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## **An Analysis of India's Thirteenth Finance Commission Report**

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### **Abstract**

The paper looks at the trends of fiscal consolidation in India following the introduction of the Fiscal Responsibility and Budget Management (FRBM) Act of 2003. It examines the deviations from the FRBM targets since 2007 and analyses the recommendations of the Thirteenth Finance Commission in the light of the evolving pressures on India's public finances. The paper argues that apart from laying out the roadmap for devolution of resources from the Centre to the States, the Commission's key contribution has been on emphasising restoration of fiscal discipline by reducing deficits, more transparent use of public debt and greater accountability in managing public finances.

### **Introduction**

The Constitution of India envisages a federal structure with distinct responsibilities for the Union and the States. Analysts have pointed out that the responsibilities enjoined on the States are not matched with the capacity to generate revenues for fulfilling them, and that delivery of programmes in education, health, agriculture, irrigation, internal security and local administration require resources far in excess of the constitutional ability of the states to tax. The Constitution, however, provides a mechanism for the devolution of revenues from the Union to the states from out of central tax revenues. The criteria for vertical and horizontal devolution are based on the recommendations of a finance commission that is appointed every five years for that purpose. The Thirteenth Finance Commission (TFC), dealing with the devolution of resources from the Centre to the States, has just submitted its report for the period 2010 to 2015 and the Finance Minister has, in his budget speech, indicated that the Government would accept their recommendations for devolution.

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Apart from the normal terms of reference to determine the share of central tax revenues that would devolve to the states, the TFC was also requested to come up with a roadmap for the fiscal consolidation of public revenues, in the light of the fiscal expansion that had taken place since 2008.

### **Fiscal Responsibility and Budget Management Act, 2003 and Subsequent Developments**

The post-2003-04 period witnessed a number of important developments which had a bearing on the public finances of the Centre as well as the states. The introduction of the Fiscal Responsibility and Budget Management Act (FRBM) in 2004-05<sup>2</sup> led to a more transparent, rule based, management of public finances. The FRBM Act envisaged the following obligations of the Central Government:

- i. eliminating revenue deficit by the year 2008-09 by ensuring a minimum annual reduction of 0.5 per cent of GDP every year beginning from 2004-05.
- ii. reducing fiscal deficit by at least 0.3 per cent of GDP annually from 2004-05, so that fiscal deficit is reduced to no more than 3.0 per cent of GDP at the end of 2008-09.
- iii. limiting government guarantees to 0.5 per cent of GDP in any financial year and limiting additional liabilities to 9.0 per cent of GDP in 2004-05 and thereafter reducing the limit of 9.0 per cent by one percentage point of GDP in each subsequent year.
- iv. prohibiting the Central Government to borrow from the Reserve Bank of India (RBI) from 2006-07 onward.
- v. disclosing specified information, such as arrears of revenue, government assets and guarantees, latest from the year 2006-07.
- vi. undertaking quarterly review of receipts.

The introduction of the Value Added Tax (VAT) by the state Governments in 2005-06 considerably augmented their tax bases. The Twelfth Finance Commission (FC-XII) submitted its report in 2004 for the period 2005-2009 which raised the share of states entitlement of net central tax revenues from 29.5 per cent to 30.5 per cent. More importantly, the Commission recommended debt relief facility to the states conditional on their enacting legislations for fiscal responsibility, a condition that all states, barring West Bengal and Sikkim, complied with. The debt relief facility resulted in considerable relief to the states in the form of debt write-off and interest savings, leading to considerable improvements in the state finances till 2007-08. By this time, the Centre's fiscal deficit declined by 1.79 percentage points, to 2.69 per cent of GDP in the same period. The aggregate fiscal deficits of the states declined by 1.89 percentage points, to 1.51 per cent of GDP over the same period.

