by the end of 1987-88 is 9.87. It is imperative to achieve the target of 10.8 per cent by 1989-90 to inspire and sustain the confidence of the States in the scheme.

7.16 We feel somewhat concerned about two other issues on which the States have expressed serious misgivings. One of them relates to the numerous exemptions issued by the Central Government in respect of goods which would otherwise have attracted additional duties of excise. They have an adverse effect on the total revenue from these levies. The other matter relates to the undue expansion in the coverage of additional duties of excise. As a result, the list of items on which the States may levy sales tax is becoming restricted. The States in general feel that the Central Government has not demonstrated earnestness to sort out these issues which make the States apprehensive. We recommend that the Standing Review Committee may meet urgently to resolve these issues. The report of the Committee in this regard may be made available to us by the end of October, 1988 to enable us to consider the matter in our second report.

GRANT IN LIEU OF TAX ON RAILWAY PASSENGER FARES

8.1 Article 269 of the Constitution lists the taxes and duties which can be levied and collected by the Government of India but are to be assigned to the States. The net proceeds of these taxes or duties, except for those attributable to the Union Territories, do not form part of the consolidated fund of India. They are, on the other hand, assigned to the States within which the duty or the tax is levied. Distribution of the proceeds among the States is done in accordance with the principles formulated by a law of the Parliament.

8.2 Tax on railway passenger fares is one such tax covered by Article 269 and in terms of Paragraph 5(b) of the Presidential Order dated 17-6-1987, we are required to suggest changes, if any, in the principles governing the distribution of the grant in lieu of the tax under the repealed Railway Passenger Fares Act, 1957.

8.3 Before we proceed further, a look into the history of the tax on railway passenger fares and the grant in lieu of it, which was a subsequent development, would be worthwhile.

8.4 It was in 1957 that a tax on railway passenger fares was levied for the first time through the Railway Passenger Fares Act, 1957. This tax remained in force during the period 15th September, 1957 to 31st March, 1961 when it was repealed by the Railway Passenger Fares (Repeal) Act, 1961. The tax was, in fact, merged in the basic fares from 1st April, 1961 in pursuance of a recommendation of the Railway Convention Committee (1960) of the Parliament. The Railway Board had earlier pleaded before the Committee that the levy of the tax had limited the scope for raising passenger fares.

8.5 It was felt that the States should be compensated for the consequential loss of revenue. On the recommendations of the Railway Convention Committee, the Railways undertook to contribute to the general revenues of the Government of India, a lump sum amount of Rs.12.50 crore per annum in each of the five years from 1961-62 to 1965-66. This amount was distributed among the States as ad hoc grant under Article 282 of the Constitution. The amount of this grant was raised to Rs.16.25 crore per annum from 1966-67. This was on the basis of a suggestion made by the Ministry of Railways to the Railway Convention Committee (1965).

8.6 The railway passenger fares tax was revived in 1971 through an Ordinance following the Bangladesh crisis. The Ordinance was later replaced by an Act of Parliament which remained in force till it was repealed on 31st March, 1973. Since the States had agreed to transfer the proceeds of the tax to the Centre to meet the expenditure on Bangladesh refugees, the grant of Rs.16.25 crore continued to be paid to the States even

during the currency of the tax. The amount of the grant did not, however, undergo any change till 1980-81, when, on the basis of the recommendation of the Railway Convention Committee (1980) it was raised to Rs.23.12 crore. It remained at that level during the period 1980-81 to 1983-84. It was for the Eighth Finance Commission to suggest a further hike in the size of the grant.

8.7 The terms of reference of the Eighth Finance Commission did not enjoin upon them to make any recommendation about the quantum of the grant. However, that Commission relied on the Seventh Report of the Railway Convention Committee (1980) which had suggested that increase in the amount of the grant from Rs.23.12 crore could be considered on the basis of the recommendations of the Eighth Finance Commission. The Eighth Finance Commission recommended a hefty increase from Rs.23.12 crore to Rs.95 crore per annum during the period of the award. This amount was calculated on the basis of a common observation of the Sixth and the Seventh Finance Commissions that the tax, when it was in force, constituted roughly 10.7 per cent of the total fare structure. The total amount of the grant was determined by taking the latest figures (1981-82) of the total non-suburban passenger earnings made available to the Eighth Finance Commission.

8.8 We now turn to the principles of distribution of the grant among the States, which form part of our terms of reference. The Second Finance Commission adopted actual passenger travel on the railways within each State as the basis for which it took route length as the proxy. This formula was continued by all the Commissions upto the Sixth.

8.9 The Seventh Commission endorsed the principle that each State should receive the amount it would have raised if it had the power to levy and collect the tax itself. Since each State could collect tax only on the railway fares paid within the State at the commencement of the journey, and since there could be no extra-territoriality, it adopted the formula of distribution of grant in lieu of tax in proportion to the non-suburban passenger earnings from traffic originating in each State. The Eighth Commission favoured this practice, reinforcing it by the argument that the taxable event being the payment of fare, the States should get grant on tax paid within their boundaries, regardless of the route or the length of the journey. On this basis, that Commission recommended that the shares from the newly determined grant of Rs.95 crore should be allocated in the same proportion as the average of the non-suburban passenger earnings in each State in the years 1978-79 to 1981-82 bears to the average of the aggregate non-suburban passenger earnings of all States in those years.

8.10 Let us now consider the views of the States in the matter. Haryana, Uttar Pradesh, Kerala, Manipur and Karnataka would like the repealed tax to be revived. Uttar Pradesh (if the tax is not revived) Rajasthan, Punjab, Bihar, Goa and Jammu and Kashmir want the grant to continue to be determined at 10.7 per cent of the non-suburban railway passenger earnings but the amount should be calculated on a year to year basis. Maharashtra has suggested that the quantum of the grant should be calculated not at 10.7 per cent of the non-suburban railway passenger earnings but at 12 per cent. Haryana desires it to be raised to 15 per cent. Tamil Nadu has expressed the view that the grant may be a fixed amount for all the five years during 1990-95 calculated at 10.7 per cent of the average estimated earnings of railway passenger fares for these years. Madhya Pradesh has suggested that the size of the grant should be calculated at 10.7 per cent of the 1987-88 non-suburban passenger earnings but for subsequent years the Commission may suggest an annual increase either in proportion to the increase in the non-suburban passenger earnings or by a fixed percentage. West Bengal and Punjab have complained that the quantum of the grant has been inelastic. Karnataka's case is that the grant should be enhanced by the extent of the increase in the non-suburban railway passenger fares between 1984-85 and 1988-89. For the purpose of estimating the variations in the railway passenger fare, it considers that the concessional and the subsidised fares should be valued as the corresponding normal fares. Andhra Pradesh, Nagaland and Tripura have supported the Eighth Finance Commission formulation regarding determination of the size of the grant though the first two States among them have urged that the quantum of the grant should be finalised on the basis of the latest available information on non-suburban passenger earnings.

8.11 As far as the principles of inter-se distribution of the grant among the States are concerned, Maharashtra, Uttar Pradesh, Tamil Nadu, Kerala, Andhra Pradesh, Tripura, Meghalaya, Nagaland and Goa are in favour of retaining the Eighth Finance Commission formula with one rider that only the latest available figures should be used for calculating the States' shares. Against this, Haryana, Rajasthan, Punjab and Madhya Pradesh would like us to go back to the formula prior to the Seventh Commission. Bihar has an altogether different view in the matter. Since the grant represents the tax element in the fare structure, they think it also to be distributed among the States as per the principle laid down for other taxes.

8.12 Coming to the hill States, Arunachal Pradesh, Manipur, Sikkim and Mizoram favour the Eighth Finance Commission recommendation that such States should get a share of the grant on the basis of out-agency collections since they do not have any railhead. Sikkim has, however, suggested that to the collections from the out-agency in the State, the passenger traffic earnings by Sikkim Nationalised Transport on the Gangtok-Siliguri route and Sikkim Helicopter service should be added.

8.13 On the basis of the States' suggestions and our terms of reference, the following issues arise:-

- (i) Whether the tax in lieu of railway passenger fare should be revived;
- (ii) What should be the formula for distribution of the grant in lieu of railway passenger fare tax in case it is not revived; and
- (iii) What should be the size of the grant and on what basis it should be calculated.

8.14 As regards the first issue i.e., reviving the tax on railway passenger fares, we do not consider that we are required, given our terms of reference, to recommend whether the tax should be reintroduced. Also, the railways have opposed it on the ground that the tax would be too cumbersome to administer. Hence, we prefer not to go into this question.

8.15 As regards the principles of distribution, we find the logic adopted by the Seventh and Eighth Commissions is sound. We must, however, mention that while this matter was engaging our attention we gave thought to two other issues.

8.16 Even today, some of the States do not have railway facilities. Most of them, no doubt, have out-agencies from which railway tickets can be purchased for journeys commencing from another State. We seriously considered whether a State like Mizoram, without railway lines (and without any out-agency) should also have a share of the grant. It does appear somewhat odd that a State should stand to lose on both the counts i.e., by not having any railway lines and then by not getting any share of the grant.

8.17 Similarly, people of one State often purchase railway tickets in a neighbouring State for a journey which might commence within the State itself. We have considered whether the principle of distribution should require any modification on this account.

8.18 We have examined the above situations in the light of the provisions of Article 269(1)(d) and Article 269(2) of the Constitution. The tax element has a direct nexus to the station where the fare is paid. In the light of the wordings of Article 269(2), that the proceeds of the tax "shall be assigned to the States within which that duty or tax is leviable", we are inclined to hold that it is not possible, in keeping with the spirit of the provision of the Constitution applicable to the repealed tax, to allot any share of the grant to a State in which no railway ticket is purchased. A State without any railway line and also without any out-agency would fall in this category.

8.19 For similar reasons we feel that while distributing the grant, it would not be possible to compensate a State on the ground that in certain cases the people of that State purchased tickets from originating stations falling within the boundary of another State. Apart from the fact that it is not possible to physically

verify the cases where tickets were purchased in a neighbouring State, since the taxable event is the payment of the fare, as observed by the Eighth Commission, no special dispensation can be made in this regard. The situation is also not altogether unique. We have a parallel in the matter of collection of Central sales tax. Here also the tax is paid where the taxable event i.e. sale of goods, takes place. Therefore, we have decided that no modification in the existing principles of distribution is called for on this account.

8.20 Our terms of reference do not require us to determine the quantum of the grant. However, we cannot just ignore the fact that it was at the request of the Ministry of Railways that the tax on railway passenger fares was abolished and in its place a grant came to be distributed among the States. Like the Eighth Finance Commission we also consider that there should be a nexus between the amount of the grant and the incidence of the tax when it was leviable. On this basis we are justified in going into the size of the grant. But before we do this, we thought we should consider what the Railways have got to say in this matter.

