Chapter 1

INTRODUCTION

1.1 The Constitution recognizes that the division of resources and functions between the Union and the States is such that there would be between them a vertical imbalance. Although some of the Constitutional provisions themselves provide for the sharing of resources, it is left to the Finance Commissions to examine the dimensions of both vertical and horizontal devolution. States in particular, look to the Finance Commission to address the problems of imbalance and correct them. The Twelfth Finance Commission which has been set up in the golden jubilee year of fiscal federalism in India arouses greater hopes and expectations.

1.2 Successive Finance Commissions have adopted equity and efficiency norms for determining the inter-se shares of the States. Horizontal equity has been solely guided by the consideration to even out the resource deficiencies across the States. But in effect over the years this has created moral hazard in encouraging fiscal imprudence. Inspite of eleven Finance Commissions in the past making recommendations in right earnest and despite collective wisdom backed to a large extent by a normative approach, the finances of the States and the Centre have gone from bad to worse. The revenue deficits have kept on rising, the debt is fast reaching an unsustainable level and the fiscal crisis is deepening. The Twelfth Finance Commission has the opportunity to explore whether equity consideration as applied has actually resulted in convergence of income or attainment of higher growth rates or improvement in social and economic infrastructure. The per-capita income gap continues and may in fact widen over the years. The Honourable Finance Commission may study the recommendations of the previous Commissions in that light and adopt more transparent and realistic norms to assess the needs of the States.

1.3 The EFC on its part assigned significantly more weight than its predecessor to the goal of reducing horizontal fiscal imbalances. It sharply reduced the weightage given to population and increased the weightage given to various parameters of backwardness. Most of the criteria used were inappropriate for Kerala compared to other States in most respects on account of Kerala's development model.

1.4 Kerala is one among the middle-income States but is characterized by some unique development features. Its achievements in social sector despite its low economic growth are internationally acclaimed as the famed Kerala Development Model. The State is now in the final stage of demographic transition with a declining trend in population growth. The role of State in innovating progressive policies is well recognized. However despite a very high Tax/GSDP ratio, the deteriorating fiscal situation since the late eighties has halted the tempo of social sector development and has adversely affected the quality of services in education and health.

1.5 While Government of India and many States are still grappling with first generation reforms in education, health care and social security, Kerala is saddled with second-generation problems resulting from its very success in attaining a higher level of human development: problem of an ageing population, large unemployment among the educated and burden of maintenance of capital assets and services.

1.6 The way the previous Commissions have approached the Centre-State finances has not solved the fiscal problems of the States nor has it solved the problem of backwardness. Why have the States slipped from the position of revenue surplus in 1980s to persistent revenue deficits since early 1990s? Why has the devolution formula not helped in convergence of income or attainment of higher growth rates or improvement in social and economic infrastructure in the States in whose favour the formula was overloaded? Can the States alone be held responsible for fiscal imprudence in a federal set up when there is a mismatch between revenue raising capacity and expenditure responsibilities?

1.7 We feel that issues confronting the Honourable Commission require fundamental correction and not mere procedural or administrative action. We have to reorient ourselves to tackling fundamentals, however painful this process may be in the short term. It is necessary to address the core issue of revenue deficit and not the non-plan revenue deficit alone. With plan revenue expenditure accounting for 65-70 percent, revenue deficit is already built into the plan. We feel that this Commission has the historic opportunity to walk another mile to enable the States to wipe out the revenue deficit. We have, therefore, suggested some fundamental systemic changes so that the major problems afflicting the State's finances can be tackled.

1.8 Before moving on to present our proposals, we would briefly touch on one aspect which is vital to making a fundamental and comprehensive system change really effective. Our reference is to the Commission's reassessment of our forecast of the likely Budget position during 2005-2010. We have made sincere effort to make our forecast not only need based but also in full conformity with the objective of promoting fiscal prudence. We have therefore stayed away from the temptation to exaggerate our needs or under estimate our potential. Each item of receipt and disbursement has been studied in detail and depth. Wherever we have included provisions deviating from the practice of trend growth, we have given elaborate explanation in the documents presented along with this Memorandum. Our plea is that the Commission may be pleased to accord adequate attention to this when reassessment of our forecast is made. We believe this will ensure that whatever standard of performance Commission lays down will be achievable by those States who are willing and fully prepared to tread the optimum course between need and norms.

Chapter 2

FISCAL SITUATION

2.1 The fiscal crisis afflicting the Centre and the States today is well known and widely documented. The less than planned for macro-economic performance since 1990s is part of the reason. More important is the increase in public expenditure combined with sluggish growth in resources. This has led to persistent revenue deficits, increased borrowing and a high level of fiscal deficit.

2.2 Kerala with a mainly cash crop oriented agricultural sector suffered in no small way during the 1990s due to fall in international prices for many years, especially during the end of the decade. This had an impact not only on consumption expenditure but also on the growth of primary and secondary sectors. Combined with the State Government's reduced ability to provide quality physical infrastructure for the secondary and tertiary sectors, the situation adversely affected economic performance. This affected the rate of growth of State Government's resources. The fiscal situation deteriorated sharply since 1998 when the liabilities due to all round increase in emoluments of Government servants, teaching staff and employees of autonomous institutions had to be met. The worsening fiscal situation of the Centre and the States in the 1990s is captured in Table 1.

Table -1

Fiscal Situation - Centre & States

(% of GDP/GSDP)

Sl. No.		1973-74		1986-87		1990-91		2001-02	
	Fiscal Indicators	**Centre**	**State**	**Centre**	**State**	**Centre**	**State**	**Centre**	**State**
1	Gross Fiscal Deficit	2.64	2.24	8.47	2.71	7.85	3.30	6.14	4.64
2	Revenue Deficit	0.36	0.18	2.50	0.24	3.26	0.93	4.36	2.64
3	Gross Primary Deficit	1.30	1.40	5.49	1.65	4.07	1.78	1.46	1.83
4	Gross Tax Revenue	7.73	5.29	10.30	7.85	10.54	7.84	8.15	8.21
5	Non-tax Revenue	1.70	3.18	2.48	4.18	2.33	3.85	2.95	3.59

Source: RBI's Handbook of Statistics on the Indian Economy

2.3 The decomposed fiscal deficit of the States brings out the rapidly rising component of revenue deficit, and the lower share of primary deficit, implying that an increasing portion of the deficit is accounted for by interest commitments on the contractual loans. Since deficit reduction is constrained by contractual obligations such as interest and other committed expenditures like salaries and pensions, States had to resort to cuts in capital expenditure as short-term measure of correction, sacrificing long term capital formation. This was in addition to the dismally low maintenance expenditure on existing assets.

2.4 The growing inability of States to generate revenue surpluses to fund developmental expenditure caused by wage and pension increases, increases in subsidies and high levels of interest commitments, has on the one hand, forced them to hold down capital expenditure and, on the other, led them to resort to off-budget borrowing. Given the poor returns from utilities and the negative balance of current revenues, increases in plan expenditure are largely debt financed. In the plan financing there is discrimination against the non-Special Category States, which receive Central Assistance at a 70:30, loan to grant ratio. This formula was evolved when the share of capital to revenue expenditure in the plans was 70:30. While the formula has remained unchanged, the State Plans have had an increasing revenue component. The proliferation of the Central Sector and Centrally Sponsored Schemes in the 1980s and early 1990s with grant assistance for a specific number of years saddled the States with additional commitments once the period of assistance was over. Inadequate receipts to meet growing committed expenditure and ballooning of debt stock to meet the unaffordable plan size exacerbated the crisis. Given the distinction between Plan and Non-plan and the evolved practice of arriving at annual plan sizes in general, it was well known that revenue deficits would eventually arise in the State budget. Plan funds in the form of 70 % loans and 30 % grants were largely expended in sectors such as education, health, roads and water supply and irrigation that do not bring financial returns in the short term. The following table shows that the States experienced in most years, a larger revenue deficit on the plan side than on non-plan side until the effect of pay and pension revision was felt.

Table -2

Comparison of Revenue Deficits in the States-Plan and Non-Plan

(Rs. in crore)

Year	Revenue Deficit	BCR	Plan Revenue Deficit
1989/90	4998	2917	7915
1990/91	5309	-1365	3944
1991/92	5651	-2940	2711
1992/93	5114	220	5334
1993/94	1813	-1709	2104
1994/95	6156	-5722	434
1995/96	8201	-590	7611
1996/97	16114	-3797	12317
1997/98	16333	-7431	8902
1998/99	43642	-33913	9729
1999/00	54642	-43372	11266
2000/01	55386	-39725	15661
2001/02 (LE)	59333	-30288	29045

Source: Government of India, Ministry of Finance. Midterm Review of States' Fiscal Reform Facility, 2003.

2.5 The trends in Kerala State are dealt with in subsequent chapters. But it is pertinent to point out here that the situation was aggravated by lower Central transfers to the State. Table - 3 is relevant in this context:

Table-3

States' Own Fiscal Effort vis-à-vis improvements due to Central Transfer

(as a % of Total Revenue Receipts)

Item/Year	1990-00 (Act.)	2000-01 (Act.)	2001-02 (Act.)	2002-03 (BE/RE)
All States Revenue deficit as % revenue receipts	26.02	22.40	22.10	17.17
All States own fiscal effort	62.06	59.65	60.38	55.81
All States Reliance on Central transfer	36.04	37.25	38.28	38.64
Kerala's Revenue deficit	45.63	36.05	28.77	38.76
Kerala's own fiscal effort	72.08	74.48	71.41	75.04
Kerala's Reliance on Central transfer	27.92	25.22	28.59	24.96

Source: Government of India, Ministry of Finance. Midterm Review of States' Fiscal Reform Facility, 2003.

