July 7, 2008

CPI (M)'s Note
To the Thirteenth Finance Commission

We greatly appreciate the gesture of the Thirteenth Finance Commission in seeking the views of our Party, the Communist Party of India (Marxist), on the issues arising out of the terms of reference. This gives us an opportunity to present our views on the past trends in Centre-State relations, recent experiences and the need for a change in approach towards a host of issues.

We would like to note that there has been a growing tendency on the part of the Centre to concentrate and consolidate various administrative, legislative and financial powers, despite the federal character of the Constitution, the recommendations of the Sarkaria Commission and the demands of State Governments. This problem has been aggravated in the financial sphere, with newer forms of intervention and restriction on the powers of the States after the adoption of neoliberal economic policies by the Central Government since 1991. In what follows, we summarise the major financial issues in Centre–State relations and our expectations from the 13th Finance Commission (hereafter 13th FC).

I. Formation of Finance Commissions:

The ability of the FC to work as an independent semi-judicial authority is undermined by its unilateral formation by the Central Government, without prior consultation with or representation from the States.

We therefore propose the following:

- All constitutionally mandated bodies like the Finance Commission, which arbitrate between the Centre and the States, must be formed only after prior consultation with the States and subsequent ratification by the Inter-State Council, where both the Centre and the States are represented.

II. Terms of Reference (ToRs):

The Constitution provides very clear provisions for the work of the FC, i.e., the determination of vertical and horizontal transfers as well as grants for States to meet their non-Plan revenue deficits. However, in recent years the Central Government has usurped for itself the powers to draw up the terms of reference of the FCs. In the last decade these have transgressed the Constitutional provisions.

For example, even as the term of the 11th FC was drawing to an end, the Presidential Order of April 28, 2000, asked it "to draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the states and recommend the manner in which the grants to states to cover the assessed deficit on their non-Plan revenue account may be linked to progress in implementing the programme". This had two far-reaching implications: first, it made a certain notion of "fiscal reform" constitutionally legitimate; and second, it gave the Centre the ability to use assistance to cover non-Plan revenue deficits (which was a Constitutional right of the States) as an instrument to enforce compliance. The ToR of the 12th FC marked an even greater divergence from the Constitutional mandate by further pushing State Governments along a reform path conceived and designed by the Central Government, since it included suggesting “a plan by which the (State) governments, collectively and severally, may bring about a restructuring of the public finances, restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth”.

The 13th FC is burdened with a huge number of ToRs, six in all, with the third ToR having as many as 10 sub-clauses, including demands to “manage ecology, environment and climate change consistent with sustainable development”, and “to assess the impact of the proposed implementation of goods and services tax …on the country’s foreign trade”. Such multiplicity of ToRs is extra-Constitutional, unnecessary and distracting. Many of the ToRs echo the economic viewpoint of the Central Government, which may not reflect the thinking of several State Governments, which are under different political dispensations.

In addition, Clause 9(ii) of the ToR requires the 13th FC to consider “the demands on the resources of the Central Government, in particular, on account of the projected Gross Budgetary Support to the Central and State Plan, expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities”. This is effectively a prioritization of Central Government’s committed expenditure, which gives the Centre first right over joint resources and effectively implies that the 13th FC would be transferring only the residual resources for the States to share. This is clearly un-Constitutional as it violates Article 280 of the Constitution, which mandates the entire pool as divisible between the Central Government and the States. It also privileges the committed expenditure of the Central Government over that of the States, even when States may be burdened with high committed expenditure on interest and salaries wholly on account of Central policies. In a context where there are legally binding limits on fiscal deficits and aggregate transfers to the states, this asymmetric treatment is not only un-Constitutional but also unfair.

It is worth drawing attention to ToR 6(x) where a mention has been made to “the need for ensuring commercial viability of irrigation projects, power projects, departmental undertakings and public sector enterprises through various means, including levy of user charges and adoption of measures to promote efficiency”. Experience suggests that the commercial viability and efficiency of these important projects very often urgently require a significant investment on appropriate renovation and modernisation of plants and machinery. We trust that the requirement of expenditure for these purposes will be seriously taken into account while assessing the needs of public expenditure by the Thirteenth Finance Commission.