8.21 The Ministry of Railways have informed us that the Railway Convention Committee (1985) has yet to take a final view about the amount of the grant to be paid by the Railways for the period 1985-86 to 1989-90. For the present, the Railways are contributing only Rs.23.12 crore out of Rs. 95 crore grant recommended by the Eighth Finance Commission, the balance being made up by the general exchequer. The Chairman and senior officers of the Railway Board appearing before us have brought to our pointed attention the overall policy framework within which the Railways have to function and their financial commitments and requirements for maintenance, modernisation and development. They have stated that the Railways are required to discharge social obligations by providing passenger services and transport of certain essential commodities below cost. This meant a loss of Rs. 1678 crore to them in 1987-88. Included in this loss is the amount of Rs. 81 crore incurred by them in maintaining 138 uneconomic railway lines at the insistence of the State Governments. Besides, the Railways have to generate resources internally for the Seventh Plan and to meet the gap they had to take recourse to market borrowings with a high interest burden. By way of example, they stated that the calculation of the grant at 10.7 per cent of the non-suburban passenger earnings on a year to year basis would mean a commitment of Rs. 232 crore in 1988-89 itself - a staggering increase of approximately Rs.209 crore in one year. This would be about 10 times their own current commitment of Rs. 23.12 crore and 8 times their estimated surplus for 1988-89. They have proposed as an alternative that the size of the grant should be related to the growth in the volume of passenger traffic. Based on the non-suburban passenger kilometres in 1988-89 (223.8 million) which exceeds the figure for 1961-62 (68.6 million) by a factor of 3.26, the Railways have worked out a figure of Rs. 40.70 crore as a reasonable

amount of the grant for the year 1989-90.

8.22 While we agree that there is considerable strength in the argument that one should adhere to the figure of 10.7 per cent as the basis for the grant, we also cannot overlook the financial difficulties of the Railways which play a unique role in the economic life of the nation from which all the States benefit. We would, therefore, like to retain the grant in 1989-90 at the present level of Rs.95 crore. We may revert to this matter in our second report after our visits to the remaining States and a detailed examination of the Railways' finances.

8.23 As stated earlier, the formula of distribution of the grant amongst the States based on the proportion of non-suburban railway passenger earnings in each State to the total of non-suburban railway passenger earnings on the basis of originating stations followed by the Seventh and the Eighth Finance Commissions appeals to us and we adopt it. Even though we have retained the amount of the grant of Rs.95 crore, for calculating the percentage share of the individual States we have obtained the latest actuals of non-suburban passenger earnings in respect of each State for the period 1983-84 to 1986-87, except for Mizoram which does not have railway line or out-agency. (Annexure VIII.1). We have also noted that since the report of the previous Commission the number of States has gone up from 22 to 25.

8.24 Summing up, we recommend as below :-

(i) The quantum of the grant in lieu of railway passenger fares tax should be retained at Rs.95 crore for 1989-90.

(ii) The shares of the States in the grant in lieu of the repealed tax on railway passenger fares be allocated in the same proportion as the average of the non-suburban passenger earnings in each State in the years 1983-84 to 1986-87 bears to the average of the aggregate non-suburban earnings of all the States in those years. On this basis, the shares of the States would be as follows:-

| State | Percentage Share |
|----------------------|------------------|
| 1. Andhra Pradesh | 7.574 |
| 2. Arunachal Pradesh | 0.006 |
| 3. Assam | 1.472 |
| 4. Bihar | 8.215 |
| 5. Goa | 0.131 |
| 6. Gujarat | 5.772 |
| 7. Haryana | 1.600 |
| 8. Himachal Pradesh | 0.101 |
| 9. Jammu and Kashmir | 0.522 |
| 10. Karnataka | 3.282 |
| 11. Kerala | 3.602 |
| 12. Madhya Pradesh | 5.936 |
| 13. Maharashtra | 22.767 |
| 14. Manipur | 0.015 |
| 15. Meghalaya | 0.037 |
| 16. Mizoram | - |
| 17. Nagaland | 0.152 |
| 18. Orissa | 1.552 |
| 19. Punjab | 3.081 |
| 20. Rajasthan | 4.772 |
| 21. Sikkim | 0.008* |
| 22. Tamil Nadu | 6.924 |
| 23. Tripura | 0.038 |
| 24. Uttar Pradesh | 15.174 |
| 25. West Bengal | 7.267 |
| Total | 100.000 |

* Based on the average of years namely 1985-86 and 1986-87 only.

CHAPTER IX

FINANCING OF RELIEF EXPENDITURE

9.1 The terms of reference of the Commission on financing relief expenditure reads as follows :-

"The Commission may review the policy and arrangements in regard to the financing of relief expenditure by the States affected by natural calamities and suggest such modifications as it considers appropriate, in the existing arrangements, having regard, among other considerations, to the need for avoidance of wasteful expenditure. The Commission may examine, inter alia, the feasibility of establishing a national insurance fund to which the State Governments may contribute a percentage of their revenue receipts".

9.2 We have received memoranda from all the States on the subject, the last one being from Assam in May, 1988. We are now in the preliminary stages of our study of the material. We have had discussions only with the State Governments of Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Kerala, Madhya Pradesh, Maharashtra and Punjab. The comments of the Central Ministries concerned are still awaited. It is only after we have had discussions with the other State Governments and completed our studies that we shall be in a position to formulate our final recommendations in this regard.

9.3 The Commission has also been asked to study the feasibility of setting up a national insurance fund. The Commission has been in touch with the Life Insurance Corporation and General Insurance Corporation of India for examining the feasibility of a national insurance fund. A series of meetings have been held from which it transpired that while there is no scope for insurance of public assets against damages by floods or States' liabilities for providing relief on the occurrence of natural calamities, there do exist a number of schemes for covering individual risks arising out of fire, floods, cyclones, earthquakes etc.

9.4 We are examining the question of an umbrella scheme to cover the plethora of schemes now being operated by insurance companies or administered on behalf of the Central Ministries with a bearing on the relief of natural calamities. Since the examination of this matter is likely to take some time, we have decided to consider such a scheme only in the context of our second report for 1990-95.

9.5 Meanwhile, the Commission has to consider a scheme for funding relief expenditure in 1989-90.

9.6 In view of the problems indicated above and our concern to suggest a scheme which will be equitable and acceptable, the Commission would like to study the matter in depth before suggesting any change in the

present scheme of financing relief. We, therefore, recommend that the scheme of financing of relief expenditure as recommended by the Eighth Finance Commission should continue in 1989-90 as well. We have revised the requirement of margin money for different States based on the average of the ceilings of expenditure approved for each State over the period 1982-87 classified as "Non-Plan" following the methodology adopted by the Eighth Finance Commission. Expenditure in excess of the margin money on drought and floods may be met in the manner visualised by the Eighth Commission. (Annexure IX.1)

9.7 The margin money as recommended by us and the Eighth Finance Commission is given below :-

| | (Rs. Crore) | |
|----------------------|---|--|
| | Margin money recommended by Ninth Finance Commission. | Margin money recommended by Eighth Finance Commission. |
| 1. Andhra Pradesh | 43.25 | 24.50 |
| 2. Arunachal Pradesh | 0.25 | - |
| 3. Assam | 13.00 | 7.25 |
| 4. Bihar | 33.75 | 33.75 |
| 5. Goa | 0.25 | - |
| 6. Gujarat | 28.75 | 28.75 |
| 7. Haryana | 5.75 | 4.50 |
| 8. Himachal Pradesh | 3.25 | 1.75 |
| 9. Jammu and Kashmir | 2.75 | 1.50 |
| 10. Karnataka | 6.00 | 6.00 |
| 11. Kerala | 9.00 | 5.00 |
| 12. Madhya Pradesh | 6.00 | 4.75 |
| 13. Maharashtra | 13.00 | 7.25 |
| 14. Manipur | 0.50 | 0.25 |
| 15. Meghalaya | 0.50 | 0.25 |
| 16. Mizoram | 0.50 | - |
| 17. Nagaland | 0.25 | 0.25 |
| 18. Orissa | 46.25 | 26.25 |
| 19. Punjab | 10.75 | 6.00 |
| 20. Rajasthan | 16.75 | 16.75 |
| 21. Sikkim | 0.50 | 0.25 |
| 22. Tamil Nadu | 15.50 | 8.75 |
| 23. Tripura | 1.50 | 0.75 |
| 24. Uttar Pradesh | 57.25 | 32.50 |
| 25. West Bengal | 23.75 | 23.75 |
| Total: | 339.00 | 240.75 |

One half of the margin money for each State, as now fixed by us, has been taken into account in the reassessment of the States' forecast. We recommend that the remaining half of the margin money should be provided by the Centre.

UPGRADATION OF STANDARDS OF ADMINISTRATION AND SPECIAL PROBLEMS OF THE STATES.

10.1 Unlike in the case of the preceding three Finance Commissions, our terms of reference do not specifically ask us to take into consideration the requirements of the States for the upgradation of their standards of administration. Perhaps, this has been deliberately done because, while assessing expenditure requirements of the States on a normative basis, the requirements of upgradation of general services automatically get subsumed as far as the revenue expenditures are concerned. However, as regards capital expenditures, the additional requirements will have to be computed separately wherever raising of the levels of services is attempted and, either the Finance Commission should make capital grants as in the past or it should recommend to the Planning Commission that these requirements should be taken into account. Thus, estimation of expenditure requirements for upgradation of general services in the revenue account need not be undertaken separately when we make revenue expenditure assessment of the States on a normative basis.

10.2 However, we have decided to make fully normative assessment of expenditures only for the period 1990-95 and for the first year of our recommendations i.e. 1989-90, norms would be applied only selectively. Therefore, for the first year of our recommendations expenditure requirements for upgradation of administration would not be subsumed and hence will have to be estimated separately. Given the fact that the Eighth Finance Commission had already initiated upgradation in the sphere of IO specific services, we have thought it fit to continue the good work started by them. It may also be noted that as the recommendation of the Eighth Finance Commission was not applied to 1984-85, targets for upgradation on revenue account set for 5 years had to be rescheduled for 4 years and those for capital schemes scaled down. Besides, for various reasons, there has been a serious shortfall in the achievement of physical targets set for upgradation by that Commission. Keeping this in view, we have decided to continue the upgradation grants so as to provide for, inter alia, fulfilling of the shortfall in the physical targets set by the previous Finance Commission.

10.3 Most of the States have submitted to us proposals for upgradation of standards of administration. These proposals cover the whole gamut of administration. The total cost of these proposals in 1989-90 is estimated at Rs.3,753.78 crore. The sectors/services which have been proposed to be

upgraded in the States' proposals are as given below:-

Table 1
Cost of States' Proposals for Upgradation
(Rs. Crore)

| | | |
|----------------|--------------------------------------|-----------------|
| 1. | Police Administration | 445.23 |
| 2. | Education | 1,723.21 |
| 3. | Jail Administration | 67.17 |
| 4. | Tribal Administration | 63.63 |
| 5. | Health | 392.11 |
| 6. | Judicial Administration | 154.83 |
| 7. | District and Revenue Administration | 99.90 |
| 8. | Training Administration | 12.21 |
| 9. | Treasury and Accounts Administration | 140.07 |
| 10. | Welfare of SC and ST | 115.66 |
| 11. | Labour and Employment | 98.54 |
| 12. | Others | 441.22 |
| Total : | | 3,753.78 |

10.4 For purposes of dealing with the subject of upgradation of standards of administration, we are collecting the requisite data and are also in touch with the various Ministries/institutions to ascertain the areas which need to be taken up for upgradation on a priority basis. However, as this would take some time, we have decided to deal with this subject in detail in our report for the five-years 1990-95. As for our report for the year 1989-90, we have decided to make available to the States grants for completion of the task which is likely to remain unfulfilled by 1988-89 out of that chartered by the Eighth Finance Commission for the five years 1984-89.

10.5 The Eighth Finance Commission recommended grants-in-aid of Rs.967.33 crore to 17 States for upgradation of standards of administration, for the five years 1984-89, in the following sectors -

- (i) Police
- (ii) Education
- (iii) Jail Administration
- (iv) Tribal Administration
- (v) Health
- (vi) Judicial Administration
- (vii) District and Revenue Administration
- (viii) Training
- (ix) Treasury and Accounts Administration
- (x) Special Problems

As a result of the Government of India accepting the recommendations of the Eighth Finance Commission only for four years 1985-89, those grants-in-aid got reduced to Rs.899.32 crore. Further, because of the increase in prices, the unit costs assumed by the Eighth Finance Commission based on 1983 prices had to be revised upward.