2.6 It can be seen from the above table that while for all States the Central transfers went up from 36 % to 38 %, in the case of Kerala Central transfers remained at a low of around 27 % of the total revenue receipts.

2.7 From Table 4 it can be seen that while Kerala's Own tax/ GSDP has moved from 0.091 in 1997-98 to 0.078 in 2000-01 the all States' average had moved from 0.058 to 0.062. The difference between all States' average and Kerala is still over 0.016 indicating a persistent effort in this State to raise own resources. The decline from 0.091 to 0.078 in the case of Kerala has to be seen in the context of starting from a higher base in the late 1980s and the steep fall in prices of cash crops already referred to.

Table-4

Tax / GSDP Ratio of States

Sl. No	States	Own Tax/GSDP				N.T. Revenue/ GSDP			
		1997-98	1998-99	1999-00	2000-01	1997-98	1998-99	1999-00	2000-01
1	2	3	4	5	6	7	8	9	10
1	Andhra Pradesh	0.074	0.069	0.073	0.077	0.035	0.029	0.036	0.036
2	Arunachal Pradesh	0.007	0.007	0.009	0.012	0.436	0.421	0.416	0.462
3	Assam	0.039	0.038	0.043	0.047	0.086	0.085	0.077	0.085
4	Bihar	0.071	0.069	0.086	0.063	0.066	0.056	0.091	0.041
5	Chathisgarh	0.000	0.000	0.000		0.000	0.000	0.000	
6	Delhi	0.072	0.066	0.065	0.076	0.013	0.012	0.016	0.018
7	Goa	0.085							
8	Gujarat	0.073	0.073	0.077	0.081	0.033	0.033	0.038	0.046
9	Haryana	0.061	0.072	0.073	0.080	0.077	0.043	0.036	0.036
10	Himachal Pradesh	0.054	0.053	0.052	0.056	0.118	0.095	0.181	0.154
11	Jammu and Kashmir	0.036	0.035	0.042		0.271	0.228	0.271	
12	Jharkhand	0.000	0.000	0.000		0.000	0.000	0.000	
13	Karnataka	0.089	0.079	0.081	0.086	0.028	0.027	0.031	0.030
14	**Kerala**	**0.091**	**0.083**	**0.080**	**0.078**	**0.027**	**0.021**	**0.019**	**0.017**
15	Madhya Pradesh	0.076	0.074	0.076	0.078	0.056	0.048	0.055	0.045
16	Maharashtra	0.070	0.067	0.072	0.076	0.025	0.022	0.022	0.027
17	Manipur	0.016	0.012	0.013	0.014	0.233	0.205	0.201	0.233
18	Meghalaya	0.029	0.030	0.031	0.033	0.135	0.151	0.152	0.234
19	Mizoram	0.007	0.007	0.008		0.415	0.358	0.439	
20	Nagaland	0.014	0.015	0.017		0.232	0.236	0.233	
21	Orissa	0.045	0.044	0.047	0.060	0.052	0.040	0.067	0.058
22	Punjab	0.063	0.058	0.063	0.072	0.054	0.034	0.046	0.055
23	Rajasthan	0.056	0.054	0.057	0.069	0.047	0.037	0.038	0.056
24	Sikkim	0.042	0.036	0.037		1.817	1.665	1.623	
25	Tamil Nadu	0.084	0.081	0.086	0.089	0.021	0.019	0.022	0.024
26	Tripura	0.022	0.022	0.024	0.028	0.176	0.191	0.194	0.282
27	Utharanchal								
28	Uttar Pradesh	0.051	0.051	0.055	0.061	0.025	0.024	0.027	0.026
29	West Bengal	0.046	0.041	0.040	0.042	0.015	0.017	0.017	0.031
	All States	0.058	0.056	0.058	0.062	0.035	0.030	0.034	0.037

Source: State Finances- A Study of Budgets of 2002-03 RBI, Feb 2003 GSDP - Central Statistical Organisation

2.8 With a sense of responsibility the Government of Kerala accepts the need for fiscal correction both at the Centre and in the States inasmuch as continuing large fiscal deficits and revenue deficits cannot but have an adverse effect on the economy. Deficit control is necessary but should not be such as to override needs of development and employment creation. A delicate balance has to be struck and in this the Central Government has a major role to play both by way of setting an example and in bringing about basic changes in past practices of Centre-State fiscal relations. We have presented our views on these matters in subsequent chapters.

Chapter 3

FISCAL REFORMS AND MEDIUM TERM FISCAL FRAMEWORK

3.1 Eleventh Finance Commission (EFC) for the first time gave a recommendation for a programme of fiscal correction at the State level through a Medium Term Fiscal Framework and an Incentive Fund to the States adhering to the correction process quantified as annual five percent reduction in Revenue Deficit. The Finance Commission expected the States to eliminate revenue deficit by 2004-05. Kerala like most other States has drawn up a Medium Term Fiscal Reforms Programme (MTFRP) to bring about fiscal sustainability in the medium term.

3.2 Our strategy for Medium Term Fiscal Reforms is built on two pillars: rationalization of expenditure and augmentation of revenue realization. On the expenditure side, the elements of the strategy include (a) a shift in the current expenditure mix to expenditure for developmental and productivity oriented activities (b) increased budgetary allocations for operations and maintenance (c) improving key physical infrastructure to attract higher private investment in the State and (d) improve the quality of existing public assets. Our main consideration is to prioritize expenditure and to reduce non-productive expenditure.

3.3 We have imposed a ban on creation of posts and establishment of new institutions in Government and in aided sector. We have undertaken a major exercise of re-deployment of excess staff for rationalization of expenditure. We have also brought about changes in the commutation of pension and announced a new Contributory Pension Scheme for new recruits. To augment revenue we have initiated a series of measures for streamlining the tax administration and enforcement of tax compliance. We have also taken a number of fiscal reform measures. We have enacted two legislations- one to cap Government Guarantees and the other on Fiscal Responsibility. The other key reforms under way in the State are listed below: -

- PSE reforms through VRS, reduction of budgetary support and restructuring
- Phasing out of non-merit subsidies and better targeting of merit subsidies
- Compression of administrative costs and effective economy and austerity measures. Enactment of legislation to promote transparency in Government procurement
- Modernization of Government Programme to improve the service delivery to the people
- Budgetary controls through on-line computerized treasury net work
- Budget cycle brought forward to ensure passing of the full budget before March from FY 2005
- Budget transparency ensured through appending schedules on salaries, pensions and contingent liabilities
- Supplementary demands for grants reduced to two in a fiscal year

3.4 As regards the various initiatives under the programme for power reforms, both State Government and the Kerala State Electricity Board have taken several steps. A separate note in this regard will be submitted to the Commission.

3.5 Reform measures outlined above are expected to restore the State's financial health, improve governance and service delivery, attain higher levels of investment through private sector participation, consolidate and sustain current levels of social infrastructure and improve key physical infrastructure for achieving higher economic growth and reducing poverty.

3.6 We find that the Medium Term Fiscal Reforms Programme has shown mixed results. In the first two years we were able to bring down the ratio of revenue deficit/revenue receipt from 45.6 % in 1999-2000 to 36 % in 2000-01 and to 28.77 % in 2001-02. This was achieved mainly by expenditure compression and postponement of many committed payments especially when there was practically no growth in revenue receipts during these two years. During this period we did not announce any Dearness Allowance, even though 16 % arrears had fallen due. We adopted several economy measures including ban on creation of posts and lowering the commutation factor for pensions. Government resorted to both short term and medium term measures. While short term measures such as expenditure compression and postponement of liabilities is bound to show up as expenditure in the following years the medium term measures are expected to bring in the fiscal sustainability.

3.7 In 2002-03 revenue receipts went up by 18 % while the revenue expenditure went up by nearly 25 %. After a gap of two years Government had to announce 6 % Dearness Allowance increase for Government employees. The expenditure increase was due to this as also to the fact that Government had to take on the committed liability of Rs 400 crore of Ninth Plan. The net result was that revenue deficit/revenue receipts as a percentage went up from 28.77 % in 2001-02 to 32 % in 2002-03 as per pre-actual figures of the Accountant General (AG). Hence we could not bring down the percentage of revenue deficit/ revenue receipts by 5 %. However, the percentage of combined expenditure on salary, pension and interest against revenue receipts could be brought down from 104 % in 1999-2000 to 88 % in 2002-03.

3.8 There are certain lessons to be learnt from the evaluation of the Medium Term Fiscal Reform Programme. The fiscal reform matrix drawn up for the States was based on a single objective-reduction of revenue deficit as a proportion of revenue receipts by 5 % annually leading to a phase out by 2004-05.

3.9 As mentioned earlier we managed to achieve the target in the first two years by bringing down the percentage substantially from 45 to 28 but found it difficult to sustain the improvement. With Plan Revenue expenditure constituting 60-65 % of the annual Plan expenditure, it would not be realistic to expect that we would be able to continue to reduce, much less eliminate the Plan revenue deficit.

3.10 Our commitment to fiscal correction is clear. Given the macro-context of fiscal imbalance, and given the statutory requirement to bring down the fiscal deficit to 2 % of the GSDP by March 2007, we would urge the Twelfth Finance Commission to take a proactive role in supporting us to sustain our efforts. In the present situation, we believe that it would be futile to have a target of reducing fiscal deficit without first attempting to tackle the core issue of non-plan revenue deficit and plan revenue deficit. We would urge the Commission to draw up a programme for wiping out the non-plan revenue deficit and enable the States to have revenue surplus for capital investment.