Therefore, we propose the following:

- The 13th FC must assert its autonomy and reject the additional ToRs that reduce the States’ freedom.
- The 13th FC should also recommend that in future, the TORs must be drawn up jointly by both parties through consultation and ratification by the ISC.

- The 13th FC should maintain the Constitutional position of equivalence and neutrality between the Central Government and the States and reject ToR 9(ii).
- In case ToR 9(ii) is accepted, then the 13th FC should treat the States' committed expenditure on civil administration, debt servicing, salaries and pensions, etc. (including the burden of pay revision resulting from the Centre's decision) as committed expenditure as well.

III. Vertical Imbalance and Devolution

In the financial sphere, there has been a long-standing problem of centralisation of resources in the hands of the Central Government, and a gross inadequacy of resources with the States in relation to their development needs. In recent years, this problem has been aggravated by the curtailment of various financial and decision-making powers of the States.

The basic financial imbalance in Centre-State relations arises from the fact that, while the Constitution gives the States the major responsibilities in the sphere of developmental expenditure (e.g., on irrigation, roads, power, education, health, etc.) and administrative expenditure (e.g., on law and order, general administration, etc.), the more important powers of revenue-raising have remained concentrated in the hands of the Centre. As a result, there is a major problem of vertical imbalance and inadequate devolution. To take just one example, in 2004-05 the total development expenditure of the States, at Rs 3.62 lakh crores, was more than 1.5 times that of the Centre, but State Governments received only 38% of the total revenues collected in the country.

In this context, it is essential to work out a fair principle for sharing of Central taxes with the States, such that the ratio of Central taxes net of transfer to the States and the State taxes including the share of Central taxes is equal to the ratio of the needed development expenditures of the Centre and the States respectively. Applying this principle to the actual and required trend of development expenditures of the States, the States' share of Central tax revenue should be at least 50%.

In addition, the devolution of Central taxes and grants from the Centre to the States has not occurred as was envisaged in Chapter-I, Part XII and Article 275 of the Constitution. The devolution of Central taxes and grants (net of interest payment by the States on Centrally imposed loans) as a proportion of total revenue receipts of the Centre fell from 32.7% in 1990-91 to 29.5% in 2004-05. This problem has been exacerbated by the neoliberal economic policies of the Central Government, which have included sharp reduction in import duties, reluctance to enhance the rate of direct taxes for the richer groups and inadequate attention paid to unearthing of tax-evaded black money. As a result, the actual collection of Central taxes fell significantly short of the amount recommended by the Eleventh Finance Commission. Therefore, not only has the States' share of Central taxes remained low at 29.5%, but the actual amount received by the States has also been substantially lower, by nearly 19%, from what was recommended by the Commission over the reference period (2000-05).

In the past, States have assessed the flow of their revenue and expenditure for the five years covered by the relevant FC in order to estimate their non-Plan Revenue

Deficits for awards from the FC. However, the 12th FC evolved its own normative criteria-based methodology to project revenue and expenditure estimates for the States and the Centre over the next five years. States had argued at the time that this methodology was arbitrary and heavily biased in favour of the Centre. For example, while the Centre's revenue receipts were shown to rise by only an additional 1.17% of GDP, backward states were assumed to achieve 11-12% growth rates of State incomes. GSDP growth rates and buoyancy factors too were highly ambitious, and the non-tax revenue estimates were unrealistically high. Five per cent return or dividend on equity in PSUs and recovery of 90% operation and maintenance costs in irrigation were not only prescribed but also taken as achieved in the subsequent calculations of pre-devolution deficits. This was clearly on the basis of wishful thinking rather than any actual macroeconomic interventions.

Furthermore, non-Plan revenue expenditure (NPRE) was assumed to grow moderately and NPRE projections made by the TFC were substantially lower than the experience and estimates of the states. The targets fixed on the basis of these unrealistic higher growth rates of tax and non-tax revenue and underestimation of NPRE has deprived the States of a substantial amount of revenue deficit grant, meant to be filled by the TFC, and is less than a fourth of the assessment made by the States. Instead of the normative approach, an ex ante need-based approach in line with the functional responsibilities of the States should be adopted to evaluate the resources of the States reasonably. The normative approach has meant that the deficit of the States is underestimated, leading to a huge gap in the non-Plan revenue account. The 13th FC must revert to the earlier practice of accepting the States' assessments after due examination of their methodology.