10.6 The schemes taken up by the Eighth Finance Commission for upgradation of standards of administration included both revenue and capital schemes. The revenue schemes were of two types, namely, staff schemes and those for payment of allowances like rural allowance and house rent allowance to doctors and compensatory allowance to the functionaries posted in tribal areas. The two factors referred to in the previous paragraph, we find, have not affected the five-year physical targets of these schemes, although there was a reduction in the quantum of grants-in-aid. For example, in the case of staff schemes, the impact was absorbed by a suitable rephrasing of the five year targets. Similarly, the same number of functionaries were paid allowances as was envisaged. But it was not so in respect of capital schemes.

10.7 The capital schemes consisted of those involving provision of amenities/infrastructure and construction of administrative and residential buildings. There was a reduction of 5 per cent in the five year physical targets set for all the schemes, as a result of the government's decision to accept the Commission's recommendations for four years. The price escalation was absorbed in respect of schemes other than construction by suitably adjusting the physical content. However, as regards construction schemes, we have been informed that escalation of 30 per cent was allowed in the programmes for the first three years 1985-88 and that of 50 per cent for the programmes for the final year 1988-89, over the unit costs assumed by the Eighth Finance Commission.

10.8 We have taken up for upgradation only capital schemes, since, as mentioned above, physical targets in respect of those schemes alone got eroded. We have ascertained the extent of this erosion from the targets envisaged by the Eighth Finance Commission. We find that in the case of some States, the shortfall is such that it would not be feasible to cover it entirely in 1989-90. We have, therefore, decided that wherever the shortfall exceeds the likely performance in 1988-89 by more than 20 per cent, the physical targets for 1989-90 may be limited to 20 per cent more than the achievement in 1988-89. Further, an amount of Rs.255 lakh is provided for upgradation of standards of administration during 1989-90 for each of the three newly created States of Arunachal Pradesh, Goa and Mizoram. This will be placed at the disposal of the respective State Governments for upgradation schemes in various sectors to be finalised in consultation with the Government of India.

10.9 As regards the unit cost in 1989-90, we have assumed a step-up of 87.5 per cent in the figures assumed by the Eighth Finance Commission to represent the price escalation since 1983.

10.10 The sector/scheme-wise picture in 1989-90 for each State is given in Annexures X.1 to X.9. The total outlay required for upgradation of administration in 1989-90 comes to Rs.171,66.97 lakh as per details given below.

Table 2: Financial Provision in 1989-90 for Upgradation of Standards of Administration in Different States
(Rs. Lakh)

| States | Police Administration | Education | Jail administration | Tribal administration | Health | Judicial administration | District and Revenue administration | Training administration | Treasury and Accounts administration | Total |
|----------------------|-----------------------|----------------|---------------------|-----------------------|---------------|-------------------------|-------------------------------------|-------------------------|--------------------------------------|-----------------|
| 1. Andhra Pradesh | 102.17 | 369.75 | 43.21 | 47.00 | 178.75 | 253.07 | 21.66 | 29.41 | 29.98 | 1075.00 |
| 2. Arunachal Pradesh | | | | | | | | | | 255.00* |
| 3. Assam | 147.77 | 610.50 | 138.59 | 99.25 | 108.75 | 55.16 | 19.22 | 15.35 | 1.87 | 1196.46 |
| 4. Bihar | 361.34 | 733.50 | 356.78 | 523.75 | 208.75 | 129.50 | 24.06 | 46.22 | 16.87 | 2400.77 |
| 5. Goa | | | | | | | | | | 255.00* |
| 6. Himachal Pradesh | 25.60 | 245.00 | 5.72 | 2.93 | 9.72 | 13.90 | 27.61 | 7.71 | 4.87 | 343.06 |
| 7. Jammu and Kashmir | 601.78 | 245.00 | 112.71 | - | 53.46 | 66.85 | 38.34 | 14.27 | 2.44 | 1134.85 |
| 8. Kerala | 96.59 | - | 22.38 | 1.50 | 3.75 | 50.43 | 3.92 | 30.51 | 1.87 | 210.95 |
| 9. Madhya Pradesh | 447.27 | - | 790.34 | 447.00 | 71.25 | 52.20 | 101.70 | 38.00 | 13.11 | 1960.87 |
| 10. Manipur | 118.31 | 292.04 | 89.87 | 29.38 | 14.58 | 5.86 | 22.71 | 5.70 | -- | 578.45 |
| 11. Meghalaya | 54.15 | 235.20 | 93.74 | - | 11.34 | - | 21.94 | 5.04 | -- | 421.41 |
| 12. Mizoram | | | | | | | | | | 255.00* |
| 13. Nagaland | - | 76.44 | 215.71 | - | 4.86 | 6.59 | 14.63 | 9.42 | 9.74 | 337.39 |
| 14. Orissa | 465.57 | 453.00 | 115.58 | 313.25 | 97.50 | 40.18 | 307.70 | 16.11 | 13.10 | 1821.99 |
| 15. Rajasthan | 180.95 | - | 142.57 | 68.50 | 28.75 | 75.27 | 80.60 | 25.71 | 3.74 | 606.09 |
| 16. Sikkim | 31.10 | - | 1.85 | 1.95 | 11.34 | - | 1.75 | 2.00 | - | 49.99 |
| 17. Tripura | 84.00 | 139.16 | 5.89 | 6.83 | 21.06 | 4.88 | 3.98 | 7.75 | - | 273.55 |
| 18. Uttar Pradesh | 645.88 | - | 796.08 | 0.75 | 103.75 | 112.80 | 103.14 | 53.60 | 28.07 | 1844.07 |
| 19. West Bengal | 628.94 | 792.00 | 422.17 | 100.00 | 18.75 | 74.32 | 34.96 | 25.34 | 50.59 | 2147.07 |
| Total: | 3991.42 | 4191.59 | 3353.19 | 1642.09 | 946.36 | 941.01 | 827.92 | 332.14 | 176.25 | 17166.97 |

* Sectorwise schemes will be formulated by the respective State Governments in consultation with Government of India.

The schemes for the utilisation of the grants-in-aid recommended by us for Arunachal Pradesh, Goa and Mizoram may be formulated by these States in consultation with the Inter-Ministerial Empowered Committee (IMEC) under the auspices of the Ministry of Finance constituted in pursuance of the recommendations of the Eighth Commission.

SPECIAL PROBLEMS

10.11 Para 4(i) of our terms of reference requires us to keep in view the special problems of each State, if any, while assessing receipts and expenditures on the revenue account. Several States have brought up before us the special problems facing them and asked for special dispensation to tackle these problems.

10.12 We have not had enough time to give adequate thought to these special problems and propose to deal with them after careful study, in our second report. However, we are convinced that some of these problems are such as to need immediate attention. These include Bhopal Gas Tragedy, urban decay in Bombay and Calcutta, environmental degradation and the need to clean up Dal Lake in Srinagar, problem of terrorism in Punjab, Haryana and Himachal Pradesh and Tamil refugees from Sri Lanka in Tamil Nadu. These are discussed in the subsequent paragraphs.

Law and Order in Punjab, Haryana, Himachal Pradesh and West Bengal

10.13 There has been a tremendous strain on the law and order machinery in Punjab, Haryana and Himachal Pradesh because of the terrorist activities in these States. The State Governments have sent to us proposals for strengthening the police administration to meet the situation. These proposals were examined in consultation with the Ministry of Home Affairs and we recommend grants of Rs.85 crore for Punjab, Rs.20 crore for Haryana and Rs.10 crore for Himachal Pradesh for taking measures to fight terrorism. These sums may be utilised for the schemes to be formulated in consultation with the Ministry of Home Affairs.

10.14 The Gorkhaland agitation has strained the law and order machinery of West Bengal. Public property has also been the target of attack. The Government of West Bengal has approached us for assistance in regard to the augmentation of police force and for restoration of public assets damaged on account of the agitation. We appreciate the demand and recommend a grant-in-aid of Rs.20 crore to the West Bengal Government to be spent on measures (recurring and non-recurring) to be formulated in consultation with the Ministry of Home Affairs.

Drought Loans

10.15 Some of the States have suffered enormously on account of the unprecedented drought in the recent past. These States have been provided additional Plan assistance for approved relief expenditure over and above 5 per cent of the annual Plan outlay which is not

adjusted against Plan assistance allocation. As 50 per cent of this assistance was by way of loans, this has created an additional burden on the States concerned in terms of interest payments and repayment of the principal.

In order to mitigate the hardship to these States, we recommend moratorium on the interest payments and the repayment of principal for 1989-90 on the additional Plan assistance given during 1986-87 and 1987-88. This would give relief of about Rs. 63 crore - Rs. 35 crore by way of interest payment and Rs. 28 crore by way of repayment of principal - to Andhra Pradesh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Rajasthan and Uttar Pradesh, during 1989-90. (Details in Annexure X.10). We have assessed the revenue position of the Centre and States accordingly.

Special Loans to Punjab

10.16 We are aware of the compulsions under which large sums of money had to be given to Punjab by way of special loans during 1984-89. The State Government is required to pay in 1989-90, in respect of these loans, Rs. 201.75 crore by way of interest payment and Rs.156.98 crore by way of principal. Given the strained budgetary position of the State, it would be, we feel, extremely difficult for the State to meet this obligation in 1989-90. Keeping this in view, we recommend that the moratorium allowed by the Government of India on the interest payment and repayment of principal in respect of these special loans should continue in 1989-90.

Bhopal Gas Leak Tragedy

10.17 The Bhopal Gas Leak Tragedy was an industrial disaster of unprecedented magnitude. The massive escape of lethal gas caused widespread death and destruction. We have visited the scene of the tragedy and met a large number of affected people. Considering the impact of the disaster and its multi-dimensional implications, it is obvious that a crisis of this magnitude cannot legitimately be construed as the exclusive responsibility of the State Government. The speedy rehabilitation of the gas victims and continued medical attention to the large number of persons affected by the tragedy is a matter of paramount urgency. During the years 1984-88, the Central Government has given loans totalling to Rs.66.62 crore to the State Government out of which Rs.11 crore have been recovered inclusive of Rs.3 crore as interest. The State Government has formulated an action plan with a seven year perspective proposing a cumulative expenditure of Rs.371.29 crore spread over a period starting from 1988-89 to 1994-95. The proposed action plan is fairly comprehensive in character and covers the entire gamut of relief activities including medical, economic, social and environmental rehabilitation.

10.18 By virtue of a Parliamentary legislation, the Government of India has assumed the role of "parens parentis" on behalf of the victims of the disaster. The memorandum of the State Government on this account calls for the special funding of the action plan from

Government of India. The detailed action plan submitted by the State Government is currently under scrutiny of the Government of India. We would urge that the action plan should be examined by the Government expeditiously and the estimates of expenditure projected for various activities should be fully scrutinised and made available to us by September, 1988 so as to enable us to take a final view in the matter for the period from 1990-91 to 1994-95. For the year 1989-90, we would like to make the following recommendations towards the relief and rehabilitation of the gas affected victims :

- (a) the loans already advanced by Government of India to the State Government to meet the situation in the wake of the Gas Leak Tragedy should be converted into long-term interest-free loans;
- (b) the requirements towards relief and rehabilitation of the gas affected victims during the year 1989-90 should be met fully out of interest-free long-term loans to be advanced by the Central Government; and
- (c) the entire amount advanced by Government of India to the State Government by way of interest-free loans should be adjustable against the compensation as and when received by Government of India from the Union Carbide Ltd. Till then, there should be moratorium on the repayment of loans by the State Government.

