General Elective Economics 4th Semester Public Finance

Part B: Issues from Indian Public Finance

Unit 5: State and Local Finances

Reading 1: Report of the Fourteenth Finance Commission, Chapter 7: State Finances: Assessment of Revenue and Expenditure (Sections 7.1-7.8 and 7.42-7.47)

The Commission had to follow some guidelines while assessing the revenue and expenditure of the states. It was required to assess revenues and expenditures of each of the States for the period from 2015-16 to 2019-20. The Commission was required to consider "the objective of not only balancing receipts and expenditure of revenue account of all States but also generating surpluses for capital investment."

As per the Andhra Pradesh State Reorganisation Act, 2014 led to formation of two separate states of Andhra Pradesh and Telangana. The Commission was required according to the terms of reference, recommendations for the successor States as well.

The basic approach to assessment remained similar to the previous finance commissions, but there were differences in projecting individual items of receipts and expenditure.

The Commission takes into consideration the views of State before making their recommendations as follows:

1. In comparison to States' own projections there had been under-estimation of the non-Plan revenue expenditures and over-estimation of the own revenue receipts of the States. This was because of the normative approach for assessing revenues and expenditures adopted in the past.
2. Implications of economic slowdown to be taken into consideration while assessing their own revenue receipts. States with low revenue base have pointed out that expenditure on the maintenance of assets such as building, roads and irrigation works worked out on the basis of budget estimates would be inadequate due to insufficiency of resources. The assumption of a meagre 5 percent annual growth rate in expenditure made by the previous Finance Commissions artificially depressed their resource requirements for the provision of various services. The growth rates for projection of maintenance expenditure of major, medium and minor irrigation projects should be indexed to inflation, based on the consumer price index (CPI), instead of assuming an annual growth rate of 5 per cent over the base year estimates. In the case of roads, the norm recommended by the Ministry of Road Transport and Highways for maintenance expenditure projections may be adopted and, in addition, indexed for inflation based on CPI.
3. There is a huge backlog in filling up sanctioned posts due to the fiscal restraint exercised in adhering to fiscal consolidation targets set in the state-level Fiscal Responsibility and Budget Management (FRBM) Acts. Expenditure assessment should take into account the consequent increase in salary expenditure for fresh recruitment in the future. The implications of the Seventh Central Pay Commission's recommendations on the fiscal position of States should be factored into the assessment of expenditure. In the past the

salary projection norm of 35 per cent of the revenue expenditure (net of interest payment and pension) resulted in under-assessment of expenditure needs whereas the share of salary expenditure was more than 60 per cent in many States in reality.

4. The scope for increasing tax revenue in the North Eastern States is very limited due to low levels of commercial activity and low levels of consumption. Different growth rates should be applied for them while projecting their tax revenues. The growth rate applied to make revenue projections in their case should be lower than that of the general category States. The severe disadvantages they faced due to cost disabilities need to be kept in view while undertaking assessment.
5. The projection of deficit in the non-Plan revenue account estimated by States should be taken into account while determining the non-Plan revenue deficit grants. The borrowing limits should be related to the gross state domestic product (GSDP) of the State and not as assumed by the Finance Commission while assessing their compliance with the targets.

Compensation and Assignment to Local Bodies

The expenditure under this major head reflects the transfer in the form of grants-in-aid to local bodies by the States. A normative 8 per cent growth rate for the purpose of projection had been applied by the Fourteenth Finance Commission as was adopted by the previous two finance Commissions.

Plan Revenue Expenditure

Plan revenue expenditure of States is financed by States' own resources, borrowing and Plan grants from the Union. The Plan grants include normal Central assistance, which is untied, additional Central assistance for specific-purpose schemes and transfers, special Plan assistance, special Central assistance, Central Plan schemes and Centrally Sponsored Scheme (CSS). Expenditure incurred on State Plans and States' contribution to CSS have been included in this assessment. This excludes Union expenditure on CSS, Central Plan schemes and North Eastern Council Plan schemes and externally aided projects financed through grants from the Union. Estimation of the 2014-15 base year Plan revenue expenditure for each State, applying an annual growth rate of 13.5 per cent over 2012-13 and 2013-14 have been assumed. Also, an annual growth rate of 13.5 per cent over base year estimates for all the States have been assumed for the projection period.

Assessment of Revenues and Expenditure of Andhra Pradesh and Telangana:

As mentioned earlier, according to the Terms of Reference (ToR) 5A of the Commission, for the reference period resources available to the States of Andhra Pradesh and Telangana to undertake their expenditure responsibilities have been assessed. The Commission reviewed the methodology and approach adopted by the 12th Finance Commission to address the requirements of the then newly-formed States of Jharkhand, Chhattisgarh and Uttarakhand. The mandate is very similar to the current scenario except that the data regarding the finances of the new States for two full years (2001-02 and 2002-03) while formulating the assessment of States' finances was available as against to the non-availability of data except for projections of estimated data for 2014-15 submitted by the two States (Andhra Pradesh and Telangana) in their respective budgets and memorandum. This is the first challenge faced by the Commission in the absence of finalised accounts was to address the issues involved in the division of past finances between Andhra Pradesh and Telangana before undertaking a detailed assessment. Treasury-wise/head-wise Finance Accounts for the erstwhile State of Andhra Pradesh in addition to the 2014-15 estimates have been made available by the two States. To make projections for the reorganized States, assumptions had to be made regarding their existing and previous or prior fiscal/financial positions, in the absence of audited finance accounts. According to the available consolidated raw data the Commission have apportioned them between the two States on the basis of some objective principles.

Equalisation

The Commission have taken a comprehensive view along with the attempt to address the goal of equalization while formulating their assessment of expenditure of the Sates. The equalization of expenditures across States is not sector specific, but an aggregate assessment of the per capita expenditure needs of States to enable all States to spend a certain minimum expenditure, to the extent feasible within the overall resource envelope. The methodology used by Commission for equalisation involved a baseline assessment of the revenue expenditure (net of interest and pension payments and CSS transfers) of all States based on the norms assumed for individual items of expenditure. Subsequently, the per capita revenue expenditures of States for the period from 2015-16 to 2019-20, using State-wise projections of population have been estimated. States were ranked on the basis of their per capita expenditure in the terminal year. In the equalisation exercise, additional expenditure provision to ensure that in the final year of the projections, every State reached at least 80 per cent of the all-State average projected per capita revenue expenditure (excluding interest payment and pension and CSS transfers).

Summary of Assessment

The assessment shows that the own revenue receipt-GDP ratio will be 8.58 per cent between 2015-16 and 2019 20 as against 7.36 per cent projected by the States. The assessment of expenditure needs would be 11.12 per cent of GDP against 13.57 per cent projected by the States. The pre-devolution deficit, as estimated by the Commission, is 2.70 per cent of GDP. This gap has been covered by tax devolution and revenue deficit grants.