In this context, we demand the following:

- At least 33.33% of the total pool of collection of Central taxes should be devolved to the States, which should be progressively increased to 50% over a period five years.
- The 13th FC should fix a minimum guaranteed devolution of Central taxes from the Centre to the States in absolute terms, on the basis of expected revenue and percentage share for vertical devolution. Any resource mobilization over and above this should be shared in the recommended ratio.
- The 13th FC must revert to the earlier practice of accepting the States' assessments of required expenditure and projections of revenue deficits after due examination of their methodology.

IV. Limitations on Financial Powers of States

The share of total market borrowing to which the States may be entitled is fixed by the Centre. While in 1950s, the shares of market borrowing of the States and the Centre in the total Government market borrowings were approximately in the proportion of 50:50, this ratio has now fallen to 15:85, with the dominant share of market borrowing being appropriated by the Centre.

Moreover, the States have also justifiably urged for transfer of at least residuary powers in the Constitution, particularly residuary powers of taxation of services to the States. Unfortunately, through a Constitutional amendment of late, the Centre has acquired for itself the entire power of levy of service taxation. Fairness requires that the States may now at least be given the concurrent powers of taxation of all services. An opportunity in this regard has arisen in the context of the proposed introduction of Goods and Services Tax by the Centre and the States beginning April 1, 2010.

We therefore demand the following:

- Consistent with the development responsibilities of the States, the share of market borrowing of the States should be increased from the absurdly low proportion of about 15 % to 33.33% immediately and then steadily to 50 % within a period of five years.
- State governments should be given concurrent powers for taxation of all services.

V. Impact of Central Government’s Policies on States

Neoliberal economic policies have forced the States to compete with one another in attracting industrial investment in terms of granting of tax exemptions, resulting in shortfall in the collection of State's own tax revenues as well. In addition, the Government of India created a significant distortion in the over-all tax structure by granting Central tax exemption for certain areas instead of providing direct financial support for infrastructure development for industrial growth in those areas. This has often forced other States to give matching State tax concessions, resulting in further declines in their tax revenues.

The Central policy of charging unfairly high rate of interest on the Central loans to the States, particularly for the loans related to small savings (with interest rate at one time exceeding even 16%), has substantially increased the debt burden of the States. As a result, the ratio of interest payments to revenue receipts of the State Governments increased from 13% in 1990-91 to 26% in 2003-04.

The debt burden on the States caused by the Central loans has been exacerbated in the case of small savings collection (now called the National Savings Scheme Fund or NSSF loan). The rate of interest charged by the Government of India on such loans to the States has remained significantly higher (often by more than 2 percentage points) than the rate of interest paid by the Government of India to the depositors of the Small Savings Scheme.

A new problem has recently arisen due to the rate of interest on bank deposits becoming much higher than the rate of interest on small saving schemes resulting in erosion of small savings collection. In this backdrop it is imperative to realign the interest rates on small saving schemes to its previously attractive position relative to bank interest rates.

The impact of the pay revision on the basis of the Centre's decision on the implementation of the recommendations of the Fifth Central Pay Commission has been severe on the finances of the States, leading to serious financial crisis. After much protest by the States, the Central Government agreed to bear at least 50% of the additional financial burden of the States due to pay revision. This assurance, however, was not honoured and no Central assistance on this account was actually provided. This is extremely relevant now because the Centre is will soon take a decision on the recommendations of the Sixth Central Pay Commission, which may once again have serious financial implications for the States. We have already noted that the ToR of the 13th FC is asymmetrical in this regard, specifying that the expenditure on civil administration of the Central Government should be considered as committed expenditure but making so such recommendation with respect to similar expenditure of the State Governments.