Slum Improvement

10.19 The great national cities of Bombay and Calcutta have fallen into a state of decay with urbanisation, congestion and immigration which have over-strained the civic services. Both the cities are principal industrial and commercial centres serving a vast hinterland well beyond the limits of their respective State boundaries. They also provide livelihood, shelter and support to a significant proportion of population migrating from outside. Therefore, provision of a certain minimum level of civic facilities and infrastructure support in these cities is indeed a matter of national concern. The Commission considers that this is primarily the responsibility of the States concerned. We recommend that Rs.50 crore each may be given by way of one-time special grants-in-aid to the Governments of Maharashtra and West Bengal for slum clearance and environmental improvement of slums and provision of basic amenities in the cities of Bombay and Calcutta, on the condition that they would provide a matching amount for the purpose. The instalments may be released on the basis of 50:50 sharing of expenditure at each stage by the concerned State.

10.20 We would consider this matter further in our second report. Meanwhile, we would expect the States concerned to restructure the outmoded rent control legislation so as to lead to the growth of revenues of the municipal corporations and to strive for relocation of

industries with a view to releasing prize land for improving the environment.

Elementary Education

10.21 Equalisation of certain social and community services is regarded as one of the objectives of the Finance Commission. We propose to attend to this aspect in detail in our second report. We have however made a modest beginning in this direction in the field of education.

10.22 The main thrust of the National Policy on Education approved by the National Development Council in May, 1986 is to universalise elementary education (elementary education is defined to cover the age group 6-14 years or classes I to 8) by 1990 and to improve its quality. Under the Operation Black Board, a number of Centrally Sponsored Schemes have been launched for making good deficiencies in matters such as the number of teachers, opening of new schools, basic equipment and reading material to be provided. However, the requirement of school buildings has been left to be taken care of by the normal allocation under the Plan supplemented by certain funds earmarked under NREP and RLEGP. But the Ministry of Education expressed to us the view that this amount is totally inadequate. On the other hand, the availability of pucca school buildings is a prerequisite for attracting children to schools. We have, therefore, decided to give assistance of Rs.200 crore to the 10 educationally backward States identified by us on the basis of the total enrolment in their elementary schools being below the all-India average, for construction of school buildings, as indicated below :

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 20.44 |
| 2. Arunachal Pradesh | 0.28 |
| 3. Bihar | 41.07 |
| 4. Haryana | 4.88 |
| 5. Jammu and Kashmir | 2.98 |
| 6. Karnataka | 12.64 |
| 7. Madhya Pradesh | 18.16 |
| 8. Orissa | 10.58 |
| 9. Rajasthan | 19.36 |
| 10. Uttar Pradesh | 69.61 |
| Total | 200.00 |

The specifications of the school buildings to be constructed out of this grant would be the same as prescribed in the scheme of 'Operation Blackboard' i.e. two rooms, each of which measuring approximately 30 sq. metres in area and a verandah of approximately 9 - 10 ft. deep with separate toilets for boys and girls. Additionally, there will be built-in space for storage of equipment and well plastered blackboards as part of the structure itself in the rooms as well as at both ends of the verandah. Keeping in view the average cost of these buildings in 1987-88 recommended by the Department of Education, we would recommend that the unit cost should not exceed Rs.1 lakh for the plains and Rs.1.10 lakh in the

hills. We have deliberately made a generous provision of cost to obviate the need for subsequent cost revision owing to price escalation leading to further time and cost over-runs. It may be pointed out that in para 10.9 supra we have taken the cost of the residual capital works of the Eighth Finance Commission with a step up of 87.5 per cent over that prescribed by that Commission, which gives the unit cost of Rs.75,000 for the plains and Rs.97,500 for hills for primary schools. Those school buildings were smaller and the specifications were also not so well-defined. We would be happy if the States were to construct those residual school buildings also to the current specifications by meeting the balance of the cost from their own resources.

10.23 On our visit to Jammu and Kashmir, the Chief Minister highlighted the backwardness of the State arising from lack of educational facilities and emphasised the political and economic problems this gives rise to. Given the geo-political situation of the State, we consider that it is extremely important to bring about qualitative and quantitative changes in the standards of education there. It is needless to mention the importance of having a larger proportion of enlightened population, particularly in a State like Jammu and Kashmir. Considering the merit of these arguments, we recommend a grants-in-aid of Rs.20 crore to the State for improvement in school education, the schemes for which should be formulated by the State Government in consultation with the Planning Commission.

Restoration and Protection of Dal Lake

10.24 Dal Lake is a major source of tourist attraction in Jammu and Kashmir and is also pivotal to the eco-system of the Kashmir Valley. We recognise that long-term measures are required for the restoration and protection of the lake from inflow of wastes from adjoining habitation, conversion of the flowing water into floating gardens, sedimentation from the catchment area due to deforestation and other activities in that area, increasing number of house boats without proper and safe sewage disposal arrangements, etc. The State Government has requested Rs.20 crore in 1989-90 to meet the backlog of maintenance and protection measures pending clearance of a Rs.200 crore comprehensive Dal Development Project already submitted to the Government of India for negotiating international assistance. To enable the State to meet the immediate requirement for arresting further deterioration, we recommend a grant-in-aid of Rs.10 crore. The schemes for the purpose would be formulated in consultation with the Ministries of Urban Development and Environment.

Sri Lankan Refugees

10.25 In view of the pressure on the Tamil Nadu Government for provision of services to refugees from Sri Lanka, we recommend a grant-in-aid of Rs.25 crore to the Tamil Nadu Government to enable it to cope with the problem of Sri Lankan refugees. The schemes for the purpose would be formulated in consultation with the Ministry of Home Affairs.

Improvement of Infrastructure

10.26 It has been brought to our notice that in the three newly created States of Arunachal Pradesh, Goa

and Mizoram as also in Nagaland and Sikkim, there is acute dearth of necessary administrative and developmental infrastructure and the normal expenditures provided for by us on revenue account would not be adequate to remedy the situation. We therefore recommend the grant-in-aid as shown below to these States :

| | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Arunachal Pradesh | 12.50 |
| 2. Goa | 3.00 |
| 3. Mizoram | 14.50 |
| 4. Nagaland | 14.50 |
| 5. Sikkim | 2.50 |
| Total | 47.00 |

The above grants-in-aid may be utilised for construction of roads and bridges and buildings for schools and hospitals. In Arunachal Pradesh and Mizoram the grants-in-aid are also intended to be utilised for construction of secretariat and administrative buildings. Exact schemes may be formulated by these States in consultation with the Inter-Ministerial Empowered Committee.

Balance work under special problems for which grants were recommended by the Eighth Finance Commission

10.27 The Eighth Finance Commission had recommended grants-in-aid to certain States to tackle special problems. Because of the Government of India's decision to implement the report of that Commission from 1985-86 and also because of the price rise, the physical content of the programmes envisaged got eroded. As in the case of general upgradation schemes we have worked out the likely shortfall in the physical content of the schemes because of the above two factors and recommend grants-in-aid for funding that balance, as shown in the table below :

| Scheme | Amount (Rs. Crore) |
|--|-----------------------|
| 1. Construction of Central Jail at Shimla | 0.20 |
| 2. Creation of infrastructure in Leh district of Jammu and Kashmir | 1.00 |
| 3. Development of Bastar district in Madhya Pradesh | 4.01 |
| 4. Construction of security prison at Imphal | 0.80 |
| 5. Border problems of Punjab | 4.01 |
| 6. Development of desert areas in Rajasthan | 4.01 |
| 7. Creation of new sub-divisions in Sikkim | 0.20 |
| 8. Construction of office buildings and related facilities for the autonomous District Councils in Tripura | 0.32 |
| Total | 14.55 |

For the reason explained earlier in this chapter, while dealing with the general upgradation schemes, we are not recommending any grants-in-aid for revenue schemes under the special problems also.

Reduction In Intra-State Disparities

10.28 Before concluding this chapter, it is necessary to discuss the important issue of inter-regional imbalances. The Vidarbha Industries Association, in its memorandum to us has highlighted the economic backwardness of Vidarbha region in Maharashtra and has urged that special grants-in-aid under Article 275 should be recommended to raise the level of socio-economic infrastructure in the region. The State Government also in its memorandum has brought out the problem of unbalanced development in the State and has emphasised the need to enhance the infrastructural facilities in Vidarbha, Marathwada and Konkan regions. The State Government has stated that raising the infrastructure to the State's average level in these regions would require an investment of Rs. 5000 crore and has decided to set apart Rs. 1500 crore for the removal of regional imbalances during the Seventh Five Year Plan. We are aware that similar imbalances in development exist in other States also. Needless to say, inequalities, be they between persons, regions or States are undesirable. They create social tensions and lead to unintended migration of productive resources and people. Therefore, concerted efforts should be made to remove these imbalances. However, our main concern is with the financial relations between the Centre and the States and inter-State disparities in financial capacities. Development of economic infrastructure in backward areas, which requires large volume of capital investment does not strictly come under our purview. However, this is a task which the Planning Commission and the States

should jointly endeavour to undertake. It is our fervent hope that the States will realise the importance of this issue and accord high priority to the removal of intra-State disparities with the help of the Planning Commission.

Monitoring

10.29 As regards the monitoring of the utilisation by the States of the grants recommended by us for upgradation of standards of administration and special problems, we recommend that the same mechanism as was recommended by the Eighth Finance Commission may continue to be operative in 1989-90, specially for the reason that the grants-in-aid recommended by us are mostly for the continuing schemes. However, as we have recommended grants-in-aid for certain sectors/schemes which were not covered earlier by the recommendations of the Eighth Finance Commission such as slum improvement, we suggest that the Ministries/ Departments concerned with those sectors/schemes at the Centre may also be associated with the monitoring machinery.

10.30 It has been brought to our notice that in a number of cases the unit cost of works assumed by the Eighth Finance Commission turned out to be more in practice, mainly because of price rise, leading to protracted correspondence and delay in the execution of works. In order to avert this situation, we suggest that in the event of such a situation arising, for any reason, in 1989-90, the excess cost may be met from Plan funds, in the interest of progress of works.

सत्यमेव जयते

GRANTS-IN-AID

11.1 One of the duties of the Finance Commission as laid down in sub-clause (b) of clause (3) of article 280 of the Constitution is to make recommendations as to "the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India." Paragraph 3(b) of the President's Order, however, enjoins us to make recommendations not only on the principles which should govern the grants-in-aid but also on the "sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article." In making our recommendations, we have been asked in the President's Order to have regard to the considerations set out in paragraph 4 of the said order.

11.2 Clause (1) of Article 275 provides for payment of grants-in-aid of the revenues to the States as Parliament may determine to be in need of assistance. However, no law has so far been enacted by Parliament in this regard. Therefore, the grants-in-aid under article 275 continue to be paid to the States, as provided in clause (2) of that article, through an Order of the President after considering the recommendations of the Finance Commission, as required.

