REPORT OF
THE WORKING GROUP ON
STATES' RESOURCES

FOR
THE ELEVENTH FIVE YEAR PLAN
(2007-2012)

JULY 2007

WORKING GROUP ON STATES' RESOURCES

ACKNOWLEDGEMENTS

I express my gratitude to the Members of the Working Group for their invaluable inputs. In particular, I am grateful to Shri Valluri Narayan, Dr. Kavita Rao and Dr. A.K. Singh for chairing the respective Sub Groups on Expenditure, Tax and Non Tax Revenues and providing highly analytical reports that form part of the Final Report of the Working Group.

I thank the Finance Secretaries of the different States for providing accurate and comprehensive data and offering their considered views and suggestions that have given shape to this Report.

I must express my gratitude to Shri R. Sridharan, Joint Secretary (State Plans), Planning Commission for working closely with the Working Group and providing valuable inputs during the deliberations from time to time. His insights and overall perspective of the States' Finances have guided the Working Group throughout its proceedings.

I would also like to thank Shri V.S. Senthil, Joint Secretary, Department of Expenditure, Ministry of Finance for presenting the point of view of the Ministry of Finance and helping the Working Group in finalizing its recommendations.

The inputs provided by the Perspective Planning Division (PPD) of the Planning Commission has been of considerable help in projecting the growth scenarios of the respective States.

In particular I would like to express my gratitude to Shri S. Lakshmanan, Director, Planning Commission for his single handed help in synthesizing the reports of the three Sub Groups constituted by us for looking into the trends in tax and non tax revenues and the expenditure patterns of the States.

I thank all the other officers of the Planning Commission, in particular Shri K.M.M.Alimalmigothi, Director, but for whose assistance the Working Group would not have been in a position to conduct the deliberations and conduct its proceedings.

Dated: July 4, 2007 **(Dr. E.A.S. Sarma)**

Chairman,
Working Group on States' Resources
For the Eleventh Five Year Plan

Introduction

Chapter - 1

Constitution and Terms of Reference of the Working Group/ Sub-Groups

1.1. The Steering Committee on Financial Resources for the Eleventh Five Year Plan (2007-12) set up three Working groups in January 2006, one to examine the trends in Savings and the projections for the Eleventh Plan, the second one to deal similarly with Resources of the Centre and the third one to deal with Resources of the States. The Working Group on States' Financial Resources was set up under the chairmanship of Dr. E.A.S. Sarma.

1.2. The composition and Terms of Reference of the Working Group are as follows.

Composition of the Working Group on States' Resources:

1)	Dr. E.A.S Sarma	Chairman
2)	Representative of CAG	Member
3)	Joint Secretary (PF I),M/o Finance	Member
4)	Joint Secretary (Budget)	Member
5)	Pr. Finance Secretary, Govt. of Maharashtra	Member
6)	Pr. Finance Secretary, Govt. of Assam	Member
7)	Pr. Finance Secretary, Govt. of West Bengal	Member
8)	Pr. Finance Secretary, Govt. of Haryana	Member
9)	Pr. Finance Secretary, Govt. of Karnataka	Member
10)	Pr. Finance Secretary, Govt. of Rajasthan	Member
11)	Executive Director (RBI)	Member
12)	Dr. Mahesh C Purohit, Director, Foundation for Public Economics and Policy Research	Member
13)	Shri Haseeb A. Drabu	Member
14)	Dr. A.K. Singh, Professor, GIDS, Lucknow	Member
15)	Dr. (Mrs.) R. Kavita Rao, Senior Fellow, NIPFP	Member
16)	Shri Valluri Narayan	Member
17)	Shri P.V Rajaraman,	Member
18)	Dr. N.J.Kurian, Director, CSD	Member
19)	Director(PPD)	Member
20)	Sh. S. Lakshmanan, Director (FR)/ Sh. K.M.M. Alimalmigothi, Director (FR)	Member Secretary

Terms of Reference of the Working Group on States' Resources

1) To analyse the resource position of the States with particular reference to the implementation of the recommendations of the Twelfth Finance Commission (including replacement of Central Loans by Market Borrowings), fiscal responsibility legislation (s), debt restructuring introduction of VAT, tax on services, flow of EAP funds and other policy changes in that regard;