3.11 It is clear from the above that Medium Term Fiscal Reforms Programme in its current form does not serve the purpose for which it was intended. The recommendation of EFC did not tackle the core issue of non-plan revenue deficit let alone revenue deficit on the plan side. As a basic pre-requisite of the fiscal reform programme, the revenue deficit should have been taken care of. In the absence of this requirement being met, the fiscal reforms programme was *ab initio* faulty. Therefore, inspite of our continued commitment to fiscal correction we could not meet the targets of MTFRP. We would urge that any fiscal correction programme be based on realistic and not merely prescriptive parameters to break the vicious circle of rising revenue deficit, increased borrowing and deepening fiscal crisis.

3.12 We urge the Commission to assist the reforming States and ensure that the vicious circle is broken with fiscal correction leading to fiscal sustainability, revenue buoyancy, high growth path and high levels of human development in the long term.

Chapter 4

FORECAST OF RECEIPTS AND EXPENDITURE

4.1 While submitting the Memorandum before the Eleventh Finance Commission we had projected expenditure on to pension and other retirement benefits. On the basis of 1998-99(LE) the pension commitment was fixed as Rs.1096 crore and the estimates for subsequent years were projected with 20 % growth rate. However the Commission presumed that the impact of pension revision had been largely absorbed in 1999-00 and that the future requirements would depend upon the net increase in number of retired persons and the need to provide inflation protection in the basic pension. It took the view that a 10 % growth per year in pension and other retirement benefits over the base year would be reasonable. The Accounts for the year 2000-01, 2001-02 and 2002-03 show that as against Rs.4832 crore for the three years projected by the Commission, the actual expenditure was Rs.6048 crore. This figure is on the basis of 43 % of Dearness Relief against 59 % that was given.

4.2 Similar is the case with the salaries. The actuals in respect of salaries and pension would have been substantially higher during 2000-01, 2001-02 and 2002-03 had we paid the DA and DR as per GOI announcements during those years and as had been the previous practice in the State.

4.3 The vast variation between the Finance Commission projections and what actually occurs could be largely attributed to the basic failure in arriving at realistic assessments. While normative estimates have to be made, a 'one size fits all' approach has also to be avoided and inevitable commitments on salaries [without pay revision], pensions and Dearness Allowance and Dearness Relief have to be fully provided for. If the Commission could make a normative-cum-realistic assessment of the potential of non plan revenue account, the vast variations between the assessment and the future realisation and consequent financial distress and strain on the State Government could be avoided. The following table gives the comparison of our projections, EFC projections, and the actuals.

Table-5

Revenue and Expenditure Projections

(Rs in Lakhs)

No	Particulars	2000-01	2001-02	2002-03 (Preactual)	2003-04	2004-05	2000-05
A	Revenue Receipts						
1	Own Tax Revenue						
	Projection of Government of Kerala	586462	650289	725959	815929	923286	3701925
	EFC Projection	635998	742846	867644	1013408	1183661	4443557
	Actual	587025	592342	730255			
2	Own Non tax Revenue						
	Projection of Government of Kerala	70955	73646	79346	82746	87713	394406
	EFC Projection	68478	82578	98424	116436	144108	510024
	Actual	65909	54338	67776			
3	Other Non Plan Grants						
	Projection of Government of Kerala	1328	1328	1328	1328	1328	6640
	EFC Projection	1154	1270	1397	1536	1690	7047
	(Rly Passenger fare)	852					
4	Total Revenue Receipts						
	Projection of Government of Kerala	658745	725263	806633	900003	1012327	4102971
	EFC Projection	705630	826694	967465	1131380	1329459	4960628
	Actual	653786	646680	798031			
B	Non-Plan Revenue Expenditure						
I	General Services						
(I)	Interest Payments						
	Projection of Government of Kerala	224486	261322	294228	347189	409683	1536908
	EFC Projection	180674	198741	218615	240477	264525	1103032
	Actual	225760	248947	294676			

No	Particulars	2000-01	2001-02	2002-03 (Preactual)	2003-04	2004-05	2000-05
(ii)	Pension						
	Projection of Government of Kerala	157769	189323	227188	272626	327151	1174057
	EFC Projection	146021	160623	176685	194353	213789	891471
	Actual	192948	183793	228290			
(iii)	Elections						
	Projection of Government of Kerala	10288	1782	4230	2006	2132	20438
	EFC Projection	1880	9094	2385	2636	9846	25841
	Actual	3362	2750	1106			
(iv)	Other General Services						
	Projection of Government of Kerala	94500	104286	109036	116616	123556	547994
	EFC Projection	95557	100626	105969	111601	117538	531291
	Actual	122993	121592	135921			
	Total Genl Services (I) to (iv)						
	Projection of Government of Kerala *(Comp & Assign to LBs shown separate)*	487043	556713	634682	738437	862522	3279397
	EFC Projection	424132	469084	503654	549067	605698	2551635
	Actual	545063	557082	659993			
II	Social Services						
	Projection of Government of Kerala	307086	322157	338824	356690	375974	1700731
	EFC Projection	328630	363776	403486	448410	499293	2043595
	Actual	346680	341647	396687			
III	Economic Services						
	Projection of Government of Kerala	125435	135466	146491	158617	171563	737572
	EFC Projection	82970	88825	95162	102020	109425	478402
	Actual	96494	84220	107695			
IV	Compensation and Assignments to Local Bodies						
	Projection of Government of Kerala	10248	11785	13553	15586	17924	69096
	EFC Projection	6215	7023	7936	8968	10133	40275
	Actual	5504	6700	5806			
V	Committed Liabilities						
	Projection of Government of Kerala			112752	121772	131514	366038
	EFC Projection			85819	94401	103841	284061
VI	Total Non Plan Revenue Expenditure (I to V)						
	Projection of Government of Kerala *(Excluding Fresh expenditure) (Forecast of GOK)*	929812	1026121	1246302	1391102	1559497	6152834
	EFC Projection	841947	928708	1096057	1202866	1328390	5397968
	Actual	993741	989649	1170181			
VII	Pre-devolution Non-Plan Revenue Deficit/Surplus						
	Projection of Government of Kerala *(Excluding Fresh expenditure)(Forecast of GOK)*	-271067	-300858	-439669	-491099	-547170	-2049863
	EFC Projection *(Table 10.1 page 96 of EFC report)*	-136317	-102014	-128592	-71486	1069	-437340
	Actual	-339955	-342969	-372150			

Source: EFC Report and Kerala Budget documents

4.4 In preparing the estimate of forecast of revenue and expenditure we have made realistic assessments to the extent possible, taking into account the potential for revenue growth (considering the fact that Kerala has the highest GST/GSDP ratio in the country) and the minimum expenditure commitments that we have to fulfil under the Constitution.

4.5 The year 2002-03 was a particularly difficult year for us. Difficult in more ways than one as brought out by the White Paper issued by the Government in 2001. The financial position was extremely critical and there were large amounts of payments that were over due. Even with such large amounts being in arrears there was considerable deficit. In addition, the years 2001 and 2002 turned out to be years of falling prices and consequent distress for the principal sectors of the State's economy like plantations. As a result, consumption expenditure had a sluggish growth and the collection of taxes like sales tax was not as buoyant as in earlier years. We had to resort to considerable expenditure compression in 2001-02 and 2002-03. While making sizeable payments against earlier arrears, we had to postpone decisions on inevitable items such as increases in dearness allowance. Accounts of these years do not reflect the actual liabilities and commitments of the State Government or give a true picture of the State Government's non-plan expenditure. During the last five years, the first two years were years when pay revision and arrear payments were effected. Next years were years of expenditure compression on account of fiscal stress. The year 2002-03 was not a normal but a near normal year since there were still arrears of social security pension and arrears of contractors' bills, apart from payments of DA/DR which had

had to be postponed. Therefore we have taken these factors into account and have adjusted the base figures 2002-03 in making the forecast. The adjustments are explained in detail at appropriate places in the Statement on Forecast of Expenditure.

4.6 The estimates for 2003-04 and estimates for 2004-05 and for the forecast period have been computed on the basis of the pre actual figures of Accountant General for the year 2002-03. Financial commitment on account of instalments of D.A to be sanctioned after 31.12.2003 (including arrears to be sanctioned) is exhibited separately as fresh expenditure.

4.7 In a marked deviation from the method of flat rate projection adopted in the past we have disaggregated the expenditure under each head as salary and non-salary components.

4.8 We have given 2.5 % projection to salary component for accommodating future increments. Non salary portion is projected for non-development services at 7 %, development services (Social Services) at 15 %, Economic Services at 11 %; of this 5 % to cover inflation. Provision for DA revision on account of price rise has been made under 'Fresh expenditure'.

4.9 The Total State Plan Outlay for Tenth Five Year Plan (2002-2007) at constant prices is Rs. 24000 crore, of which the Annual Plan Outlays approved for the first two years are Rs. 4025 crore (2002-03), Rs.4430 crore (2003-04) respectively. The outlays for remaining three years are assumed as Rs.4524 crore for 2004-05, Rs. 5100 crore for 2005-06 and Rs. 5921 crore for 2006-07. The estimates of Plan Revenue Expenditure of the Tenth Five Year Plan period have been framed on the basis of Revenue content of the Plan outlay of the corresponding years. Under the Plan we have taken up a major exercise for improving delivery of public services through Human Resources Development, simplification of system, evaluation of performance standards and monitoring. The success of this programme called Modernising Government Programme is dependent on substantial improvement of maintenance of assets and facilities.

4.10 In estimating the forecast of revenue receipts we have made a realistic assessment taking into account the potential for revenue growth (considering the fact that Kerala has the highest GST/GSDP ratio in the country) and the limited areas available to us for raising resources.