11.3 In the memoranda submitted to us by the States and also during our discussions with them, several suggestions have been made regarding the principles which we should follow in the matter of payment of grants-in-aid to States under Article 275(1). Rajasthan, Punjab and Karnataka have suggested that grants-in-aid should be given to States to cover fiscal gap on revenue account inclusive of both Plan and non-Plan expenditures, left after devolution of taxes and duties. Gujarat and Haryana do not agree with this view. According to them, the role of the grants-in-aid should no longer be gap-filling. They have pleaded that the requirements of the States should, by and large, be met through tax devolution and the grants-in-aid should be paid to the States irrespective of their revenue position. Gujarat has in support of the above referred to sub-para (iv) of para 4 of the President's Order, laying down that while making recommendations on the grants-in-aid Finance Commission should keep in mind the need for "not only balancing the receipts and expenditure on revenue account....., but also generating surpluses for capital investment". In view of this, it has urged that the grants-in-aid should play a positive role. In this connection, Goa has suggested that the scheme of grants-in-aid should be used for correcting regional imbalances. Bihar has

suggested that the instrument of grants-in-aid should be used for ensuring that per capita revenue surplus of the poor States is higher than that of the developed States.

11.4 Orissa and Haryana have suggested grants-in-aid for providing adequate incentives for better resource mobilisation and efficiency in financial management. Gujarat, Orissa and Maharashtra have asked for grants-in-aid for relief on account of natural calamities. Jammu and Kashmir, Kerala, Karnataka, Sikkim and Uttar Pradesh have proposed indexation of grants so that in case of price rise the real value of grants to the States does not get eroded.

11.5 Jammu and Kashmir, Kerala, Madhya Pradesh, Orissa, Punjab, Sikkim and West Bengal would like the grant to be paid to the States to cover the cost of revision of pay scales and additional instalments of DA and terminal benefits to the Government employees during the forecast period. Gujarat and Tamil Nadu have requested for payment of grants-in-aid to cover expenditure on certain programmes considered important by the States. Kerala, Orissa and West Bengal have suggested that the grants-in-aid may be paid to take care of their debt servicing liabilities. Kerala, Sikkim and West Bengal have asked for grants-in-aid for adequate maintenance and up-keep of capital assets and plan schemes. Gujarat, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Nagaland, Orissa, Punjab and Tripura have sought grants-in-aid for upgradation of standards of various services. Karnataka, Madhya Pradesh, Maharashtra, Nagaland, Punjab, Rajasthan and Tamil Nadu want grants-in-aid for enabling the States to deal with special problems of national importance.

11.6 All the previous Finance Commissions have held the view that the scope of Article 275 extends to both general purpose grants and grants for some broadly specified purposes. The principles that should govern the grants-in-aid of revenues to the States have been clearly enunciated by the First Finance Commission. According to these, eligibility of a State to receive grants-in-aid and its quantum should be on the basis of fiscal need. This should be derived by appropriately modifying budgetary needs in the light of the factors such as tax effort and economy in expenditures. Besides, the grants should also serve the purpose of equalising standards of basic social services, help the States to meet special burdens of national concern and to augment services of primary importance in the less developed States in the national interest. Although that Commission laid down

these guidelines, when actually making the recommendation, it largely went by budgetary needs and factors such as tax effort and expenditure economy were not taken into account. Though later Commissions selectively applied some norms in their assessments, grants continued to be made largely on the basis of budgetary needs.

11.7 For recommending grants-in-aid for 1989-90, we have gone by these principles. Accordingly, we are recommending grants-in-aid not to fill the budgetary gaps of the States, but to meet their fiscal needs as represented by the difference between normatively determined revenue receipts and non-Plan expenditures. Further, in keeping with the enunciated principles, we are recommending grants to raise the standards of social services, to help the States to meet special burdens and obligations of national concern and to improve the standards of services of primary importance in the national interest in less advanced States.

11.8 As mentioned in Chapter III, we have assessed revenue receipts of the States normatively and norms have been selectively applied to assess expenditures. We are recommending grants-in-aid under Article 275 to those States which are left with gaps after tax devolution is made. It must, however, be emphasised once again that in recommending these grants, we are filling the normative gaps and not the 'budgetary gaps'. It is also necessary to state here that we are filling the non-Plan gaps only, and giving grants for Plan purposes on a different basis as explained in Chapter III, in order not to disturb the planning process in the final year of the Seventh Plan. We are also recommending specific grants-in-aid for upgradation of administration and special problems.

11.9 The following table gives the non-Plan revenue surplus (+) or deficit (-) as assessed by us for different States for the year 1989-90 together with the corresponding position about such surplus or deficit after taking into account the transfer of tax resources under our recommendations:

Table : 1
Revenue Surplus/Deficit before and after devolution - 1989-90
(Rs. Crore)

| State | Non-plan revenue position without devolution of taxes and duties | Revenue Surplus after devolution of taxes and duties | Revenue deficit after devolution of taxes and duties |
|----------------------|--|--|--|
| (0) | (1) | (2) | (3) |
| 1. Andhra Pradesh | (-) 592.32 | 256.38 | |
| 2. Arunachal Pradesh | (-) 135.74 | | 70.44 |
| 3. Assam | (-) 544.33 | | 140.05 |
| 4. Bihar | (-) 411.05 | 961.94 | |
| 5. Goa | (-) 41.27 | | 16.68 |
| 6. Gujarat | (+) 13.72 | 435.85 | |
| 7. Haryana | (+) 128.83 | 265.88 | |
| 8. Himachal Pradesh | (-) 239.18 | | 98.72 |
| 9. Jammu and Kashmir | (-) 428.33 | | 191.89 |
| 10. Karnataka | (+) 302.11 | 862.42 | |
| 11. Kerala | (-) 314.57 | 89.84 | |
| 12. Madhya Pradesh | (-) 630.57 | 278.99 | |
| 13. Maharashtra | (+) 1304.51 | 2164.98 | |
| 14. Manipur | (-) 142.06 | | 66.79 |
| 15. Meghalaya | (-) 107.28 | | 47.61 |
| 16. Mizoram | (-) 153.19 | | 80.67 |
| 17. Nagaland | (-) 153.16 | | 79.78 |
| 18. Orissa | (-) 566.69 | | 57.14 |
| 19. Punjab | (+) 152.58 | 336.80 | |
| 20. Rajasthan | (-) 613.50 | | 38.82 |
| 21. Sikkim | (-) 27.92 | | 13.86 |
| 22. Tamil Nadu | (-) 303.05 | 536.31 | |
| 23. Tripura | (-) 179.20 | | 81.61 |
| 24. Uttar Pradesh | (-) 1232.78 | 813.97 | |
| 25. West Bengal | (-) 653.16 | 198.74 | |
| Total: | (-) 7469.35 | | |
| | (+) 1901.75 | 7202.10 | 984.06 |

Annexure XI.1 sets out the revenue receipts and non-Plan expenditures for each State on the basis of which the revenue position as in column 1 of the above table has been arrived at.

11.10 We recommend that the amounts shown in the table below be paid as grants-in-aid of the revenues of the States under clause (1) of Article 275 of the Constitution to cover the revenue deficits after devolution of taxes and duties as shown in Table 1 above:

Table 2

Revenue gap Grants-in-aid to States

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Arunachal Pradesh | 70.44 |
| 2. Assam | 140.05 |
| 3. Goa | 16.68 |
| 4. Himachal Pradesh | 98.72 |
| 5. Jammu and Kashmir | 191.89 |
| 6. Manipur | 66.79 |
| 7. Meghalaya | 47.61 |
| 8. Mizoram | 80.67 |
| 9. Nagaland | 79.78 |
| 10. Orissa | 57.14 |
| 11. Rajasthan | 38.82 |
| 12. Sikkim | 13.86 |
| 13. Tripura | 81.61 |
| Total | 984.06 |

11.11 In our scheme, thirteen States qualify for revenue gap grants. Three of these are the newly created States of Arunachal Pradesh, Goa and Mizoram.

Of the remaining ten, nine are the same as were recommended grants-in-aid by the Eighth Finance Commission. Rajasthan gets grants-in-aid under our scheme which according to the Eighth Finance Commission's assessment was deficit in the first two years (1984-86) and surplus in the remaining three years (1986-89). West Bengal is the only State which under the dispensation of the Eighth Finance Commission received gap grants but does not qualify for the same according to our assessment.

11.12 An important reason for the State of West Bengal not qualifying for gap grant is the relative level of under-taxation by that State. Our analysis clearly shows that in relation to other middle income States in the group, West Bengal actually exploited resources much below its tax potential. In other words, while the State, according to its relative capacity, would have to raise about Rs. 2235 crore in 1989-90, its trend estimates on the basis of actuals would be lower by about Rs. 690 crore. For the same reasons, the tax revenues of Bihar and Orissa too have been targetted substantially higher. It must be noted

in this connection that our normative estimates themselves have been derived on the basis of actually observed behavioral relationships between tax revenues and economic variables in the States belonging to the group. In order to further soften the impact of the application of norms, we have estimated tax revenues of West Bengal at only Rs. 1774.55 crore which is 15 per cent higher than their trend estimates. It may also be noted that interest and dividends from State undertakings also in this State are much below the rates stipulated by the last Commission which have been adopted by us.

11.13 We have already indicated in Chapter III the methods adopted for the assessment of receipts and expenditures of the States and revenue outlays on the State Plan in 1989-90 in respect of each State. Correspondingly, we are required to determine the level of grants-in-aid from the Centre for State Plan in that year.

The year 1989-90 being the last year of the Seventh Plan, we have, in this regard, gone mainly by the balance of Central assistance remaining out of the five-year allocation (1985-90) duly adjusted for the price factor. In this connection it may be stated that we have deflated the actual releases of Central assistance from year to year to 1984-85 prices on which five year allocation under the Gadgil Formula was based and inflated the balance for the fifth year to 1989-90 prices. By doing so we have, for the first time, ensured that the States get the real value of the five-year allocation of Central assistance. With a view to impart some operational flexibility, five per cent of the figure so arrived at for 1989-90 has been set apart for distribution later by the Planning Commission. The assistance for externally aided projects is in the nature of reimbursement of expenditures incurred on specified projects/schemes and involves international funding. It is not possible to accurately forecast disbursement of this assistance to States in 1989-90. For this reason, we have left out of our exercise this assistance. However, we have worked out the balance of such assistance in 1989-90 at Rs. 1000 crore inclusive of a grant component of Rs. 315 crore on an overall basis and taken the same into account purely for computing the revenue deficit of the Centre and the States. On this basis, we recommend that an amount of Rs. 2475.52 crore may be paid in 1989-90 to the States as grants-in-aid under clause (1) of Article 275 as shown in the following table, for meeting the requirements of the revenue component of the State Plans.