Over this period, revenue realisation also improved. The gross tax-GDP ratio went up by over three percentage points in a span of four years, from 9.23 per cent in 2003-04 to 12.56 per cent in 2007-08. The entire improvement came from the buoyancy of direct taxes, more particularly from corporation tax, reflecting the increasing profitability of the Indian corporate sector (Table 1).

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<sup>2</sup> Though the FRBM Act was passed by the Indian Parliament in 2003, the Act was notified and came into force from 5 July 2004.

**Table 1: Central Government Tax Trends: 2003-04 to 2009-10<sup>3</sup>**

Year	Corporation Tax	Income Tax	Total Direct Taxes	Customs Duties	Union Excise Duties	Service Tax	Total Indirect Taxes	Total Central Tax Revenues (Gross)
<i>per cent of GDP</i>								
2003-04	2.31	1.50	3.81	1.77	3.30	0.29	5.42	9.23
2004-05	2.63	1.56	4.22	1.83	3.15	0.45	5.47	9.68
2005-06	2.82	1.56	4.61	1.81	3.10	0.64	5.60	10.21
2006-07	3.50	1.82	5.57	2.09	2.85	0.91	5.89	11.47
2007-08	4.08	2.17	6.61	2.20	2.62	1.09	5.95	12.56
2008-09 (RE)	4.17	2.03	6.55	2.03	2.04	1.22	5.25	11.80
2009-10 (BE)	4.38	1.82	6.32	1.67	1.82	1.11	4.63	10.95
<i>per cent of Centre's Gross Tax Revenue</i>								
2003-04	24.99	16.27	41.31	19.12	35.69	3.10	58.69	
2004-05	27.11	16.15	43.53	18.89	32.50	4.66	56.47	
2005-06	27.66	15.29	45.12	17.77	30.38	6.30	54.88	
2006-07	30.48	15.86	48.61	18.23	24.84	7.94	51.39	
2007-08	32.52	17.30	52.63	17.55	20.84	8.65	47.37	
2008-09 (RE)	35.35	17.20	55.48	17.20	17.26	10.35	44.52	
2009-10 (BE)	40.05	16.66	57.72	15.29	16.61	10.14	42.28	

Note: Total Direct Taxes and Total Indirect Taxes include Other Taxes.

Source : Basic data from Central Budget documents

The period 2007-2009 witnessed sharp fiscal expansion, in part due to the global slowdown, and equally due to the populist measures prior to the general elections that included write-off of agricultural debt as well huge subsidies for petroleum products and fertilizer. The Centre has put in place three fiscal stimulus packages in quick succession (December 2008, January 2009 and February 2009). Collectively, these have meant a 'pause' in the implementation of the FRBM Act by the Centre. The states, too, have been allowed relaxation in their fiscal and revenue deficit targets. These measures resulted in a deterioration of public finances for the states as well as the Centre (Table 2)

<sup>3</sup> Table 4.4 of the Thirteenth Finance Commission (TFC) report, available at <http://fincomindia.nic.in/ShowContentOne.aspx?id=27 &Section=1> [Accessed on 4 March, 2010].

**Table 2: Central Government Deficit Trends: 2003-04 to 2009-10<sup>4</sup>**

*(per cent of GDP)*

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Ratio of Revenue to Fiscal Deficit (%)
2003-04	4.48	3.57	-0.03	79.71
2004-05	3.98	2.49	-0.05	62.57
2005-06	4.08	2.57	0.38	63.03
2006-07	3.45	1.94	-0.19	56.27
2007-08	2.69	1.11	-0.93	41.42
2008-09 (RE)	6.14	4.53	2.51	73.89
2009-10 (BE)	6.85	4.83	3.00	70.51

Note: Minus (-) sign indicates 'surplus'.

Source: Basic data from Central Budget documents

As greater share of public borrowings were utilised for meeting current expenses, capital formation deteriorated from 3.96 per cent of GDP in 2003-04 to 1.83 per cent in 2008-09. The share of total debt of the central government increased to 59.68 per cent of GDP by 2008-09 (Table 3).