The 13th FC should consider compensating the States for the fiscal and socio-economic hardships they face due to changes in national policies, a matter not taken up by any FC apart from the First. The Central government enters into bilateral and multilateral trade agreements with other countries, which have an immense bearing on the agricultural sector, without even consulting the State Governments, even though agriculture is a State subject. The commitments of the country under WTO, SAARC etc. have negatively affected the agricultural sector in several States resulting in starvation and farmer's suicides, as has the appreciation of the Rupee harmed export-oriented crops. Similarly, changing macroeconomic policies of the Centre can cause havoc on State finances as well as on human development. In all such cases, at the very least, a system of compensation of losers by the gainers should be put in place. In the present context, this means compensation by the Central government to State Governments for the losses suffered by agriculturists belonging to the latter's domain. The Central Government at present announces occasional "relief packages" for those who are hit by distress caused by its own policies, but such occasional "relief packages", which are subject to the Centre's discretion, are no substitute for a system of compensation that would be in keeping with the spirit of the Constitution in allocating powers between the Centre and the States. Hence the 13th FC should devise a system whereby the States are compensated by the Centre for losses suffered in sectors like agriculture, which are under the jurisdiction of the States.

There are certain important national level and inter-State issues which are located within the States, such as major irrigation projects, erosion of major rivers, Central investment in CPSUs, railways, national highways, ports, airports, etc. For each of these issues, Central investment is required and the interests of both Centre and States are involved. Therefore it is necessary to ensure inter-State balance in taking these decisions. Similarly, there is, in the interests of containment of inflation, an urgent need to augment and expand the Public Distribution System in co-ordination with the States as well as strengthening of Essential Commodities Act and effective regulatory measures. In the interest of the States, it is also necessary to revise the royalty rates on coal (and other minerals) more frequently and charged on ad valorem basis, and also to ensure that coal royalty be paid at the latest revised rates without any discrimination among the States. The present scheme of the National Calamity Relief Fund also needs to be changed in order to increase the corpus of funds for the States.

In this context, we demand that:

- The anomalies resulting from differential interest rates faced by Centre and States should be removed forthwith.
- The Government of India should bear at least 50% of the additional consequential burden of the States for pay revision; OR
- The 13th FC should rise above the dictated ToR and uphold its Constitutional position of a neutral arbiter by considering in its recommendations the States' expenditure on civil administration and committed expenditure taking into account the assessed burden of pay revision consequent upon the Centre's decision on Sixth Pay Commission.
- The distortions created by the Central tax exemptions should be stopped and compensatory direct development grants should be given to the concerned States.
- Before discussing any issue with WTO, IMF, World Bank or any agency on State subjects, the consultation with the States should be made mandatory and the Central Government should not impose any external loan/aid-agency

conditionality on a State subject on any State Government without its concurrence.

- The 13th FC should devise a system whereby the States are compensated by the Centre for losses suffered owing directly to the policies of the Central government.
- Royalty on coal (and other minerals) should be revised more frequently, and coal royalty should be paid on ad valorem basis and at the latest rates, and without any discrimination among the States.
- The corpus of funds of the National Calamity Relief Fund for the States needs to be increased.

V. Conditionalities Imposed upon State Governments

The financial crisis of the States, which was a result of the Central Government's policies, has been used to impose the conditionalities of neoliberal reforms on the States. For example, on the basis of recommendation of the 11th FC, 15% of the States' entitlement of revenue deficit grant were to be withheld unless the States had complied with the reduction of the 5% of revenue deficit as a proportion of revenue receipts in every year over the period 2000-2005. This was despite strong protests from the States, and dissent within the 11th FC expressed in the form of a Dissent Note questioning the very Constitutionality of such a move.

Such neoliberal conditionalities forced the States to impose a virtual ban on recruitment, which created genuine problems in delivery of welfare services and developmental activities of the States. Moreover, this mechanical neoliberal conditionality has also started showing signs of design failure. The uniform prescription was oblivious of the widely different problems and magnitudes of the proportions of revenue deficit to revenue receipts among the States, and it created an anomalous situation in the Centre-State relations.