Table 3
Grants-in-aid for revenue plan

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 116.10 |
| 2. Arunachal Pradesh | 118.50 |
| 3. Assam | 151.86 |
| 4. Bihar | 165.48 |
| 5. Goa | 28.84 |
| 6. Gujarat | 48.12 |
| 7. Haryana | 13.86 |
| 8. Himachal Pradesh | 133.27 |
| 9. Jammu and Kashmir | 148.85 |
| 10. Karnataka | 63.38 |
| 11. Kerala | 57.68 |
| 12. Madhya Pradesh | 115.84 |
| 13. Maharashtra | 92.53 |
| 14. Manipur | 128.25 |
| 15. Meghalaya | 111.19 |
| 16. Mizoram | 79.94 |
| 17. Nagaland | 106.97 |
| 18. Orissa | 70.62 |
| 19. Punjab | 10.72 |
| 20. Rajasthan | 89.78 |
| 21. Sikkim | 58.83 |
| 22. Tamil Nadu | 96.51 |
| 23. Tripura | 154.46 |
| 24. Uttar Pradesh | 234.06 |
| 25. West Bengal | 79.88 |
| Total | 2475.52 |

11.14 In the previous chapter we have considered the requirements of the States for upgradation of standards of administration in 1989-90. We recommend that their requirements on this account be met by grants-in-aid under clause (1) of Article 275 of the Constitution. We have, therefore, decided to recommend grants-in-aid to them also, as under :

Table 4
Grants-In-aid for upgradation of Administration

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 10.75 |
| 2. Arunachal Pradesh | 2.55 |
| 3. Assam | 11.97 |
| 4. Bihar | 24.01 |
| 5. Goa | 2.55 |
| 6. Himachal Pradesh | 3.43 |
| 7. Jammu and Kashmir | 11.35 |
| 8. Kerala | 2.11 |
| 9. Madhya Pradesh | 19.61 |
| 10. Manipur | 5.78 |
| 11. Meghalaya | 4.21 |
| 12. Mizoram | 2.55 |
| 13. Nagaland | 3.37 |
| 14. Orissa | 18.22 |
| 15. Rajasthan | 6.06 |
| 16. Sikkim | 0.50 |
| 17. Tripura | 2.74 |
| 18. Uttar Pradesh | 18.44 |
| 19. West Bengal | 21.47 |
| Total | 171.67 |

11.15 We have also discussed in the previous chapter the special problems of States and recommended outlays in 1989-90 to cope up with the same. We have decided that grants-in-aid may be given to States to fund those outlays regardless of whether a State has a revenue surplus before devolution or not. Accordingly, we recommend grants-in-aid of Rs.537 crores under clause (1) of Article 275 of the Constitution to the following States in 1989-90.

Table 5
Grants-In-aid for Special Problems

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 20.44 |
| 2. Arunachal Pradesh | 12.78 |
| 3. Bihar | 41.07 |
| 4. Goa | 3.00 |
| 5. Haryana | 24.88 |
| 6. Himachal Pradesh | 10.00 |
| 7. Jammu and Kashmir | 32.98 |
| 8. Karnataka | 12.64 |
| 9. Madhya Pradesh | 18.16 |
| 10. Maharashtra | 50.00 |
| 11. Mizoram | 14.50 |
| 12. Nagaland | 14.50 |
| 13. Orissa | 10.58 |
| 14. Punjab | 85.00 |
| 15. Rajasthan | 19.36 |
| 16. Sikkim | 2.50 |
| 17. Tamil Nadu | 25.00 |
| 18. Uttar Pradesh | 69.61 |
| 19. West Bengal | 70.00 |
| Total | 537.00 |

Further, we recommend grants-in-aid of Rs. 14.55 crore under clause (1) of Article 275 of the Constitution to the following States for completion of the balance of work under special problems for which grants-in-aid had been given by the Eighth Finance Commission :

Table 6
Grants-In-aid for balance of works under special problems for which grants were recommended by Eighth Finance Commission

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Himachal Pradesh | 0.20 |
| 2. Jammu and Kashmir | 1.00 |
| 3. Madhya Pradesh | 4.01 |
| 4. Manipur | 0.80 |
| 5. Punjab | 4.01 |
| 6. Rajasthan | 4.01 |
| 7. Sikkim | 0.20 |
| 8. Tripura | 0.32 |
| Total | 14.55 |

11.16 On the basis of our recommendations on the pattern of funding the relief expenditure, as set out in Chapter IX of this report, we recommend that an amount of Rs. 169.50 crore may be paid to States in 1989-90 as grants-in-aid under clause (1) of Article 275 of the Constitution as shown in the following table subject to the observations made in that chapter as to the manner of their disbursement to the States :

Table 7**Centre's Contribution to Margin Money**

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 21.62 |
| 2. Arunachal Pradesh | 0.13 |
| 3. Assam | 6.50 |
| 4. Bihar | 16.87 |
| 5. Goa | 0.13 |
| 6. Gujarat | 14.37 |
| 7. Haryana | 2.88 |
| 8. Himachal Pradesh | 1.63 |
| 9. Jammu and Kashmir | 1.38 |
| 10. Karnataka | 3.00 |
| 11. Kerala | 4.50 |
| 12. Madhya Pradesh | 3.00 |
| 13. Maharashtra | 6.50 |
| 14. Manipur | 0.25 |
| 15. Meghalaya | 0.25 |
| 16. Mizoram | 0.25 |
| 17. Nagaland | 0.13 |
| 18. Orissa | 23.12 |
| 19. Punjab | 5.38 |
| 20. Rajasthan | 8.37 |
| 21. Sikkim | 0.25 |
| 22. Tamil Nadu | 7.75 |
| 23. Tripura | 0.75 |
| 24. Uttar Pradesh | 28.62 |
| 25. West Bengal | 11.87 |
| Total | 169.50 |

11.17 The following table shows the position regarding total amount of grants-in-aid under clause (1) of Article 275 of the Constitution to be paid to States during 1989-90:

Table 8
Total Grants-In-aid

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 168.91 |
| 2. Arunachal Pradesh | 204.40 |
| 3. Assam | 310.38 |
| 4. Bihar | 247.43 |
| 5. Goa | 51.20 |
| 6. Gujarat | 62.49 |
| 7. Haryana | 41.62 |
| 8. Himachal Pradesh | 247.25 |
| 9. Jammu and Kashmir | 387.45 |
| 10. Karnataka | 79.02 |
| 11. Kerala | 64.29 |
| 12. Madhya Pradesh | 160.62 |
| 13. Maharashtra | 149.03 |
| 14. Manipur | 201.87 |
| 15. Meghalaya | 163.26 |
| 16. Mizoram | 177.91 |
| 17. Nagaland | 204.75 |
| 18. Orissa | 179.68 |
| 19. Punjab | 105.11 |
| 20. Rajasthan | 166.40 |
| 21. Sikkim | 76.14 |
| 22. Tamil Nadu | 129.26 |
| 23. Tripura | 239.88 |
| 24. Uttar Pradesh | 350.73 |
| 25. West Bengal | 183.22 |
| Total | 4352.30 |

11.18 The picture regarding estimated transfer of resources to the States in 1989-90 on the basis of our recommendations is given in the following table :

Table 9

Estimated Transfer To States In 1989-90

(Rs. Crore)

| State | Share of Taxes and Duties | | | | Addl. Excise Duties | Tax on Railway Passenger Fares | Total | Grants - (Non-Plan) | | | | | Total Col. (7) + (12) | Percent to Total Col. (13) |
|----------------------|---------------------------|-------------------------|----------------------------|---------|---------------------------|---|----------|---------------------|---------------------------|---------------------|--------|---------|-----------------------------|-------------------------------------|
| | Income Tax | Basic Excise Duties | | Total | | | | Deficit Grants | Upgrada- tion Money | Special Problems | Total | | | |
| | | 40% to All States | 5% to Deficit States | | | | | | | | | | | |
| | | | | | | | | | | | | (1) | | |
| 1. Andhra Pradesh | 219.67 | 503.60 | -- | 503.60 | 118.23 | 7.20 | 848.70 | -- | 10.75 | 21.62 | 20.44 | 52.81 | 901.51 | 6.60 |
| 2. Arunachal Pradesh | 1.97 | 4.49 | 57.34 | 61.83 | 1.49 | 0.01 | 65.30 | 70.44 | 2.55 | 0.13 | 12.78 | 85.90 | 151.20 | 1.11 |
| 3. Assam | 74.97 | 173.49 | 114.02 | 287.51 | 40.40 | 1.40 | 404.28 | 140.05 | 11.97 | 6.50 | -- | 158.52 | 562.80 | 4.12 |
| 4. Bihar | 368.36 | 869.87 | -- | 869.87 | 126.96 | 7.80 | 1372.99 | -- | 24.01 | 16.87 | 41.07 | 81.95 | 1454.94 | 10.65 |
| 5. Goa | 2.72 | 4.74 | 13.58 | 18.32 | 3.43 | 0.12 | 24.59 | 16.68 | 2.55 | 0.13 | 3.00 | 22.36 | 46.95 | 0.34 |
| 6. Gujarat | 126.58 | 199.25 | -- | 199.25 | 90.82 | 5.48 | 422.13 | -- | -- | 14.37 | -- | 14.37 | 436.50 | 3.19 |
| 7. Haryana | 31.37 | 69.02 | -- | 69.02 | 35.14 | 1.52 | 137.05 | -- | -- | 2.88 | 24.88 | 27.76 | 164.81 | 1.21 |
| 8. Himachal Pradesh | 15.10 | 35.18 | 80.36 | 115.54 | 9.72 | 0.10 | 140.46 | 98.72 | 3.43 | 1.63 | 10.20 | 113.98 | 254.44 | 1.86 |
| 9. Jammu and Kashmir | 20.40 | 45.69 | 156.21 | 201.90 | 13.65 | 0.49 | 236.44 | 191.89 | 11.35 | 1.38 | 33.98 | 238.60 | 475.04 | 3.48 |
| 10. Karnataka | 147.67 | 326.34 | -- | 326.34 | 83.18 | 3.12 | 560.31 | -- | -- | 3.00 | 12.64 | 15.64 | 575.95 | 4.22 |
| 11. Kerala | 106.28 | 237.57 | -- | 237.57 | 57.14 | 3.42 | 404.41 | -- | 2.11 | 4.50 | -- | 6.61 | 411.02 | 3.01 |
| 12. Madhya Pradesh | 239.32 | 559.23 | -- | 559.23 | 105.37 | 5.64 | 909.56 | -- | 19.61 | 3.00 | 22.17 | 44.78 | 954.34 | 6.98 |
| 13. Maharashtra | 302.39 | 361.14 | -- | 361.14 | 175.31 | 21.63 | 860.47 | -- | -- | 6.50 | 50.00 | 56.50 | 916.97 | 6.71 |
| 14. Manipur | 5.41 | 12.62 | 54.37 | 66.99 | 2.86 | 0.01 | 75.27 | 66.79 | 5.78 | 0.25 | 0.80 | 73.62 | 148.89 | 1.09 |
| 15. Meghalaya | 5.47 | 12.75 | 38.75 | 51.50 | 2.67 | 0.03 | 59.67 | 47.61 | 4.21 | 0.25 | -- | 52.07 | 111.74 | 0.82 |
| 16. Mizoram | 1.76 | 4.17 | 65.68 | 69.85 | 0.91 | -- | 72.52 | 80.67 | 2.55 | 0.25 | 14.50 | 97.97 | 170.49 | 1.25 |
| 17. Nagaland | 1.91 | 4.49 | 64.95 | 69.44 | 1.89 | 0.14 | 73.38 | 79.78 | 3.37 | 0.13 | 14.50 | 97.78 | 171.16 | 1.25 |
| 18. Orissa | 121.26 | 285.45 | 46.51 | 331.96 | 54.85 | 1.48 | 509.55 | 57.14 | 18.22 | 23.12 | 10.58 | 109.06 | 618.61 | 4.53 |
| 19. Punjab | 45.51 | 83.95 | -- | 83.95 | 51.83 | 2.93 | 184.22 | -- | -- | 5.38 | 89.01 | 94.39 | 278.61 | 2.04 |
| 20. Rajasthan | 142.79 | 326.66 | 31.61 | 358.27 | 69.09 | 4.53 | 574.68 | 38.82 | 6.06 | 8.37 | 23.37 | 76.62 | 651.30 | 4.77 |
| 21. Sikkim | -- | 2.05 | 11.28 | 13.33 | 0.72 | 0.01 | 14.06 | 13.86 | 0.50 | 0.25 | 2.70 | 17.31 | 31.37 | 0.23 |
| 22. Tamil Nadu | 227.75 | 498.92 | -- | 498.92 | 106.11 | 6.58 | 839.36 | -- | -- | 7.75 | 25.00 | 32.75 | 872.11 | 6.38 |
| 23. Tripura | 8.04 | 18.91 | 66.44 | 85.35 | 4.16 | 0.04 | 97.59 | 81.61 | 2.74 | 0.75 | 0.32 | 85.42 | 183.01 | 1.34 |
| 24. Uttar Pradesh | 548.17 | 1273.88 | -- | 1273.88 | 210.28 | 14.42 | 2046.75 | -- | 18.44 | 28.62 | 69.61 | 116.67 | 2163.42 | 15.83 |
| 25. West Bengal | 225.51 | 495.34 | -- | 495.34 | 124.15 | 6.90 | 851.90 | -- | 21.47 | 11.87 | 70.00 | 103.34 | 955.24 | 6.99 |
| TOTAL (All States) | 2990.38 | 6408.80 | 801.10 | 7209.90 | 1490.36 | 95.00 | 11785.64 | 984.06 | 171.67 | 169.50 | 551.55 | 1876.78 | 13662.42 | 100.00 |

IMPLICATIONS OF OUR APPROACH AND SUMMARY OF IMPORTANT RECOMMENDATIONS

12.1 Before we summarise our recommendations for 1989-90, it is necessary to bring out the implications of the approach we have adopted in making these recommendations. Making the implications explicit would help persuade the Central and State Governments to adopt appropriate adjustment policies so that the appropriate degree of fiscal discipline is restored to the mutual benefit of the two levels of Government.