**Table 3: Central Government Expenditure Trends: 2003-04 to 2008-09<sup>5</sup>**

*(per cent of GDP)*

Year	Revenue Expenditure	Interest Payments	Defence	Pay and Allowances	Pensions	Subsidies	Capital Expenditure	Total Expenditure
2003-04	13.14	4.50	2.18	1.21	0.58	1.61	3.96	17.11
2004-05	12.20	4.03	2.41	1.16	0.58	1.46	3.62	15.82
2005-06	12.25	3.70	2.25	1.08	0.56	1.32	1.85	14.10
2006-07	12.46	3.64	2.07	1.00	0.54	1.38	1.67	14.13
2007-08	12.58	3.62	1.94	0.97	0.51	1.50	2.50	15.09
2008-09 (RE)	15.10	3.62	2.15	1.33	0.61	2.43	1.83	16.93
2009-10 (BE)	15.32	3.85	2.42	1.50	0.60	1.90	2.11	17.43

Source : Basic data from Central Budget documents

State finances, after improving initially, deteriorated over the last two years. The revenue account of states turned surplus in 2006-07 from a deficit of 1.25 per cent of GDP in 2004-05. The fiscal deficit declined significantly from 3.40 per cent in 2004-05 to 1.51 per cent of GDP in 2007-08. The primary balance also turned surplus in 2006-07 from a deficit of 0.65 per cent of GDP in 2004-05. The surplus on the revenue account provided more fiscal space to states to enhance their capital spending. In line with other fiscal indicators, the debt-GDP ratio too exhibited a declining trend. However, in 2008, the Central government permitted fiscal expansion to take place, and the target for elimination of revenue deficit was moved to 2009-10. The aggregate fiscal deficit of states is budgeted to increase further to 3.23 per cent of GDP in 2009-10, close to the level obtaining in 2004-05.

<sup>4</sup> Ibid; Table 4.1

<sup>5</sup> Ibid; Table 4.5

**Table 4: Central Government Revenue, Expenditure & Deficit: 2003-04 to 2009-10<sup>6</sup>**

*(per cent of GDP)*

	2004-05	2005-06	2006-07	2007-08	Change 2007-08/ 2004-05	2008-09 (RE)	2009-10 (BE)
I. Total Revenue (A+B)	11.49	11.99	12.92	13.20	1.71	13.87	13.60
A. Own Revenue	7.25	7.24	7.73	7.70	0.45	7.70	7.60
i) Tax Revenue	5.78	5.91	6.11	6.07	0.29	6.21	6.27
ii) Non-tax Revenue	1.47	1.33	1.62	1.63	0.16	1.50	1.33
B. Transfers from Centre	4.24	4.75	5.18	5.50	1.26	6.16	6.00
i) Tax Share	2.49	2.65	2.92	3.22	0.73	3.26	3.17
ii) Grants	1.75	2.10	2.27	2.29	0.54	2.90	2.83
II. Revenue Expenditure	12.73	12.18	12.21	12.26	-0.47	13.59	14.09
Of which: Interest Payments	2.75	2.36	2.29	2.12	-0.63	1.96	1.95
III. Total Expenditure	14.62	14.33	14.53	14.73	0.11	16.53	16.73
IV. Revenue Deficit	1.25	0.19	-0.71	-0.94	-2.19	-0.27	0.50
V. Fiscal Deficit	3.40	2.56	1.69	1.51	-1.89	2.64	3.23
VI. Primary Deficit	0.65	0.20	-0.60	-0.61	-1.26	0.68	1.28
Memo: Non-debt capital receipts	0.26	0.25	0.18	0.17	-0.09	0.31	0.12

Source: Basic Data from State Finance Accounts

The following is a summary from Chapter 4 (Pg.59-60) of the TFC report<sup>7</sup> on the comparative performance of the states:

- i. there was significant improvement on the revenue account, with the number of revenue-surplus general category states going up from four in 2004-05 to 14 in 2007-08. The only three states with revenue deficits in 2007-08 were Kerala, Punjab and West Bengal. Thus, in most general category States, elimination of the revenue deficit was achieved one year ahead of the target date. All special category states were in revenue surplus in 2007-08.
- ii. elimination of revenue deficit in all states (barring three) by 2007-08, meant that fiscal deficits were now incurred on account of capital expenditure. This marks the quality of fiscal correction achieved.
- iii. only five of the 17 general category states had fiscal deficits exceeding 3.0 per cent of Gross State Domestic Product (GSDP) in 2007-08, as compared to 11.0 in 2004-05. Among the 11 special category states, only four (Jammu & Kashmir, Mizoram, Nagaland and Uttarakhand) had fiscal deficits exceeding 3.0 per cent of GSDP in 2007-08, as compared to 10.0 in 2004-05.
- iv. in six of the 17 general category states, fiscal deficit was less than 2.0 per cent of GSDP, and in Maharashtra and Orissa, the fiscal account turned surplus in 2007-08. The borrowing limits prescribed for states in accordance with the correction path stipulated

<sup>6</sup> Ibid; Table 4.8

<sup>7</sup> <http://fincomindia.nic.in/ShowContentOne.aspx?id=27&Section=1> [Accessed on 4 March, 2010].

by FC-XII, were with reference to the GSDP paths as projected by FC-XII. States with higher GSDP growth than projected would, thereby, exhibit lower fiscal deficits as a percentage of their actual GSDP.

- v. corresponding to the declining path of fiscal deficits, the debt-GSDP ratios of states also declined over the period. There were only four general category states with debt-GSDP ratios exceeding 40.0 per cent in 2007-08, as compared to seven in 2004-05. However, the debt position of six of the 11 special category states worsened by 2007-08.
- vi. with a few exceptions, the tax-GSDP ratios of all states improved over 2004-08, both in the general category and the special category, the exceptions being Haryana and West Bengal in the general category and Assam in the special category. The tax-GSDP ratio is the highest in Karnataka, followed by Tamil Nadu and Andhra Pradesh. Bihar and West Bengal are at the bottom of the list of general category states in terms of tax-GSDP ratios.
- vii. there was only a marginal decline of 0.20 percentage points of GSDP in the aggregate revenue expenditures of general category states in 2004-08, with eight states witnessing an increase and nine states registering a decline. There was significant increase in revenue expenditure in Andhra Pradesh, Bihar and Jharkhand. Further, significant reduction in revenue expenditure took place in Chhattisgarh, Gujarat, Maharashtra and West Bengal. There was a marginal increase in revenue expenditure of special category states during 2004-08, with the exception of Assam, Sikkim, and Tripura, which saw a reduction in their revenue expenditure-GSDP ratios.

In short, even though the implementations of the Twelfth Finance Commission recommendations brought public finances of the Central Government and the States into a modicum of fiscal discipline, fiscal expansionism after 2007 has resulted in a considerable deterioration. The causes of the deterioration are argued to be the fiscal stimulus packages following the global crisis of 2007-08, though several analysts feel that they are more due to the political requirements of the general elections of 2009. Whatever the origin, there is consensus that fiscal discipline needs to be restored, and hence it is not surprising that the recommendations of the Thirteenth Finance Commission focus substantively on these issues. It is to be noted that fiscal management is not the constitutional role of the finance commission, but for the first time, the terms of reference have included this role, and the recommendations have been considered seriously by the Government in the budget of 2010-11. The recommendations attempt to address three distinct issues: the devolution of revenues, need for greater transparency and removal of distortions and, corrections required in public finances.