4.11 In the case of tax revenue, we have estimated the potential revenue for each tax that the State can raise under the Constitution individually and we have taken the four year average growth rates for each tax as the most feasible growth rate and applied these in the projections. The Eleventh Finance Commission opted for the aggregate tax revenue approach instead of looking at the taxable capacity of a State on each of the taxes. The Commission also divided the States into two groups, namely, Special Category and Non Special Category. When the average tax ratio for a given State fell below the relevant average rates for the group, the Commission made upward adjustment in the ratio on the ground that the State should try to move towards the group average over a period of time. This kind of presumptive normative approach adapted by the Commission has cost the State Governments a great deal. Even though Kerala had a very high Tax / GDP ratio for over two decades and further growth at high annual rates was unreasonable to expect, the Commission by adopting its approach included Kerala in the category of States that have to achieve the above average rate. While the Commission projected that the State's own tax revenue would grow at 16.8 % per annum the actual figures for the first three years revealed that the average growth is only 12.4 per cent. Against the GSDP growth rate of 14 % assumed by EFC, the actual growth rate was only 9.5 - 10 %.

4.12 Assuming inflation of 5 % and real growth of the economy at 6 % during the period we have projected the State's tax revenue (SOTR) to grow at 13 % and the non-tax revenue to grow at 11%. These growth rates, we believe, are realistic and based on the potential in the State. It bears repeating that Kerala had been maintaining a very high Sales Tax/NSDP ratio, much above the national average for over twenty years. As per the published figures on the General Sales Tax, Central Sales Tax collected by various States and their NSDP for the years 1999-00 and 2000-01, Kerala ranks first in terms of Total Sales Tax/NSDP (6.77), GST/NSDP(6.25 %). While CST collected in Kerala was Rs 287.31 crore in 1999-00 and Rs 356 crore in 2000-01, it was as high as Rs. 1655 crore and Rs. 1865 crore in Maharashtra during the same period. Our performance must be seen against the backdrop of a low primary and secondary sector contribution to the economy and a large tertiary sector on which we do not have powers to levy taxes. Kerala is a consumer State and the people here pay for the Central Sales Tax that accrues to the producing States like Maharashtra and Tamil Nadu. Given this situation, it is neither fair nor realistic to expect Kerala to exhibit the same kind of buoyancy as a State with low Tax/NSDP ratio or a State with large contribution from Central Sales Tax.

4.13 Similarly in the case of non-tax revenue, we have projected an overall healthy 11 % growth over the seven year period. There is real difficulty in the State for higher realization of non-tax revenue beyond the growth rate projected. There are areas where we cannot expect more than 5 % growth on annual basis. But there are areas where the growth is expected to be over 15 %. The average growth of 11 % is in accordance with the potential in the State.

4.14 The estimates for 2002-03, 2004-05 and forecast for 2005-10 have been framed broadly on the basis of 2002- 03 pre actual figures and in keeping with the growth rates adopted by the State and approved by the Planning Commission in the State's resource forecast for the Tenth Five-Year Plan. We have made modifications or deviations wherever necessary, taking into account the trend and changes in the socio-economic scenario and shifts in the State and Union Government policies. The rates of growth and indeed estimates compare with those in the State's resource forecast for the Tenth Five-Year Plan.

4.15 In accordance with the directions of the Government of India and the decisions of the Empowered Committee of Finance Ministers, we passed the legislation on VAT to bring in value added tax from 1.4.2003. The budget proposals were also presented to the Legislature in the expectation of introduction of the VAT regime.

Considerable time, effort and resources were spent in training departmental officers and merchants and in building general awareness among the public. With GOI backing out of VAT at the last moment, we were forced to put the legislation on hold. Since additional sales tax was not included in the budget proposals because of the expectation that VAT would come into effect, the State lost nearly Rs.170 crore in the first three months until the Government re-introduced the Additional Sales Tax. Considering the composition of the structure of the State Economy, tax buoyancy can show improvement only when the State gets the powers to levy service tax. With combined primary and secondary sectors accounting for only 50 % of the GDP, the State is finding it difficult to generate the kind of buoyancy prevalent when the tertiary sector was less than 35 %. We have therefore proposed a growth rate of 13 % per annum during the forecast period and which we consider to be realistic.

4.16 For the Tenth Plan, central assistance approved is Rs. 7736.15 crore and 30 % of this is assumed as plan grant (Rs. 2320.84 crore). We have taken the pre actual figures for 2002-03 as the basis for grants under Centrally Sponsored Schemes and assumed 11 % growth for the subsequent years. Similarly we have taken the pre actual figures for 2002-03 as the basis for non-plan grants and assumed 8 % growth for the subsequent years.

4.17 We have made our forecast estimates of revenue receipts and expenditure on a realistic basis taking into account our on going fiscal reforms programme. We have already pointed out the huge variation which has occurred between the projections made by the

State and the projections of the EFC. We have also shown how the projection made by the State had in fact been closer to the actual figures for the last three years.

4.18 Successive Finance Commissions have lamented the fact that no data are available for arriving at normative and realistic assessments. More over studies that have been made for the Finance Commission, while again pointing out that data are not available have accepted and assumed certain data and worked out models based on which the Finance Commission had to make its recommendations. We are of the view that when reliable or comparable data are not available, pursuing methodological perfection to build theoretical models can lead only to unrealistic or wrong conclusions. We would request the Commission to recommend and put in place institutional arrangements by which on a given set of parameters, accurate data will be available, at least to the next Finance Commission. Adequate funds may be suggested for this.

Chapter 5

DEVOLUTION OF CENTRAL TAXES

5.1 In the scheme of the Constitution the only means of transfer of funds from the Centre to the States was through devolution of taxes under Article 270 and grants-in-aid under Article 275, both on the recommendation of Finance Commissions. Article 282 enabling the Central Government to give grants was introduced only as a provision to look after any unforeseen situation. But with the formation of the Planning Commission grants under Article 282 also became important. Two principal sources of transfer namely the Finance Commission and Planning Commission have thus emerged in India, unlike in other federations. Even as this was the case, slowly over the years, centrally sponsored schemes (CSS) were introduced with regard to subjects that are in the State List. The schemes are formulated by the Central Ministries and funds are transferred to the State Government for implementation as 50 %, 75 % or 100 % grant. Even though repeated attempts have been made to get these schemes transferred to the States along with the funds or at least to drastically reduce their number and several committees, experts and Finance Commissions have recommended such a move, the number of schemes and the attached quantum funds have only increased. When the Tenth Plan was being finalized a major exercise of reducing CSS was made, but in vain. The central share of the CSS, is shown in the budgets of the Ministries of the GOI even though the funds are spent by State and Local Governments.

5.2 Thus there are at present three tracks for transfer of resources to States and not merely one as was visualized originally. The Constitution envisaged through Finance Commissions, non discretionary and transparent transfer of resources but over the years the portion of discretionary transfers has increased from the Centre to the States. In the plan also, while in the initial years there was scheme wise assistance, later on when the Gadgil formula came into effect the entire transfer of Central assistance was made under a formula agreed to by all the States. The transfer under the formula has gradually come down and is now only around 35 %. The rest is transferred as Special Central Assistance for specified types of schemes and as Additional Central Assistance for externally aided projects.

5.3 The following figures for 2002-03(BE) as provided by the Planning Commission, clearly brings out these facts:

• Normal Central Assistance **(Modified Gadgil Formula)**	Rs. 18616 crore
• ACA for Externally Aided Projects (EAP)	Rs. 18647 crore
• Special Central Assistance	Rs. 15457 crore
• Total	Rs. 52720 crore

Under Article 280 of the Constitution, the Finance Commission has the task to determine (1) the share of States in the net proceeds of taxes which have to be shared between the Centre and the States and the manner in which such share is to be distributed among the States. Thus both vertical and horizontal aspects of distribution have to be addressed.

VERTICAL DEVOLUTION

5.4 Given the asymmetry between access to revenue resources and the Constitutional responsibility for providing services, States are at a disadvantage leading to continuing vertical imbalance. In 2000-01 the States, on average, raised 38 % of total revenues but incurred about 60 % of the total developmental expenditure. Over the years while the share of the States in raising revenues has remained constant their expenditure has shown an increase, particularly since 1991. The ability of the States to finance their current expenditure from their own sources of revenue has shown a decline from 69 % in 1955-56 to around 55 % in the 1990s. There is a decline in the measure of vertical balance, but this is due to fact that an increasing proportion of expenditure over the years has been financed by borrowing. Indeed, correction of vertical and horizontal imbalance will have to be driven by the objectives of reform, growth and the need to encourage fiscal prudence and second-generation reforms

5.5 A recent econometric analysis of the deterioration of State finances by Reserve Bank of India identifies four significant factors namely: interest payment, inadequate recovery cost or lower user charges, rising expenditure on salaries and pensions and sluggishness in Central transfers to States. Deterioration in State finances (proxied by GFD/NSDP ratio in terms of value coefficients of the panel regression equation estimated for the reform period 1990-91 to 1999-00) revealed the highest statistical significance of the variable TFR (Transfer of Fiscal Resources) in explaining the deterioration of the State finances The deteriorating fiscal deficit of the States is thus not due to factors entirely within their control but due to many factors pertaining to the Centre, especially sluggishness in transfer of resources. It is clear that enlargement of the size of statutory devolution is necessary to contain acceleration in fiscal deficit and bring about restructuring of the finances of the States in terms of clause (4) and (5) of the Commission's Terms of Reference.

5.6 From 2000-01, the new procedure of forming a pool of net receipts of all Union taxes and duties and allocation for devolution of 29.5 % of that pool to the States is being followed. For vertical devolution to have any meaning, we strongly believe that, the efficiency and reform yardsticks should be extended to Centre as well. Since only net proceeds are to be pooled, there may be a certain indifference to costs of collection.