2) To examine issues arising from (a) flow of funds from National Small Savings and its related problems; and (b) Establishment of Loan Council;

3) To examine the basis of distribution of Central plan assistance to States (including the Gadgil-Mukherjee formula and ACAs) and suggest changes if required;

4) To examine the flow of funds under CSS and suggest methods of integrating them into the scheme of financing of the Plan of the States;

5) To examine the special dispensation provided to Special Category States in the allocation of Central Plan assistance and suggest changes if required;

6) To examine the relevance of the Plan – Non-Plan distinction in the expenditure in the State Governments and to suggest changes if any in the definition of the plan expenditure;

7) To examine the classification of expenditure in terms of `Revenue' and `Capital' especially in the light of the requirements under the Fiscal Responsibility Act and its implication for plan programmes;

8) To examine whether, and to what extent, investment by State PSUs financed through Internal and Extra-budgetary Resources (IEBR) should continue to form a part of the State Plan.

9) To examine the role of SPVs, PPP and other innovative methods for additional resource mobilisation by the State governments for financing Plan expenditure

10) On the basis of the above, to suggest the basis for making projections for 'resources' and 'expenditure' for the States during the Eleventh Plan period;

11) To prepare and present projection(s) on the scheme of financing for the Eleventh Plan for the States (including UTs with legislature) separately (and combined).

1.3. In the first meeting of the Working Group, preliminary discussions were held on the trends in the States' finances and the factors that were likely to influence the same during the Eleventh Plan. Keeping in view the need for examining the various dimensions of States' finances in depth, the Working Group decided to constitute three Sub-Groups, one to cover Tax resources of the States, the second one to cover the non-tax resources and the third one to look at the expenditure trends.

1.4. The composition and Terms of Reference of the Sub-Groups are as follows:;

Sub-Group (Tax Resources)

Composition

1)	Dr. Kavita Rao	Chairperson
2)	Finance Secretary, Maharashtra	Member
3)	Finance Secretary, Karnataka	Member
4)	Finance Secretary, Assam	Member
5)	Finance Secretary, Nagaland	Member
6)	Finance Secretary, Mizoram	Member
7)	Finance Secretary, West Bengal	Member
8)	Sh K.M.M. Alimalmigothi, Director (FR.)	Member Secretary

Terms of Reference

1. To estimate the year-wise tax resources of the States (including UTs with legislature) separately and combined for the Eleventh Five Year Plan period (2007-12), keeping in view the implementation of VAT, recent decisions on CST and tax on services

2. To suggest possible reform measures for maximizing the tax-SGDP ratios of States within the time frame of the Eleventh Five Year Plan and the consequent additional tax revenues that could accrue on that account to the States

Sub-Group (Other than Tax Resources)

Composition

1)	Dr. A. K. Singh	Chairman
2)	Dr. Haseeb A. Drabu	Member
3)	Secretary Finance, Uttar Pradesh	Member
4)	Finance Secretary, Gujarat	Member
5)	Finance Secretary, Assam	Member
6)	Finance Secretary, Orissa	Member
7)	Finance Secretary Maharashtra	Member
8)	Finance Secretary, West Bengal	Member
9)	Finance Secretary Tami Nadu	Member
10)	Dr. Mahesh C. Purohit, Director, Foundation for Public Economics and Policy Research	Member
11)	Representative from RBI	Member
12)	Sh. S. Lakshmanan,Director (FR)/ Sh. O.P. Shemar, Director (FR.)	Member Secretary

Terms of Reference

1. To estimate the year-wise resources (other than tax resources) of the States (including UTs with legislature) separately and combined for the Eleventh Five Year Plan (2007-12), keeping in view the implementation of the recommendations of the Twelfth Finance Commission (including replacement of Central Loans by Market Borrowings), FRBM requirements of Centre and States, Debt Restructuring, implementation of VAT, flow of CSS funds, flow of EAP funds and other relevant policy changes.

2. To examine issues of and implications of (a) National Small Savings and (b) Establishment of Loan Council.

3. To explore the scope for new measures and suggest targets for ARM by the State Governments, including innovative instruments such as SPVs, PPP.

4. To estimate the year-wise net accrual to State Provident Funds, SLR based Net Market Borrowings, proceeds from disinvestment of SLPEs and net Miscellaneous capital receipts.