12.2 In making our recommendations for 1989-90, we have been guided by two basic considerations. First, the Centre and the State Governments should be given adequate time to adjust to the normative approach and its implications. Second, the financial assumptions on which the Seventh Five Year Plan is based, should not be disturbed drastically.

12.3 In regard to the States, we may mention here that only on the revenue side we have made assessments which may be properly called 'normative'. On the expenditure side, we have applied norms only selectively; instead of projecting the non-Plan revenue expenditures on the basis of past trends and including all commitments, we have assessed them on the basis of the norms adopted by the Eighth Finance Commission. For the period 1990-95, we shall assess the revenue receipts and expenditures of the States with stricter application of norms to be devised by us.

12.4 The total volume of resource transfer which we have recommended is higher than what the States are receiving in 1988-89, for, the finances of the States are being reassessed. Besides, the level of incomes and prices would also be higher in 1989-90 than in the previous year. But in allowing for the increased transfer of resources, we have to keep in mind the financial needs and resources of the Centre, which we have endeavoured to do.

12.5 The major implications of our approach may be indicated. As mentioned earlier, the normative approach would be applied more comprehensively in relation to our recommendations for 1990-95. When this is done, it would mean that although the actual trends in revenues and expenditures may not be entirely ignored, all expenditure commitments made by different States would not be ipso facto included for assessment. Further, the costs of providing the services would also be assessed normatively at justifiable levels. It follows that in certain cases, the actual expenditure may exceed what is allowed for. This does not imply any value judgement that such excess expenditure is necessarily undesirable. The States or the Central Government for that matter have the prerogative to incur expenditures as sanctioned by their Legislatures and the Parliament respectively. The implication, however, is that all of these extra

expenditures would have to be met out of the own revenue effort of the government concerned. It is in this sense that we build a link between revenue raising and expenditure decisions. In a sense, under this approach, the States will gain greater freedom of action and can perform better without being penalised. For example, a State which increases efficiency and economises on the use of funds will not receive less transfers on that account. Similar freedom of action would also have to be allowed for the Central Government also. If the States' needs for funds are assessed on a normative basis, the Central Government can augment its own resources in order to increase its expenditures without being compelled to share a part of the increase in resources merely on the ground that it has now more resources to share. By the same token, increases in the Centre's expenditures after revenue balance has been reached must be matched by corresponding increases in revenues.

12.6 It is also necessary to state here that our assessment of non-Plan revenue expenditures should not be viewed in isolation from that of revenues. In several cases, our estimates of non-Plan revenue expenditures are much higher than the budget estimates of 1988-89 and also the trend estimates of 1989-90. This order of expenditures should be undertaken only if the revenue receipts as assessed by us are also raised.

12.7 According to our estimates, the revenue deficit of the Central Government after tax devolution and grants-in-aid in 1989-90 is expected to be Rs.7,994 crore. This would, form about 1.92 per cent of the estimated GDP.¹ On the States' account, the revenue deficit of the deficit States is estimated at Rs.1,443 crore which would form about 0.3 per cent of the estimated GDP, though the net position on the States' revenue account is estimated to have a surplus of Rs.2,229.5 crore. On the whole, in our assessment, therefore, revenue deficit in 1989-90 would not exceed 2.2 per cent of GDP. We hope that the Centre and the State Governments would make every effort and pursue appropriate policies to contain revenue deficits within the limits visualised by us in national interest.

12.8 We may now summarise our recommendations for the year 1989-90 :

I. Income Tax

- (1) Out of the net proceeds, a sum equal to 1.044 per cent thereof shall be deemed to represent the proceeds attributable to Union Territories,

¹ GDP for 1989-90 has been estimated at Rs.416854 crore. This has been arrived at by assuming growth of GDP in nominal terms at the rate of 11.5 per cent in 1987-88 and 13 per cent in 1988-89.

- (2) the share of net income tax proceeds, except the portion representing the proceeds attributable to Union Territories and Union emoluments, to be assigned to the States should be 85 per cent, and
- (3) the distribution amongst the States inter se of the share assigned to the States in respect of the financial year 1989-90 should be on the basis of percentages shown in the table below :

| State | Percentage with Sikkim (If the income tax becomes leviable in that State) | Percentage with-out Sikkim |
|----------------------|--|----------------------------|
| 1. Andhra Pradesh | 7.344 | 7.346 |
| 2. Arunachal Pradesh | 0.066 | 0.066 |
| 3. Assam | 2.507 | 2.507 |
| 4. Bihar | 12.314 | 12.318 |
| 5. Goa | 0.090 | 0.091 |
| 6. Gujarat | 4.232 | 4.233 |
| 7. Haryana | 1.048 | 1.049 |
| 8. Himachal Pradesh | 0.505 | 0.505 |
| 9. Jammu and Kashmir | 0.682 | 0.682 |
| 10. Karnataka | 4.937 | 4.938 |
| 11. Kerala | 3.553 | 3.554 |
| 12. Madhya Pradesh | 8.000 | 8.003 |
| 13. Maharashtra | 10.110 | 10.112 |
| 14. Manipur | 0.181 | 0.181 |
| 15. Meghalaya | 0.183 | 0.183 |
| 16. Mizoram | 0.059 | 0.059 |
| 17. Nagaland | 0.064 | 0.064 |
| 18. Orissa | 4.054 | 4.055 |
| 19. Punjab | 1.522 | 1.522 |
| 20. Rajasthan | 4.773 | 4.775 |
| 21. Sikkim | 0.028 | - |
| 22. Tamil Nadu | 7.614 | 7.616 |
| 23. Tripura | 0.269 | 0.269 |
| 24. Uttar Pradesh | 18.326 | 18.331 |
| 25. West Bengal | 7.539 | 7.541 |
| Total | 100.000 | 100.000 |

- (4) The propriety of showing the transactions relating to the pre-emptive purchase of immoveable properties under Major Head No.4059 - Capital Outlay on Public Works as net of recoveries should be ascertained by making a reference to the Comptroller and Auditor General of India.

(Para 5.6)

- (5) The apportionment of cost of collection between income tax and corporation tax should be re-examined.

(Para 5.8)

- (6) Receipts from "penalties" and "interest recoveries" comprised under the head "Miscellaneous Receipts" should be included in the divisible pool of income tax.

(Para 5.9)

II. Union Excise Duties

- (1) If the purpose of revising administered prices is to raise resources for the government it should be done through increases in excise duties so that the States also get a share of the proceeds thereof notwithstanding the fact that the extent of increase would be higher in such cases.

(Para 6.10)

- (2) The existing arrangement under which 45 per cent of the net proceeds of shareable excise duties is distributed among States should continue for the year 1989-90.

(Para 6.12)

- (3) 40 per cent of the net proceeds of shareable excise duties should be distributed amongst all the States on the basis of percentages shown in the table below:

| State | Percentage |
|----------------------|----------------|
| 1. Andhra Pradesh | 7.858 |
| 2. Arunachal Pradesh | 0.070 |
| 3. Assam | 2.707 |
| 4. Bihar | 13.573 |
| 5. Goa | 0.074 |
| 6. Gujarat | 3.109 |
| 7. Haryana | 1.077 |
| 8. Himachal Pradesh | 0.549 |
| 9. Jammu and Kashmir | 0.713 |
| 10. Karnataka | 5.092 |
| 11. Kerala | 3.707 |
| 12. Madhya Pradesh | 8.726 |
| 13. Maharashtra | 5.635 |
| 14. Manipur | 0.197 |
| 15. Meghalaya | 0.199 |
| 16. Mizoram | 0.065 |
| 17. Nagaland | 0.070 |
| 18. Orissa | 4.454 |
| 19. Punjab | 1.310 |
| 20. Rajasthan | 5.097 |
| 21. Sikkim | 0.032 |
| 22. Tamil Nadu | 7.785 |
| 23. Tripura | 0.295 |
| 24. Uttar Pradesh | 19.877 |
| 25. West Bengal | 7.729 |
| Total | 100.000 |

(Para 6.17 and 6.18)

- (4) The remaining 5 per cent of the net proceeds of shareable excise duties may be distributed amongst the deficit States on the basis of the

percentages shown in the table below :

| State | Percentage |
|----------------------|------------|
| 1. Arunachal Pradesh | 7.158 |
| 2. Assam | 14.233 |
| 3. Goa | 1.695 |
| 4. Himachal Pradesh | 10.031 |
| 5. Jammu and Kashmir | 19.499 |
| 6. Manipur | 6.787 |
| 7. Meghalaya | 4.837 |
| 8. Mizoram | 8.199 |
| 9. Nagaland | 8.108 |
| 10. Orissa | 5.806 |
| 11. Rajasthan | 3.946 |
| 12. Sikkim | 1.408 |
| 13. Tripura | 8.293 |
| | 100.000 |

(Para 6.16 and 6.19)

III. Additional Duties of Excise In Lieu of Sales Tax

- (1) The net proceeds of the additional duties of excise on textiles, sugar and tobacco should be determined on the following basis :

(a) A sum equal to 2.023 per cent of such net proceeds be retained by the Central Government as attributable to the Union Territories;

(b) The balance should be distributed amongst the States in accordance with the percentages indicated below :-

| State | Percentage |
|----------------------|------------|
| 1. Andhra Pradesh | 7.933 |
| 2. Arunachal Pradesh | 0.100 |
| 3. Assam | 2.711 |
| 4. Bihar | 8.519 |
| 5. Goa | 0.230 |
| 6. Gujarat | 6.094 |
| 7. Haryana | 2.358 |
| 8. Himachal Pradesh | 0.652 |
| 9. Jammu and Kashmir | 0.916 |
| 10. Karnataka | 5.581 |
| 11. Kerala | 3.834 |
| 12. Madhya Pradesh | 7.070 |
| 13. Maharashtra | 11.763 |
| 14. Manipur | 0.192 |
| 15. Meghalaya | 0.179 |
| 16. Mizoram | 0.061 |
| 17. Nagaland | 0.127 |
| 18. Orissa | 3.680 |
| 19. Punjab | 3.478 |
| 20. Rajasthan | 4.636 |
| 21. Sikkim | 0.048 |
| 22. Tamil Nadu | 7.120 |
| 23. Tripura | 0.279 |
| 24. Uttar Pradesh | 14.109 |
| 25. West Bengal | 8.330 |
| | 100.000 |

(Para 7.15)

- (2) The Standing Review Committee appointed by National Development Council to review the working of the tax rental arrangement may submit a report to the Finance Commission by the end of October 1988, regarding the misgivings of the States on numerous exemptions granted from duties of additional excise and the expansion of the coverage of these duties.