### **Past Transfers**

The pattern of transfers to the states out of Central revenue receipts is given in Table 5. It is interesting to note that total transfers have not changed significantly over the years, and have actually declined marginally in the last three years. Even though FC-XII had recommended a share of 30.5 per cent as a share of Central taxes to States, the actual devolution has been less a matter that the states have repeatedly pointed out. TFC has stated that it would like greater transparency in these transfers and the central accounts should be available for scrutiny. An area of further concern for states in the sharing of net Central tax revenue is the sharp

increase in the proportion of cesses and surcharges in the gross tax revenue of the Centre, from 3.51 per cent in 2001-02 to 13.63 per cent in 2009-10 (BE). This has considerably reduced the proportion in gross tax revenue of the Centre of net tax revenues shareable with states.

**Table 5: Transfer Trends<sup>8</sup>**

(per cent)

Commission	Share of the Centre in Combined Revenue Receipts			FC Transfers to States/ Combined Revenue Receipts	Total Transfers to States/ Combined Revenue Receipts
	Before Transfers	After FC Transfers	After Total Transfers		
FC-VIII	65.4	49.1	38.7	16.3	26.7
FC-IX	62.8	45.6	35.3	17.2	27.5
FC-X	60.8	44.1	36.3	16.7	24.5
FC-XI	58.5	40.4	33.3	18.1	25.2
FC-XII	62.6	42.4	35.7	20.2	26.9
2005-06	61.9	41.6	35.3	20.3	26.6
2006-07	62.5	41.9	35.4	20.6	27.1
2007-08	63.5	43.6	36.5	19.9	27.0

Notes: 1. For FC-XII the average is for three years (2005-08).

2. FC transfers to states include both tax devolution and grants.

3. Total transfers to states include tax devolution and grants by the Finance Commissions and other plan and non-plan grants from the Centre. These do not include transfers outside the state budget.

Source: Basic data from Indian Public Finance Statistics and Union Finance Accounts (various years).

## TFC Recommendations

The TFC has also addressed the issues of vertical and horizontal distribution of tax revenues of the Center. The vertical gap is the difference between the normatively assessed expenditure share and revenue capacities of the Centre and the States. FC-XII recommended the share of states in net central taxes at 30.5 per cent. Without disturbing the approach of normative expenditures, and recognising the relative buoyancy in the Centre and State revenues in the last five years, the TFC has recommended that the States' share of central tax revenues should be increased by 1.5 per cent to 32 per cent. As these are recommendations that are constitutionally binding, the Finance Minister has already accepted these numbers for future devolution. The TFC has also suggested direct transfer of grants to States, and has suggested that the recommendations of the State finance commissions on transfers from the States to their local bodies should be made more binding and regular.

On the distribution of the devolved revenues among the states, the TFC has followed the principles of equity and efficiency. The principle of equity addresses the problem of differences in revenue raising capacity and cost disabilities across States. The principle of efficiency has been used by earlier Finance Commissions to motivate the States to exploit their resource base and manage their fiscal operations in a cost effective manner.

<sup>8</sup> Ibid; Table 4.15

FC-XII assigned a weight of 25 per cent to population, 50 per cent to per capita income distance, 10.0 per cent to area and 7.5 per cent each to tax effort and fiscal discipline in the formula for arriving at the share of each state in tax devolution. The income distance criterion used by FC-XII, measured by per capita GSDP, is a proxy for the distance between States in tax capacity. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between States.

TFC, on the other hand, has recommended the use of separate averages for measuring tax capacity, one for general category States and another for special category States. The procedure used involves working out the three-year average per capita GSDP for the individual states based on comparable estimates for the years 2004-05 to 2006-07. In the next step, the average tax to comparable GSDP ratio has been obtained as a weighted mean separately for general category and special category states. These group-specific averages are then applied to the constituent states in each group so as to obtain the per capita tax revenue in each state, potentially available at the average tax effort for the group in which it falls. The intent is to estimate per capita fiscal capacity at reasonably comparable levels of taxation by application of the observed group average.