5.7 With service sector's contribution to the GDP increasing rapidly, it is only fair that the service tax is left to the States. States have been requesting GOI to allow revenue yielding services to be taxed by them. However using residuary powers, GOI has now added many more services under service tax and is appropriating the proceeds. Citing the requirement of amendments to the Constitution, GOI is denying the opportunity to the States to capture the new buoyancy available in the services sector. However GOI have gone ahead with levying service tax and propose to share merely a portion of it with the States without a transparent formula and outside the purview of Finance Commissions. We feel that this is not proper. The Empowered Committee of State Finance Ministers had, in fact, recommended that either certain services may be left to the State List for taxation by the States or as in the case of CST, the service tax collected by the State may be allowed to be appropriated by it. We would urge the Commission to give due regard to this suggestion.

5.8 In this context, we would request that the Honourable Commission may lay down a minimum workable fiscal reform framework for the Central Government to ensure that receipts and total expenditure projected by the Commission are adhered to. Apart from helping to achieve the larger objective of macro-economic stability, it would also ensure that there are no shortfalls in resource flows to States, as compared to Commission's estimates. This has happened in many years in the past, adversely affecting the finances of the States. We would urge the Commission to lay down that in case there is shortfall in actual vertical devolution, it should be made good in the form of grants-in-aid by the Centre under Art 275.

HORIZONTAL DEVOLUTION

5.9 The principle of horizontal equity is guided by the consideration that as a result of revenue sharing, resource deficiencies across the States arising out of systemic and identifiable factors have to be evened out. However this also tends to create a vested interest or moral hazard in continuing with fiscal imprudence. To neutralize such a tendency, the efficiency criterion is also applied to some extent.

5.10 A major portion of the problem lies with the parameters included in the equity consideration. It will be agreed that 'population' is the most important parameter and that it is also simple, transparent and objective. In fact it was the only parameter used by the first three

Finance Commissions. The State is of the opinion that there is no legal or economic basis for inter se distribution of divisible pool according to criteria other than population. It was the Fourth Commission which while agreeing with the previous Commissions that the major factor for determining the distribution should be population, premised that "relative economic and social backwardness of States should also be taken into account". It therefore gave a weightage of 80 % for population and 20 % for relative economic and social backwardness, based on seven selective indicators. The Fifth Commission while giving a weightage of 80 % to population split the remaining 20 % to be distributed among States on the basis of per capita income and index of backwardness worked out by it on the basis of six indicators. The Sixth Commission reduced the weight for population to 75 % and increased the weight for backwardness from 20 to 25 %. The Seventh Finance Commission reduced the weight for population drastically to 25 %. While retaining the factor for per-capita income it introduced two new factors – percentage of poor and revenue equalization. From the Seventh Commission onwards parameters other than population took the path of 'refinement' and the original objective criterion for inter se distribution of devolution among the States was given a go by. In the EFC, the weight for population was reduced to as low as 10 %. The State Government is of the view that population should once again become the principal criterion for inter-se distribution among the States. It is significant that in the Gadgil formula for assistance to State Plans, the percentage for population is still retained at 60 % even though dealing with backwardness is the direct concern of plan effort. That is because of the recognition that other criteria bring in subjectivity in horizontal devolution.

5.11 As a matter of national policy it was decided that population figures of 1971 would be followed wherever population is used as a criterion. This was in accordance with the national objective of reducing the rate of growth of population and to ensure that States which implemented the population policy successfully did not suffer. The sharp reduction in the weight for population in Central devolution undermines this national objective and policy. This is all the more so because, the calculations for the other parameters that have been introduced depend generally on surveys and studies based on recent or current population figures.

5.12 The transfer mechanism adopted is differentiated between the ‘ability consistent efforts’ and the ‘ability enhancing efforts’ of the States. Though there is a clear trade-off between incentives for efficiency and incentives for the equity, successive Finance Commissions have generally been guided by equity considerations. However whether the equity consideration has actually resulted in convergence of income or attainment of higher growth rates for improvement in the social and economic infrastructure by the relatively poor States is a moot question.

5.13 Over emphasis by earlier Finance Commissions on equity criteria as applied by them has inflated the shares of the poor-performing States, without significant improvement in their economic performance or their HDI vis-à-vis the better managed States. The

Combined Average Growth Rate (CAGR) of GSDP and per capita GSDP (in the period 1980-2001 for 14 large States despite gaining considerably on account of equity considerations) have in states such as Bihar, UP, Orissa, Madhya Pradesh, Rajasthan and West Bengal hovered around 4.6 % and 2.3 % respectively in 1980-1993 and 4.9 % and 2.8 % respectively in 1993-2001. At the same time, Maharashtra, Karnataka, Kerala, Punjab, Haryana, Gujarat, Tamil Nadu and Andhra Pradesh have been able to sustain average CAGR of 5.5 % and 3.5 % for GSDP and per capita SDP respectively in 1980-1993 and 6 % and 4.4 % respectively in 1993-2001

5.14 It is also a fact that those States which have performed well in terms of sectoral transformation of their economies (in terms of percent share of secondary and tertiary sectors in total NSDP) and have shown improved growth in per capita income as well as some degree of fiscal correction, have actually suffered a reduction in their shares in the Tenth Finance Commission (TFC), vis-à-vis the EFC.

5.15 Indeed, backwardness is being dealt with under the Plan in a variety of ways. There is a special dispensation for 11 special category States (30 % of the normal assistance is earmarked for them and it is in the ratio of 90 % grant and 10 % loan. These States constitute a current population of 65 million people ie. About 6.25 % of the country's population).

5.16 In the Modified Gadgil Formula per-capita income has a weightage of 25 %. In Special Central Assistance, the Special Category States and the backward States in non-special category, are given a higher shares (in B.E for 2003-04, out of a total of about Rs.

17000 crore, Rs. 4000 crore is for the power and out of the remaining Rs.13000 crore a major share is for backward States). There are now 15 major programmes for Special Central Assistance, in most of which backwardness and poverty are important criteria.

5.17 There are also a large number of Centrally Sponsored Schemes which have removal of backwardness as the main objective. It will be seen that the total for these Schemes alone comes to Rs. 130000 crore during the Tenth Plan period. More and more schemes are being added. In recent months the Government of India announced Swajaldhara Programme for implementation with close involvement of PRI, with 90 % of the cost being met by Government of India. Funds are being provided under Pradhan Mantri Grameen Jal Samvardhan Yojana (water harvesting) for providing one lakh hand pumps in rural areas, revival of one lakh traditional sources of water and providing drinking water to one lakh schools in rural area. Funds under the above mentioned Schemes are distributed on the basis of formula giving weightage to backwardness and poverty.

5.18 If backwardness is the main criterion for transfer of large funds under the discretion of the Government of India under various Centrally Sponsored and Central Sector Schemes, the State Government submits that there is no justification for adopting similar weightage in horizontal devolution by the Finance Commission**.** We strongly urge that the Honourable Commission bear in mind the whole scenario of transfer of funds and the attempts under Additional Central Assistance to State Plans, Special Central Assistance and the growing number of Centrally Sponsored Schemes to deal with backwardness.

The Honourable Commission should decrease the weightage given for backwardness, if not altogether remove backwardness as a criterion in the formula for horizontal devolution.

5.19 We also have to submit that the parameters used in the criterion of backwardness are not comprehensive.

5.20 The world over regional backwardness is measured not only in terms of the per capita income but also in terms of unemployment rates. According to National Sample Survey, the total unemployment rate in Kerala was 21.7 % in 1999. Kerala's achievement in bringing about a demographic transition and a consequent shift in the age pyramid has implications both for the dimensions and character of unemployment in the State. Kerala has strong reservations in accepting index of social and economic infrastructure as the criterion for devolution. Firstly backwardness in terms of income and infrastructure has a close relationship. There is a highly significant correlation between per capita GSDP and index of social and economic infrastructure of States both used by EFC. Including both the criteria and giving a large weightage to both has compounded the effects of the criterion of backwardness. Secondly infrastructure indices constructed for both TFC and EFC gave undue weightage to social indicators. Thirdly some of the qualitative indicators of infrastructure development are not included in the index. While a large weightage has been given to quantitative indicators of financial communication and road network in the State, qualitative dimensions of State's infrastructure development have been overlooked by the Commissions. The vehicle density of Kerala State roads is nearly three times the national average. The railway network per lakh population is only 56 % of the country's average and the system requires modernization. All these only go to show the complexities involved in adopting the criterion of backwardness in any scheme of general devolution. Each of the aspects of backwardness have to be dealt with separately and this is best done under the Plan.

5.21 The State Government would like to reiterate the basic approach as regards the criteria for horizontal devolution namely that it should be solely on the criterion of 1971 population. The State is aware that it will not be possible for the Commission to use criteria appropriate to each State. We would strongly urge the Commission to give up the criteria of backwardness and fall back on the earlier wisdom of considering population as the sole basis for inter-se distribution of the divisible pool. Assistance for overcoming backwardness must be left to the Planning Commission and the planning process. However, taking into account the need for fiscal improvement as an important prerequisite for development the State would like to suggest the following weightage for these parameters :

1. Population [1971]	**80 %**
2. Tax effort	**10 %**
3. Commitment to fiscal reforms	**10 %**

Chapter 6

GRANTS-IN-AID UNDER ARTICLE 275

6.1 Article 275 is the vehicle of statutory transfers to the States from the Centre. In so far as Article 275 is meant to meet revenue disabilities of States, the plan non-plan division should not arise in their determination but in practice what has evolved is that Finance Commission deals only with the non-plan revenue side. As submitted by us in the last chapter of this Memorandum, the Commissions have also adopted an increasingly normative approach. The norms have been applied not merely for estimating growth rates of revenue and expenditure but also for the so called backwardness in development, such as per capita income, infrastructure and the like (which are the concern of the plan in our system). As a result, the normatively determined revenue gap for a number of States became high, necessitating grants-in-aid under Article 275 also to them. This approach has turned out to be a recipe for moral hazard. Most of the States which have regularly received these grants have continued to be fiscally unsound. The gaps have actually widened, requiring larger fillers. The backwardness has also continued. Table 6 and Table 7 show the total grants as a proportion of total transfers and the regular revenue gap grant recipients.