(Para 7.16 and 7.17)

IV. Grant In Lieu of Tax on Railway Passenger Fares

- (1) In keeping with the spirit of the Constitutional provisions applicable to the repealed tax on railway passenger fares, it is not possible to allot a share of the grant in lieu thereof to a State wherein there is no railway line nor any out agency and in which no railway ticket is purchased.

(Para 8.18)

- (2) Keeping in view the financial difficulties of the Railways and their unique role in the economic life of the nation from which all the States benefit, the quantum of the grant may be retained at the present level of Rs. 95 crores. (Para 8.22)

- (3) The shares of the States in the grant in lieu of the repealed tax on railway passenger fares should be allocated in the same proportion as the average of the non-suburban passenger earnings in each State in the years 1983-84 to 1986-87 bears to the average of the aggregate non-suburban earnings of all the States in those years. On this basis, the grant may be distributed among the States as under :

| State | Percentage |
|----------------------|------------|
| 1. Andhra Pradesh | 7.574 |
| 2. Arunachal Pradesh | 0.006 |
| 3. Assam | 1.472 |
| 4. Bihar | 8.215 |
| 5. Goa | 0.131 |
| 6. Gujarat | 5.772 |
| 7. Haryana | 1.600 |
| 8. Himachal Pradesh | 0.101 |
| 9. Jammu and Kashmir | 0.522 |
| 10. Karnataka | 3.282 |
| 11. Kerala | 3.602 |
| 12. Madhya Pradesh | 5.936 |
| 13. Maharashtra | 22.767 |
| 14. Manipur | 0.015 |
| 15. Meghalaya | 0.037 |
| 16. Mizoram | - |
| 17. Nagaland | 0.152 |
| 18. Orissa | 1.552 |
| 19. Punjab | 3.081 |
| 20. Rajasthan | 4.772 |
| 21. Sikkim | 0.008 |
| 22. Tamil Nadu | 6.924 |
| 23. Tripura | 0.038 |
| 24. Uttar Pradesh | 15.174 |
| 25. West Bengal | 7.267 |
| | 100.000 |

(Paras 8.23 and 8.24)

V. Financing of Relief Expenditure

- (1) The scheme of financing of relief expenditure as recommended by the Eighth Finance Commission should continue. (Para 9.6)
- (2) The following amounts of margin money may be fixed for each State :

| State | Amount of Margin Money (Rs. Crore) |
|----------------------|--|
| 1. Andhra Pradesh | 43.25 |
| 2. Arunachal Pradesh | 0.25 |
| 3. Assam | 13.00 |
| 4. Bihar | 33.75 |
| 5. Goa | 0.25 |
| 6. Gujarat | 28.75 |
| 7. Haryana | 5.75 |
| 8. Himachal Pradesh | 3.25 |
| 9. Jammu and Kashmir | 2.75 |
| 10. Karnataka | 6.00 |
| 11. Kerala | 9.00 |
| 12. Madhya Pradesh | 6.00 |
| 13. Maharashtra | 13.00 |
| 14. Manipur | 0.50 |
| 15. Meghalaya | 0.50 |
| 16. Mizoram | 0.50 |
| 17. Nagaland | 0.25 |
| 18. Orissa | 46.25 |
| 19. Punjab | 10.75 |
| 20. Rajasthan | 16.75 |
| 21. Sikkim | 0.50 |
| 22. Tamil Nadu | 15.50 |
| 23. Tripura | 1.50 |
| 24. Uttar Pradesh | 57.25 |
| 25. West Bengal | 23.75 |
| Total : | 339.00 |

(Para 9.7)

- (3) The State Governments should provide 50 per cent of the margin money mentioned above in their budgets. The remaining 50 per cent of the margin money should be provided by the Centre as a grant-in-aid under the substantive part of Clause (1) of Article 275 of the Constitution.

(Para 9.7)

VI. Special Problems Of Debt Relief

- (1) Moratorium on the interest payments and the repayment of principal due in 1989-90 should be granted in respect of the Central loans given to the States in 1986-87 and 1987-88 by way of additional Plan assistance towards approved relief expenditure over and above 5 per cent of the annual Plan outlay on account of unprecedented drought during those years. (Para 10.15)
- (2) Moratorium on the interest payment and repayment of principal due in 1989-90 in respect of special loans given to Punjab during 1984-89

should be continued during 1989-90 also.

(Para 10.16)

- (3) The loans already advanced and those proposed to be advanced to Madhya Pradesh in connection with the Bhopal Gas Tragedy should be converted into interest-free loans to be set off against the compensation as and when received from the Union Carbide Limited. There should also be moratorium on the repayment of the principal as well as interest falling due in 1989-90 in respect of those loans. (Para 10.18)

- (4) The Government of India should take the final view on the action plan involving an outlay of Rs. 371.29 crores submitted by the Government of Madhya Pradesh to finance relief activities including medical, economic, social and environmental rehabilitation in connection with the Bhopal Gas Leak tragedy. Union Government's decision on items and the scale of expenditure should be made available to the Commission by September, 1988. (Para 10.17 and 10.18)

VII. Grants-In-Aid

- (1) To cover the deficits on non-Plan revenue account as estimated by us, the following States be paid the sums specified against each of them as grants-in-aid of their revenues under the substantive part of clause (1) of Article 275 of the Constitution:

Revenue Gap Grants-In-Aid to States

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Arunachal Pradesh | 70.44 |
| 2. Assam | 140.05 |
| 3. Goa | 16.68 |
| 4. Himachal Pradesh | 98.72 |
| 5. Jammu and Kashmir | 191.89 |
| 6. Manipur | 66.79 |
| 7. Meghalaya | 47.61 |
| 8. Mizoram | 80.67 |
| 9. Nagaland | 79.78 |
| 10. Orissa | 57.14 |
| 11. Rajasthan | 38.82 |
| 12. Sikkim | 13.86 |
| 13. Tripura | 81.61 |
| Total | 984.06 |

(Para 11.10)

- (2) The following States may be paid sums specified against each of them as grants-in-aid under the substantive part of clause (1) of Article 275 of the Constitution, for meeting their requirements of the revenue component of the State Plan. These amounts represent 95 per cent of the total grants-in-aid for State Plans excluding externally-aided projects, in 1989-90.

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 116.10 |
| 2. Arunachal Pradesh | 118.50 |
| 3. Assam | 151.86 |
| 4. Bihar | 165.48 |
| 5. Goa | 28.84 |
| 6. Gujarat | 48.12 |
| 7. Haryana | 13.86 |
| 8. Himachal Pradesh | 133.27 |
| 9. Jammu and Kashmir | 148.85 |
| 10. Karnataka | 63.38 |
| 11. Kerala | 57.68 |
| 12. Madhya Pradesh | 115.84 |
| 13. Maharashtra | 92.53 |
| 14. Manipur | 128.25 |
| 15. Meghalaya | 111.19 |
| 16. Mizoram | 79.94 |
| 17. Nagaland | 106.97 |
| 18. Orissa | 70.62 |
| 19. Punjab | 10.72 |
| 20. Rajasthan | 89.78 |
| 21. Sikkim | 58.83 |
| 22. Tamil Nadu | 96.51 |
| 23. Tripura | 154.46 |
| 24. Uttar Pradesh | 234.06 |
| 25. West Bengal | 79.88 |
| Total | 2475.52 |

(Para 11.13)

- (3) To cover the requirements of upgradation and special problems, the following States may be paid the amount specified against each of them as grants-in-aid of their revenues under the substantive part of clause (1) of Article 275 of the Constitution:

(Rs. Crore)

| State | For Upgradation | For Special Problems | Total |
|----------------------|-----------------|----------------------|---------------|
| 1. Andhra Pradesh | 10.75 | 20.44 | 31.19 |
| 2. Arunachal Pradesh | 2.55 | 12.78 | 15.33 |
| 3. Assam | 11.97 | - | 11.97 |
| 4. Bihar | 24.01 | 41.07 | 65.08 |
| 5. Goa | 2.55 | 3.00 | 5.55 |
| 6. Haryana | - | 24.88 | 24.88 |
| 7. Himachal Pradesh | 3.43 | 10.20 | 13.63 |
| 8. Jammu and Kashmir | 11.35 | 33.98 | 45.33 |
| 9. Karnataka | - | 12.64 | 12.64 |
| 10. Kerala | 2.11 | - | 2.11 |
| 11. Madhya Pradesh | 19.61 | 22.17 | 41.78 |
| 12. Maharashtra | - | 50.00 | 50.00 |
| 13. Manipur | 5.78 | 0.80 | 6.58 |
| 14. Meghalaya | 4.21 | - | 4.21 |
| 15. Mizoram | 2.55 | 14.50 | 17.05 |
| 16. Nagaland | 3.37 | 14.50 | 17.87 |
| 17. Orissa | 18.22 | 10.58 | 28.80 |
| 18. Punjab | - | 89.01 | 89.01 |
| 19. Rajasthan | 6.06 | 23.37 | 29.43 |
| 20. Sikkim | 0.50 | 2.70 | 3.20 |
| 21. Tamil Nadu | - | 25.00 | 25.00 |
| 22. Tripura | 2.74 | 0.32 | 3.06 |
| 23. Uttar Pradesh | 18.44 | 69.61 | 88.05 |
| 24. West Bengal | 21.47 | 70.00 | 91.47 |
| Total | 171.67 | 551.55 | 723.22 |

(Para 11.14 and 11.15)

- (4) To meet the margin money requirements of States they shall be entitled to the sums specified against each of them as grants-in-aid of their revenues under the substantive part of clause (1) of Article 275 of the Constitution, provided that these amounts shall be released in the manner indicated in para 9.6.

| State | Amount (Rs. Crore) |
|----------------------|-----------------------|
| 1. Andhra Pradesh | 21.625 |
| 2. Arunachal Pradesh | 0.125 |
| 3. Assam | 6.500 |
| 4. Bihar | 16.875 |
| 5. Goa | 0.125 |
| 6. Gujarat | 14.375 |
| 7. Haryana | 2.875 |
| 8. Himachal Pradesh | 1.625 |
| 9. Jammu and Kashmir | 1.375 |
| 10. Karnataka | 3.000 |
| 11. Kerala | 4.500 |
| 12. Madhya Pradesh | 3.000 |
| 13. Maharashtra | 6.500 |
| 14. Manipur | 0.250 |
| 15. Meghalaya | 0.250 |
| 16. Mizoram | 0.250 |
| 17. Nagaland | 0.125 |
| 18. Orissa | 23.125 |
| 19. Punjab | 5.375 |
| 20. Rajasthan | 8.375 |
| 21. Sikkim | 0.250 |
| 22. Tamil Nadu | 7.750 |
| 23. Tripura | 0.750 |
| 24. Uttar Pradesh | 28.625 |
| 25. West Bengal | 11.875 |
| Total : | 169.500 |

(Para 11.16)

N.K.P. Salve
Chairman

Abdus Sattar Qureshi
Member

Raja J. Chelliah
Member

Lal Thanhawla
Member

Mahesh Prasad
Member Secretary

New Delhi
The 29th July, 1988