For estimating fiscal distance, the TFC has used the distance from the estimated per capita revenue of Haryana, the second highest in the per capita income ranking state after Goa. The distance so computed for all States, barring Haryana and Goa, defines the per capita revenue entitlement of each state based on fiscal distance.

Fiscal discipline as a criterion for tax devolution was used by FC-XI and FC-XII to provide an incentive to States managing their finances prudently. Both these Commissions assigned a weight of 7.5 per cent to this criterion. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the states. TFC has worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years. FC-XII assigned a weight of 7.5 per cent each to fiscal discipline and tax effort. Thus, the combined weight assigned by FC-XII to these two criteria was 15.0 per cent. The TFC has increased this to 17.5 per cent. The criterion for horizontal devolution, then, emerges as in Table 6:

**Table 6: Horizontal Devolution<sup>9</sup>**

<b>Criteria</b>	<b>Weight</b>
1. Population (1971)	25.0
2. Area	10.0
3. Fiscal Capacity Distance	47.5
4. Fiscal Discipline	17.5

The TFC has expressed concern that the collection of cesses and surcharges are being retained by the Centre and not passed on to the States. They have recommended that the cesses and surcharges should be subsumed within the tax rates, or in the alternative, be shared

<sup>9</sup> Ibid; Table 8.1



with the States. The central government has not yet expressed a view on this recommendation, but it is likely that this may get accepted as well. There is also the recommendation that programme transfers, especially through plan grants and centrally sponsored schemes, distort public finances and these should be eschewed in favor of predominantly formula based transfers.

## **Comments**

Surprisingly, a large number of recommendations are of the nature of governance advice, like the reduction of subsidies in the power sector and criticism of use of plan funds for non-plan purposes. On the issue of Goods and Services Tax (GST), though the TFC has made strong recommendations about the need for a grand alliance between the Centre and the States, it is handicapped by the fact that studies do not reflect knowledge of the processes of tax collection at the level of the States. This is possibly because the experts who have attempted this portion of the report are people with experience in direct taxes, but with little knowledge or experience of the intricacies of taxation of goods and services and transactions. The recommendations on the GST front appear quite naïve and shorn of any detailed analysis.

Having taken care of its constitutional responsibilities of devolution, the TFC then turns to the issues of fiscal discipline, a new term of reference, and it is in this area that it has made some fundamental recommendations. First, it has suggested that the revenue deficit of the Centre should be reduced and eliminated by 2014-15. It has also recommended that the combined debt of the Centre and the States should be brought down to 68.0 per cent of the combined GDP by 2014-15. This would mean a reduction in the debt stock of the Centre to 45.0 per cent of the GDP by that time. More importantly, the TFC has recommended tighter discipline and more transparency in disclosure of debt. This would include reporting of plan as well as non-plan grants to States, as well as explicit statements of liabilities, compliance costs and costs of major policy changes. It has suggested that disinvestment receipts should be maintained in the consolidated fund. Future pay awards should not have a retrospective component.

Concern over public finances, public debt and the revenues of the states had been expressed in the report of FC-XII; this was perhaps the first time that a Finance Commission looked at the larger picture beyond the considerations of the agenda for devolution. That Commission had recommended debt relief for the states as well as incentives for fiscal discipline – the TFC has carried these thoughts forward. It has recognised that the efforts made soon after the FC-XII report yielded substantial benefits in the form of greater revenue mobilisation and tighter fiscal discipline, and it would like a similar environment to be created again, having witnessed the fiscal expansion since 2007. Most importantly, the contribution of this report is the requirement that it places on greater transparency of the use of public debt, and an attempt to enforce a stricter accountability over the use of public finances, including parliamentary disclosures on slippages. The acceptance of these recommendations would be a major step to ensure that public finances in India are not affected by internal or external shocks in the future, and that there is true disclosure at all times on the nature of the debt.

This is an important contribution that has been made by the TFC.

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