6.2 Article 275 is an instrument available with the Commission to ensure that no State has revenue deficit at the end of the process of devolution. Normally it results in some States being left with zero surpluses and others with very large surpluses. Constitution does not restrict the role of Finance Commission to take care of non-plan revenue deficit alone. Yet most Commissions had left Plan revenue deficit out of their consideration mainly due to the balance of convenience.

Table-6

Central Devolution & Grants

(Rs in crore)

Finance Commission	Devolution	Grants	Total	% Growth in Grants	Grants as % of Devolution
First	362	50	412		12
Second	852	197	1049	194	19
Third	1067	244	1311	24	19
Fourth	1323	422	1745	73	24
Fifth	4605	711	5316	68	13
Sixth	7099	2510	9609	253	26
Seventh	19233	1609	20842	-36	8
Eighth	35683	3769	39452	134	10
Ninth	99688	20031	119719	431	17
Tenth	206343	20300	226643	1.3	9

Source: Fifty Years of Fiscal Federalism, Twelfth Finance Commission, April 2003 & Fiscal Federalism in India by B.P.R. Vithal & M.L.Shastry

Table-7

Recipients of Gap-filling Grants

(Rs. in crore)

State	6th Finance Commission	7th Finance Commission	8th Finance Commission	9th Finance Commission	10th Finance Commission
AP	206			341	686
Arunachal Pradesh				303	307
Assam	255		274	874	712
Bihar	106			1374	333
Goa				166	77
HP	161	207	223	523	772
J&K	173	199	329	1096	1184
Kerala	209			412	
MP				1047	
Manipur	114	146	147	372	351
Meghalaya	75	93	119	256	316
Nagaland	129	218	190	459	530
Rajasthan	230		43	1447	33.45
TN				44	
Tripura	112	136	187	466	489
Sikkim		36	36	85	105
UP	199			3235	982
West Bengal	235		444	999	
Orissa	305	137	208	1083	372

6.3 It is time to introspect as to whether the grants have served their purpose of meeting the fiscal disabilities of the States to whom the grants were given. The first Finance Commission itself had stated that while it was not recommending grants for itemised expenditure, 'The extent to which the purpose of grant in aid is achieved may be left to be assessed by our successors when the finances of the State concerned for this period come up for review'. We would earnestly request that the review be taken up by the present Commission.

6.4 Since maintenance of assets has been neglected for a long period, we would submit that the major item under this should be for such expenditure worked out on the basis of facts and norms of maintenance of different categories of assets. The expenditure could be monitored through suitable arrangements. Any general grant that may have to be given should also be related to certain monitorable parameters to foreclose recurrence of the gap in the State concerned.

6.5 We have already urged in the Chapter on Forecasts that maintenance of assets and services based on norms should be fully provided for. We are sure that it will be done by this Commission and on that basis we would suggest the following for considering grants-in-aid under Article 275.

- Grants-in-aid to cover non-plan revenue deficit in case there is a deficit after devolution

- Cover Plan revenue deficit after taking into account plan grants and surplus if any in the revenue account (this is in accordance with our suggestion that correction of fiscal situation demands elimination of plan revenue deficit)

- Provide appropriate grants to correct too wide a range in per capita total revenue account surpluses among the States so that weak State also have a reasonable revenue account surplus for capital investment.

Chapter 7

AUGMENTING STATE RESOURCES FOR LOCAL GOVERNMENTS

7.1 The Seventy-third and Seventy-fourth Constitutional Amendments have fundamentally altered the governance structure of the nation by introducing a new third tier at the local levels. Local Governments are closer to the people and therefore more sensitive to demands and pressures for developmental and welfare action than the State and Central Governments are. They are, by very definition, more democratic and responsive. It may take a longer time to develop their capacities but they have already proved their potential for carrying out development activities in a participatory manner.

7.2 The Constitution, in letter and spirit, mandates that local Governments should be properly nurtured. In the initial years they need more support and this is justified by the following points:

- They are fledgling structures in the executive wing of the State. The Constitution envisages their evolution into institutions of local self Government for which they need supplementary nourishment

- They function closer to the people and are responsible for providing the basic services as well as meeting the minimum needs of the people

- Local Governments are the best instruments for utilizing local production possibilities especially in the field of agriculture and allied sectors and traditional industries

- Decentralisation brings in a lot of efficiency gains through better application of resources, mobilization of local resources and above all through contributions and assumption of responsibilities in critical areas of asset management by the community

- As local Governments afford greater scope for participation of the people in the development process, decentralization leads to reduction of leakages

- Though it will be good to say that local Governments have to be self-sufficient financially, it is to be noted that their fiscal domain is inherently very weak. After leaving aside the Central and State Taxes it is very difficult to identify new sources of revenue for local Governments to tap.

The gains of decentralization are obvious and the need to support the local Governments financially cannot be denied on any ground.

7.3 Kerala has been rated, nationally and internationally, as a pioneer in strengthening its local Governments. We have submitted to the Honourable Commission a detailed paper on decentralisation and local Governments in the State (Annexure XIII in Volume 4 of the forecasts). We cover the ground only briefly here. The chief features of decentralization in the State include the following:

- Powerful legislative empowerment of Local Governments

- Clear demarcation of functional domain and a relatively successful avoidance of overlap in the functioning of the different tiers of Government

- Transfer of functionaries to enable Local Governments to discharge their functions

- Appointment of State Finance Commissions (Two so far)

- Bestowing the authority to carryout local planning and the freedom to use the resources – an amount equivalent to about one-third the Plan size of the State is transferred in a practically untied form to Local Governments to prepare developmental plans according to their priority and implement them

- Introduction of fundamental governance reforms from below such as transparency, accountability, fiscal responsibility, use of IT and so on

- Proactive nurturing of the system by the State Government.

7.4 The experience of Kerala shows that the costs of decentralization include, among other things:

- Enhancement in maintenance costs arising from a change in composition of expenditure towards greater capital investment in the form of local infrastructure;

- Reduction in the maintenance deficit in public utilities and social infrastructure due to the participatory character of governance at the local level which generates demand and forces quick response;

- Higher expenditure on running of services like provision of drugs in hospitals, consumables in public institutions etc., due to improved services;

- Cost arising out of the need to bridge the wide gaps in essential infrastructure and facilities existing among Local Governments. A kind of equalization is needed before Local Governments can take full charge of their responsibilities and forge ahead;

- Higher allocations for capacity building, inclusive of both training and design of appropriate administrative operating systems suitable for decentralized governance;

- Additional expenditure on traditional civic responsibilities like public lighting and waste management arising out of increased people's participation and awareness.

7.5 The above points clearly show that decentralization is not a zero sum game. The expenditure needs of Local Governments, estimated with utmost care would be significantly higher than those incurred by the State Government in exercise of the same functions before transfer in view of the stress on improved services and due to higher awareness.

7.6 We submit that the Twelfth Finance Commission has a historic role to play in comparison with that played by the Tenth and Eleventh Finance Commissions, which were the first two Finance Commissions, set up after the Constitutional Amendments. The very fact that the Constitution was amended to include Article 280 (3) (bb) and (c) shows that just as State Government has a responsibility through Articles 243-(I) and 243-(Y) to devolve resources to local Governments, the Central Government has its responsibility clearly laid down. And the term “measures needed to augment the Consolidated Fund of State” certainly indicates direct infusion of additional resources from the Centre even if some other measures could be considered – in reality, only the former in the initial years of formation and capacity building of the Local Government system.

7.7 The Tenth Finance Commission had to adopt an adhoc approach as the contours of decentralization in the country were still not visible at the time of its functioning. The Eleventh Finance Commission had a term of reference that allowed it to make its own assessment about the manner and extent of augmentation of the Consolidated Fund of the State, as some of the States had not even by then set up a State Finance Commission. That Commission inexplicably adopted a formula which gave only 20 % weightage to decentralization and even this component was not scientifically designed with the result that it gave bizarre rankings to States. For example, Kerala figured much below States which had not even set up elected local Governments at that time. Also the total amount provided for the entire Country was a negligible Rs. 8000 crore. We submit that the Twelfth Finance Commission has the golden opportunity to make constitutionally valid and sound recommendations in the field of fiscal decentralization in the country.

7.8 The terms of reference to the Honourable Commission is simple, namely that its suggestions for a State have to be based on the recommendations of the Report of the State Finance Commission.

7.9 The spirit and intent of the Constitutional provision, which is part of Article 280 regarding devolution of resources, is that the Consolidated Fund of the State should be augmented based on the Report of the State's Finance Commission. Each State's requirement is thus to be assessed individually depending upon what the State is transferring by way of responsibilities, finance, functions etc., and the resources raised by local Governments (as detailed in SFC's Report). We admit that this is not an easy task for want of data in many cases, but gradually the situation has to be improved. So far as Kerala is concerned, we have presented to the Honourable Commission the Report of the Second State Finance Commission (for 2000-05) and have included the commitment in the revenue expenditure forecasts. Though the time periods are different and the commitment may have to be more, a beginning could be made with the acceptance of the estimates in the forecast submitted to the Commission. The formula suggested by the State Finance Commission is a simple one.

7.10 The State Government would like to place the following suggestions before the Honourable Commission:

- Going beyond the earlier Finance Commissions' adhoc approach, the Twelfth Finance Commission may move towards a resource sharing approach as far as local Governments are concerned

- In keeping with this approach it is suggested that to begin with, the divisible pool of Central Taxes may be increased by 10 % and additionally set apart for devolution to local Governments through the State Governments

- The devolution may be made to each State on the basis of the latest available Report of the State Finance Commission and an assessment based on it

- The Reports of the State Finance Commissions may be assessed on the basis of a formula linked to a transparent index of decentralization using objectively verifiable measures. The appropriate parameters will be:

  - Size of the functional domain of Local Governments (without overlap by State or Central Governments) as evidenced by detailed transfer of functions;

  - Level of fiscal decentralization both in the fiscal empowerment of Local Governments to raise their own resources and in the devolution of resources for Local planning;
  - Degree of freedom for use of resources by Local Governments;

- Extent of transfer of human resources to Local Governments for proper exercise of the additional functions.