5. To estimate the contribution of SLPEs & to suggest as to what extent investment by SLPEs through IEBR should continue to form part of the State Plan.

6. To estimate the non-SLR based market borrowings through investments of bonds/debentures.

7. To estimate the negotiated loans from various Financial Institutions including LIC/GIC, NABARD, REC, IDBI etc.

8. To estimate the year-wise flow of external assistance available for the financing State Plans, in the light of the recent trends in utilization of external aid for EAPs, flow of FDI etc.

The Sub-Group is also requested to :

- Examine the flow of funds under CSS and suggest methods of integrating them into the scheme of financing of the State Plans.
- Examine the special dispensation provided to Special Category States in the allocation of CPA and suggest improvements, if required.
- Examine the basis of distribution to CPA to States (including the Gadgil-Mukherjee formula and ACAs) and suggest changes, if required
- Comment on the likely impact of the 6^{th} Pay Commission (to be constituted) on the State's Plans.

Sub- Group (Expenditure)

Composition

1)	Shri Valluri Narayan	Chairman
2)	Dr. N.J.Kurian, Director, CSD	Member
3)	Smt. Rita Mitra, Principal Director, CAG,	Member
4)	Finance Secretary, Andhra Pradesh	Member
5)	Finance Secretary, Bihar	Member
6)	Finance Secretary, Chhattisgarh	Member
7)	Finance Secretary, Haryana	Member
8)	Finance Secretary, Jammu & Kashmir	Member
9)	Finance Secretary, Jharkhand	Member
10)	Finance Secretary, Kerala	Member
11)	Finance Secretary, Madhya Pradesh	Member
11)	Finance Secretary, Punjab	Member
12)	Finance Secretary, Rajasthan	Member
13)	Finance Secretary, Tamil Nadu	Member
14)	Finance Secretary, Uttaranchal	Member
15)	Sh. S. Lakshmanan, Director (FR)/ Sh. Sanjeev Joshi , SRO (FR.)	Member Secretary

Terms of Reference of the Sub-Group (Expenditure)

To estimate the year-wise expenditure of the States (including UTs with legislature) separately and combined for the Eleventh Five Year Plan (2007-12), keeping in view the implementation of the recommendations of the Twelfth Finance Commission, FRBM requirements of Centre and States and Debt Restructuring, possible reform of SLPEs and devolution to the urban and rural local bodies

The Sub-Group is also requested to:

- consider the existing expenditure classifications viz. Plan & non-Plan and Capital & Revenue and suggest rationalization

- examine the scope for expenditure reforms, including right-sizing of various government departments, public-private partnerships etc. and recommend policy changes

1.4 In all, the Working Group held three meetings, the first one on 15th of July, 2006, the second one on 24th of January, 2007 and the last one on 3rd July, 2007. The lists of Members/ participants at these meetings are provided at Annexes 1.1, 1.2 and 1.3. The three Sub-Groups held their meetings separately in close consultation with the Chairman and the other members of the Working Group. Their reports were available to the Working Group by January, 2007.

1.5 The Working Group and its Sub-Groups faced some difficulty in gathering comprehensive and comparable data on States' receipts and expenditure for the previous years. As a result, the Group had to make some assumptions while arriving at the projections for the Eleventh Plan. The assumptions are spelt out in the following chapters.

1.6 This chapter viz Chapter 1 is an introductory one. Chapter 2 provides an explanation of the concepts and definitions relating to States' resource mobilization. By and large, the Working Group has tried to adopt the same concepts and definitions as adopted by the Working Group on States' Resources for the Tenth Plan (2002-07). Chapter 3 provides a review of the trends in the mobilization of Plan resources by the States for the Tenth Five Year Plan and some of the previous Plans with special reference to the variance between estimates and actuals.1.7 Chapter 4 deals with the projections made by the Working Group for the Eleventh Five Year Plan. This Chapter spells out in detail the assumptions that form the basis for these projections.

1.7 There are a number of policy issues that arise in assessing the resources of the States for the Eleventh Five Year Plan and they need to be addressed by the Planning Commission, in consultation with the Ministry of Finance. Chapter 5 highlights these issues in some detail.