Another important issue relates to the conditionalities associated with debt relief and debt consolidation. This has been tied up with the neoliberal conditionality of enactment by the States of Fiscal Responsibility and Budget Management (FRBM) Act, which requires bringing out annual reduction targets of revenue deficit and fiscal deficit with total elimination of revenue deficit to zero by 2008-09. This is a very restrictive condition, imposed uniformly without regard to the initial conditions of the States. In addition, it suffers from a mechanical and inadequate understanding of the components of revenue expenditure. According to the accounting principles laid down by the Comptroller and Auditor General of India, all grants to the local bodies (i.e. panchayats and municipalities), to the aided schools and colleges, expenditure on account of salaries of doctors, medicines, etc. are classified as revenue expenditure. If the States are to make an effort to achieve the targets of FRBM Act, then there may not be much fiscal space left for them for development expenditure. This would amount to withdrawal of the welfare and developmental role of the States.

Another modality through which neoliberal conditionalities are being introduced is through the Centrally Sponsored Schemes. These schemes are formulated without adequate consultation with the State Governments and without regard to the priorities of the State Governments. Since the State Governments have to bear a substantial part of expenditure, they find it difficult to make proper allocation of their own resources keeping their own priorities in view. Moreover, the conditionalities often impinge upon the sovereign power of the States. For example, when JNNURM was launched, the State Governments were unilaterally asked by the Centre to bring down Stamp Duty rate within five years to a level not exceeding 5%. This is a direct intrusion into the sovereign power of the States, as with respect to taxes in the State list the Legislative Assembly has full power to prescribe rates. In some of the Centrally Sponsored Schemes, the share of the States' financial burden is also being unilaterally increased. For instance, despite repeated objections by all the Chief Ministers, the Centre has taken a decision to increase the share of the States in the Sarva Shiksha Abhiyan Programme from 25 % steadily to 50 % under the Eleventh Five-year Plan.

Recently the Government of India has accepted the recommendation of the Vaidyanathan Committee on revival of co-operative credit structure, whereby once again the sovereign power of the States has been infringed upon and the flow of assistance has been linked with imposition of neoliberal conditionalities, even though cooperation is a State-List subject.

States have been arguing, particularly since the 1990s, for the transfer of Centrally Sponsored Schemes with funds to the States, and this was also resolved at the Conference of the Chief Ministers convened by the Prime Minister on May 4, 1996. Although several exercises have been carried out in this regard from time to time, there has been no effective resolution of this issue. Not only has this issue remained unresolved, but more and more Centrally Sponsored Schemes, now with neoliberal conditionalities, are being introduced by the Central Government. This is reflected in the fact that, while over the years Central transfer to the States as a proportion of the Centre's revenue receipt has fallen, the proportion of transfer of funds with conditionalities in the form of Grants-in-Aid has increased from 40.9% in 1980-81 to nearly 49.3% in 2005-06 (RE).

There can be broad guidelines worked out for Central Schemes on the basis of discussions between the Centre and the States, and also an appropriate periodic joint Centre-State review. But the formulation and implementation of the schemes, with transfer of funds, should be with the States with needed federal flexibility. This transfer is urged upon not only for the purpose of correct decentralisation, but also for reduction of cost of implementation and saving of Central resources, which then can also be used for supporting the enhanced sharing of Central taxes with the States mentioned earlier.

The much-needed decentralisation of financial and decision-making powers from the Centre to the States should also be accompanied by a corresponding and appropriate decentralisation of powers from the State levels to the Panchayats and municipalities in the districts and below. Here, we urge that the ToR [Clause (iii)] of the Thirteenth Finance Commission relating to “the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State” should be taken seriously by the Thirteenth Finance Commission and the States be enthused to make full efforts at decentralisation within the States.

We therefore demand that:

- Instead of relying on rigid and uniform conditionalities, solutions to the problem of burden of Central loan should be worked out in a State-specific manner, with an appropriately defined objective discussed with the relevant State Governments. This State-specific debt relief should have a component of the relief in terms of writing off at least 25% of the loan, and another part in terms of consolidation of past loans with a provision of interest relief with the interest rate not exceeding 6%.

- Centrally Sponsored Schemes should be transferred to the States with funds, allowing for flexibility in design and implementation.