7.11 These correspond to the four ‘F’s that are considered as true indicators of decentralization, namely, Functions, Finance, Functionaries and Freedom for resource use in local planning and development (which is Constitutionally mandated unlike State and Central level planning).

- A portion of the amount set apart for Local Governments may be given as incentive to State Governments willing to undertake basic fiscal and administrative reforms in Local Governments

- Special assistance may be given to States which are far ahead in the matter of decentralization for capacity building and for redesign of administrative systems.

- The recommendation of the Eleventh Finance Commission to remove the cap on Profession Tax may be reiterated as it is felt that Profession Tax can be a very good local tax

- The recommendation of the Eleventh Finance Commission to synchronize the setting up of State Finance Commission may be reiterated in a modified form in such a way that the Constitution would enjoin the State Governments to constitute State Finance Commissions thirty months before the expiry of the award of the Central Finance Commission, stipulating a time ceiling of one year for submission of reports by the State Finance Commissions and six months for the State Governments to complete action on the recommendations. If this is done it would make the task of Central Finance Commission easier

7.12 In the changing context, the adage “for the average citizen, most Government is Local Government” is becoming gradually true in the country. It is submitted that the Twelfth Finance Commission may recognize this fact as well as the one that Kerala has been a pioneer in implementing the Constitutional provisions. We also request that such recognition may be reflected in appropriate augmentation of the Consolidated Fund of the State based on the Report of the Second State Finance Commission.

Chapter 8

CORRECTIVE MEASURES WITH REGARD TO DEBT POSITION

8.1 The interest-bearing debt of the State Government as on 31st March 2003 was Rs.31060 crore. It has increased sharply in the last seven years from Rs.10113 crore in 1995-96. The interest burden has increased during the same period from Rs.924 crore to Rs.2944 crore a year. The situation which was manageable has become disturbing and will become unsustainable unless some bold corrective measures are taken.

8.2 The starting point of this growing indebtedness was the non-plan revenue deficit from early 1980's. Instead of being corrected, this was allowed to grow, in spite of the State's efforts at raising its own revenues, largely through the reduction in the State's share of Central devolution in successive five year periods. The situation was further compounded by the fact that while the revenue expenditure component of the State plan was over fifty percent (and was growing) the Central assistance to the Plan was given in the ratio of 70 % loan and 30 % grant. While the State's emphasis on social sector development in the first four decades of planning enabled it to be at the top in Human Development Index, it also meant the use of borrowed funds for such purposes, as grant funds were meagre under the present scheme of financing of the plans.

8.3 Borrowed funds, which should normally be used for investment and capital expenditure alone, came to be increasingly used to cover the non-plan and plan revenue deficits.

8.4 The Central Government (Planning Commission and Ministry of Finance) and the Reserve Bank of India fix the limits of borrowing by a State Government. Over the years, in addition to loans from the Centre, market borrowing and negotiated loans from financial institutions have been so fixed. The other two sources were Small Savings and Public Account which depended on the State Government's efforts. Increasing resort to the latter arises from the limits on the former. Of the total market borrowing for the Centre and the States, nearly 90 % is for the Centre and only 10 % is earmarked for all States.

8.5 We submit that the debt position of the States and the Centre can be corrected only if the root causes are tackled. Successive Finance Commissions have approached the problem from a limited angle of giving some relief. The relief has been of a token nature – about Rs.212 crore for all States in 1995-2000 and Rs.600 to 700 crore in 2000-2005. It is no wonder that the debt mountain has grown.

8.6 We would urge the Honourable Commission to initiate a set of bold steps to put both the States and the Centre on the road to correction.

`To begin with, the three channels of borrowing within the full control of the Central Government could be taken for such correction. These are:

- Massive loan component of Plan assistance
- Negotiated loans
- National Savings loans

8.7 Massive loan component of Plan assistance

- It needs to be examined whether it is necessary to continue the practice of channelling loans for the State plan through the Centre. This was necessary in the early years of planning and development of the financial sector. Today with the financial markets having matured in the country there is no reason why GOI should act as a conduit and provide the loans to the States. This only increases the cost of borrowing (GOI is charging 10.5 % when it is borrowing at 6 % now). As a prudent measure, GOI could as well fix the overall borrowing limit for a State and permit the State to raise its borrowing from any channel it desires. The States would also then act judiciously to put their finances on track and raise loan at a premium that they deserve as sub- national entities. Loans from the Centre could with advantage be taken out of plan financing, the source of the funds being the same, namely, household financial savings. In so far as the existing loans are concerned, as regards Kerala, it is only fair that the loan from the Centre (comprising a smaller percentage of total debt in its case) is written off in its entirety in view of the pre-eminent position it has attained in human development through persistent efforts in earlier decades. This is justified also on another account namely, that during the last few years the State Government has been making strenuous efforts to create a climate favourable for investment, through a variety of measures including major changes in policies followed in earlier years. The Government has announced new Industrial, Labour, Information Technology and Biotechnology policies. The credit-deposit ratio in the State was low for years despite the fact that deposits were considerable, which meant that savings from the State (the quantum of which is quite high) were being used for lending and investment elsewhere in the country. The ratio has now started increasing, indicating significant improvement in the climate of investment. CII survey of industrial attractiveness gave Kerala the third place among 18 States in the country.

- States should be given freedom to enter market for borrowings within prudent caps. All debt swaps should also be done through market borrowings.

8.8 Negotiated loans

Borrowings from the institutions like LIC, GIC, NABARD and NCDC as per the allocation of Planning Commission constitute negotiated loans. The rate of interest varies from 7 % to 16.75 %. The accumulated balance and the burden of repayment have increased to an extent where the net retentions show a declining trend. In a few years it will be negative if the trend continues. These loans are supply driven and annual targets are assigned for each State by these Institutions. Almost all of them insist on guarantee from the State Government without serious evaluation of the merits of each project or scheme. This increases the contingent liability of the State Government. In the nature of its objectives, each of these Institutions has social obligations to fulfil, which are also in its own business interests. Loans given by them for agriculture and allied activities, rural development (NABARD), Water Supply and basic health programmes (LIC), Co-operative development (NCDC), Fire and rescue services (GIC) should be on concessional terms and not at the rates that they have been charging without any risk (because of guarantees). We would urge the Honourable Commission to take up this issue, which has not been touched by earlier Commissions with the Government of India and the financial institutions. If they cannot extend loans on concessional terms, we would rather that the quantum of such loans is also brought under the limit for market borrowing. After all, they are also acting as conduits for household savings.

8.9 National Savings Loans

The scheme of national savings has been a major source of State Plan financing. To a considerable extent, the scheme has met the objective of encouraging the savings habit among ordinary people and using those savings for economic development. However, over the long period of operation of the scheme some distortions have crept in. Briefly they are:

- The scheme is moving away from its basic role as a savings instrument for ordinary people and has become, mostly, an investment opportunity with relatively high returns. Corporate and even financial institutions have made use of it

- The cost of savings has steadily increased. Apart from the relatively higher interest rates, various incentives offered, payments for agents, tax relief to investors all add up to a high cost

- In addition, State Governments have to pay high rates of interest on the loans they receive from the net collections (9.5 % now)

- As the quantum of funds generated is influenced by factors like the movement of bank rates, large variations can occur in the trend growth of State Governments' receipts.

8.10 States had in the past pointed out that, as the funds they receive are from net collections and not gross collections; the repayment liability is not really fair to them. Responding to this plea, the Seventh Commission recommended that small savings loan outstanding against each State at the end of 1978-79 might be consolidated into one loan and treated as a loan in perpetuity. Though the Government did not accept its recommendations, it did decide that the States would not be required to make any repayment during 1979-84 on account of small savings loans as at the end of 1978-79. This approach was however given up after the relevant five year period.

8.11 The issue was considered by the Eleventh Finance Commission also. The Commission did not favour either the idea of giving loans in perpetuity or disbursing grants out of national savings collections. While the theoretical logic for rejection of the idea of loan in perpetuity cannot be faulted, the rejection of the suggestion to give grants to States was not based on a realistic appreciation of the working of the scheme. The reason given by the EFC was "Larger current borrowings create larger liabilities for the future, and cannot be converted into a grant as the debt has to be repaid".

8.12 The National Small Savings Fund was created as an accounting device to keep the amount out of the calculation of fiscal deficit. All investment from the Fund is in Central Government securities and is treated as internal debt of the Central Government. In other words, if and when the Government of India reaches a stage necessitating discharge of accumulated net stock, it would have a major impact on the Centre's budget. The State Governments will certainly not be immune to the fall out of this impact and will have to suffer serious shortfall in the flow of Central funds. In the interests of both the Centre and the States, the scheme for use and repayment needs to be revamped.

8.13 Taking all relevant aspects into consideration we would submit the following phased package of correction regarding this scheme:

- Even under the arrangements brought about consequent on the recommendations of Dr.Y.V.Reddy Committee this basic lacuna remains unsolved. In the ultimate analysis even now repayments made by the States do not go into the build up of a Fund which can meet the requirements of bulk discharge of liabilities in the future;
- Write off 50 % of outstanding national savings loans given to State Governments;

- Future flows of net collections may be as 50 % grant and 50 % loan. This may be achieved during a five year period with the loan component starting at 90 % the first year and being reduced by 10 % each in the subsequent four years, correspondingly increasing the grant portion to 50 % ;

- A review may be undertaken after five years. By then, a way to rationalize the cost of the funds generated under the scheme could also be devised so that there is reasonable stability in the trend of growth of amounts received by States as loans and grants under the scheme.

Chapter 9

DISASTER MANAGEMENT

9.1 We welcome the comprehensive approach implied in the use of the term ‘disaster management’ in the terms of reference to the Commission in the place of the earlier natural calamity ‘relief’. The emphasis on ‘relief’ meant that the amounts provided were of a token nature and the procedural arrangements were such that even the meagre relief was provided long after the calamity and the damage. There was hardly any emphasis on preparation to manage disasters. The policy and arrangements for meeting the relief expenditure are, by and large, based on the recommendations of successive Finance Commissions.

9.2 From the period of the Second Finance Commission to the Eighth Commission, States were assisted under the Annual Margin Money Scheme. The quantum of margin money was calculated by averaging the Non Plan expenditure (excluding advance plan assistance and expenditure of a Plan nature) on relief measures. The margin money so provided for each of the States was duly taken into account while working out the forecast of expenditure for each of the States, on the basis of which the Finance Commission based its recommendations for the devolution of resources for the period covered by them. The annual margin money thus worked out by the Sixth Finance Commission was Rs.50.71 crore, by the Seventh Finance Commission Rs.100.55 crore and by the Eighth Finance Commission Rs.240.75 crore.

9.3 The Calamity Relief Fund was established on the basis of the recommendations of the Ninth Finance Commission and the Eleventh Finance Commission also retained the CRF and recommended discontinuing the National Fund for Calamity Relief. Instead a National Calamity Contingency Fund (NCCF) was created to meet eventualities outside the Calamity Relief Fund. To begin with the NCCF was created with a corpus of Rs.500 crore along with provision to levy special surcharge on the central taxes for a limited period. It is under this provision that a one percent surcharge was levied on Income Tax to meet the expenditure following the Gujarat Earthquake in 2001. When a disaster strikes, the State concerned prepares a memorandum and sends it to Government of India. The Government of India then sends a Central Team for making an on-the-spot assessment of the damages highlighted in the memorandum. The Central Team prepares a report and submits to the Inter Ministerial Group (IMG) and recommends the quantum of assistance from the NCCF. This recommendation is presented before the Task Force headed currently by the Deputy Prime Minister (in-charge of Home), with the Agriculture Minister, Finance Minister and Deputy Chairman, Planning Commission as members. This Task Force finalises the quantum of assistance to be given to a State. There have been occasions when the recommendations made by the Central Team and the IMG after field visits have not been accepted by the Task Force themselves creating embarrassment and disappointment to the State.

9.4 The CRF is shared by Centre and State in the ratio of 3:1 and the Fund is kept outside the public account earning interest. The release of funds from the CRF by the Government of India (Ministry of Finance) will be made by the first of May and the first of November in a year provided that the State credits its share and this fact is authenticated by the Accountant General.

9.5 The list of items and norms of expenditure to be followed by the States for incurring expenditure from CRF and NCCF has been revised with effect from August 2001. The State Level Committee is headed by the Chief Secretary to take decisions related to the financing of the relief expenditure subject to general guidelines. The State is also required to have an inter-disciplinary cadre under the Relief Commissioner, of 200 to 300 trained personnel who could be deployed for relief work in and outside the State. Each State should prepare an annual report on natural calamities relating to the preceding financial year and submit it to the Union Ministry by 30^{th} September every year.

9.6 Several lacunae have been noticed in the actual working of the present arrangements:

- Considerable time expires before the memorandum is prepared by the State in view of its preoccupation with relief work and the need to collect data

- There is delay in sending the Central Team. In view of the lapse of time between the occurrence of the disaster and the visit of the Central Team, the real damages and sufferings of the people and the quantum of rescue work done are not properly reflected/appreciated by the Central Team

- On many occasions, the States are not given any funds despite the memoranda and the visit of Central Teams

- A State's specific calamity/disaster situations are not recognized or appreciated. For example, the State of Kerala faces mainly damage due to sea-erosion, floods, land slides, damage due to heavy monsoon rains, and heavy dependence on perennial corps which take years to be rehabilitated when affected by heavy or poor rainfall in some years

- The term 'calamity of rare severity' for assistance from NCRCF is ambiguous and dispensing of funds from NCRCF turns out to be highly discretionary.

9.7 The primary responsibility to deal with natural disasters is with the State Government. The Centre's role is that of providing resources and other assistance for the purpose and acting in a supporting manner. The State Government would suggest that the current practice of sending a team of officials after a memorandum is submitted by the States, to assess the damage and to determine the quantum of calamity be discontinued. Instead the Commission may recommend that a notified specialized institution in the country be entrusted with the task of determining the damages due to calamity of rare severity and take appropriate, swift and adequate action in disaster management. It follows that an institution with required capacity and skills has to be built up as early as possible so that it can set up a nation-wide network.

9.8 As regards the Calamity Relief Fund, we would suggest that:

- The corpus of the Calamity Relief Fund may be enhanced to 10 % of the amount of the annual State Plan size of the concerned State

- The contribution of the Central Government to the corpus of the Calamity relief fund may be enhanced suitably. The existing level of 75 % may be modified as 90 %

- Norms for the utilization of the CRF fund may be modified by fully permitting the states to fix their own norms and the eligible items of expenditure.

9.9 As regards the NCCF, we would suggest that it may be continued with the following changes:

- Corpus of the fund may be enhanced equal to that of 10 % of the aggregate amount transferred as the Central share of the CRF to the States

- The rules for access to the fund by the States may also to be modified

- All disasters of rare severity should be financed from this fund

- The disaster of rare severity may be defined very clearly with parameters for different kinds of disaster and scales of intensity so as to minimize discretion and delay

- In case the quantification of the loss on account of the natural disaster comes to an amount equal to 10 %of the State plan or above, the advance drawal may be allowed up to hundred per cent of the next year's provision.

9.10 The Government of India appointed a high level committee in 1999 to consider and make recommendations on Disaster Management in all its aspects. The Committee submitted its recommendations in 2001. The highlights of the recommendations are:

- Each State to prepare a disaster management plan at the State level and District level according to the vulnerability of the State and Districts. The disaster management plans to be periodically updated and also revised periodically in the month of May
- A State Disaster Management Act to be passed by the State for which a draft bill was circulated to the States
- A State Disaster Management Policy may be announced
- Awareness creation and training to be imparted to the first respondents and to the vulnerable people
- Insurance to be given priority and achieve disaster mitigation
- 10 % of the Plan Funds to be earmarked for disaster prevention and mitigation
- The Control Rooms to be strengthened at State, District and Sub-District level.

9.11 No action could be taken for want of funds and guidance. In addition to disasters caused by nature there are also man-made disasters like acts of terrorism, forest fires etc. With the transfer of disaster management to the Ministry of Home Affairs an 'all hazard approach' is to be followed – covering all kinds of disasters and their mitigation, preparedness, warning and response. The national institution proposed by us should be able to initiate work on these comprehensive lines.

9.12 The State would also suggest setting up of a National Disaster Mitigation Fund (NDMF). From years of experience, it is clear that precautionary measures are more economic and useful than measures taken in panic at the time of disaster. Several studies have confirmed the adverse economic impacts of natural disasters in the event that rapid and adequate funding is not available for replacement of productive capital. The relief work for floods is by and large a restoration work warranting more expenditure in civil construction whereas, the expenditure on relief measures of drought is basically an employment generation programme. Therefore, programmes for disaster preparedness should be linked with the existing activities of rural development programmes. Government of India is channelling funds through various schemes for the development of the rural sector. A majority of these is being implemented either through the Rural Development Department or through the Local Self Government Institutions. The NDMF should be utilized for providing assistance to the States for preparedness and for disaster mitigation measures as follows:

- Linkage of disaster mitigation with development plans
- Effective communication systems
- Use of latest information technology and early warning system
- Insurance

- Extensive public awareness and education campaigns particularly in the rural areas
- Strengthening of institutional mechanisms.
- Capacity Building through research and training programmes.

Chapter 10

SUMMARY

10.1 The overall scheme presented by us in the earlier chapters is summed up as follows.

- As regards share in taxes the following weightage may be given to three criteria, namely: population 80 %, tax effort 10 % and fiscal correction 10 %
- As regards grants-in-aid under Article 275, a three stage application as indicated below may be recommended.

Stage I. Cover non-plan revenue deficit of the States remaining after the distribution of shares of Central taxes.

Stage II. Then cover plan revenue deficit remaining even after taking into account plan grants and non-plan revenue surpluses if any.

Stage III. Provide appropriate grants for correcting too wide a range in per capita total revenue account surpluses among the States, so that weak States also have a reasonable revenue account surplus for capital investment.

- Plan assistance in future should only be in the form of grants. The past plan loan liability with regard to loans taken from GOI must be written off in respect of States like Kerala who utilised most of these funds in efforts to reach the high level of human development
- In future, loan portion of Central Assistance for State Plan and negotiated loans should be discontinued and this place, adequate

increase in open market borrowing may be allowed, with a ceiling fixed for each State. Correspondingly, borrowing by the Centre from open market can be reduced

- National Savings may be redesigned as per specific suggestion made in para 8.9

- Specific suggestion regarding funds for Local Bodies as discussed in Chapter 7

- We suggest that a National Disaster Mitigation Fund (NDMF) may be set up to provide assistance to the States for disaster preparedness and disaster mitigation

- We recognize the need for more reliable data for making normative and realistic forecasts and projections and therefore we suggest that the Finance Commission may make recommendations to put in place an independent authority who will arrange to ensure that for a given set of parameters, data will be available at least to the next Finance Commission. Adequate fund and institutional arrangements may be suggested for this.