Chapter –2

Concepts & Definitions

2.1. Government's receipts net of non-plan expenditure is a measure of Aggregate Plan Resources that are required to finance the Plan expenditure during the Five Year Plan under consideration. Broadly, government expenditure during any given Five Year Plan comprises of two parts. First is the non-plan expenditure that is required for maintaining the facilities created during the previous Plans. Second is the Plan expenditure that is required for creating new facilities during the Five Year Plan under consideration.

2.2. The Working Group for the Tenth Plan adopted the following concepts and definitions.

Aggregate Plan Resources of State Governments

Aggregate Plan Resources **(APR)** is Aggregate Receipts (**AR)** less Non-Plan Expenditure **(NPE).** .

APR = AR - NPE;

AR comprises Current Revenues (**CR**) excluding Plan Grants, Plan Grants (**PG**), Non-Debt Capital Receipts (**ND**) and Net Borrowings.(**NB**).

AR = CR + PG + ND + NB;

NPE comprises Non-Plan Revenue Expenditure (NPRE) and Non-Plan Capital Expenditure (NPC).

NPE = NPRE + NPC;

Thus,

APR = {CR + PG + ND + NB} - {NPRE + NPC};

Rearranging,

APR = (CR - NPRE) + PG +(ND - NPC) + NB

Where **(CR - NPRE**) is Balance from Current Revenues or BCR

2.3 In other words, the components of Aggregate Plan Resources are as follows:

- **Balance from Current Revenues (CR-NPRE)**: Revenues excluding Plan grants less NPRE with the latter including the budgetary support to State Level Public Enterprises (SLPEs) and Grants-in-Aid Institutions.

- **Plan Grants (PG**): Grants including the grant component of Central Assistance and Finance Commission Grants for Upgradation, Special problems and Local Bodies but excluding Centrally Sponsored and Central Plan (CSS/CPS) grants.

- **Non-Debt Capital Receipts net of Non-Plan Capital Expenditure (ND-NPC**): NonDebt Capital receipts including proceeds from disinvestment of SLPEs less Non-Plan Capital expenditure with the latter excluding repayment of borrowings.

- **Net Borrowings (NB**): Although Net Borrowings derive from deducting repayments from gross borrowings, it can be directly estimated by dividing incremental interest payments between two successive years by the effective rate of interest.

2.4. The "budgetary support" to State Plan comprises of the above four components. In addition, the States also provide guarantees to their respective SLPEs to enable the latter to raise resources through their own borrowings. The SLPEs may also have their own operating surpluses. Both these add to the resources available for financing the State Plans. Further, the local bodies (Panchayats, Municipalities) could also contribute to the States' Plans through their own positive surpluses, if any.

2.5 The above concepts and definitions are adopted throughout this report.

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Chapter – 3

Review of the Tenth Plan

3.1 The Working Group on states' Resources for the Tenth Five Year Plan had made some of macro-level assumptions in assessing the States' resources. These were as follows.

GDP:

The projections for any Five Year Plan period critically depend on the assumptions made on the GDP growth for that period.

For the Tenth Plan, keeping in view the trends during the previous years, it was assumed that the real growth rate during the first year would be 7% and it would increase progressively to 9% in the terminal year. On that basis, it was assumed that the average for the five-year period would be 8%. Assuming an average inflation rate of around 5%, the nominal growth rate was expected to be around 13.4%.

States' Own Tax Revenues (SOTR)

During the Eighth Plan, States' Own Tax Revenues (SOT) grew at a real rate of 5.2% with a buoyancy of 0.92 for all States taken together.. During the Ninth Plan, SOTR was expected to grow at a real rate of 7.2% with a buoyancy of 1.09. The increase in buoyancy could be attributed to the overall improvement in the sales tax rates brought about through the adoption of uniform floor rates of sales tax. As this was a one-time event, it was considered unlikely that it would sustain during the Tenth Plan.. Therefore, for the purpose of Tenth Plan projections, the tax buoyancies during the Eighth and Ninth Plans were averaged. For each State, the estimates for the Tenth Plan were arrived at on that basis, subject to a floor level buoyancy of 1.0

For all the States combined, the average buoyancy worked out to 1.01 and the real growth of SOTR came to 8.2%.

Share in Central Taxes (SCT)

For the Tenth Plan, the average buoyancy of Central Tax revenues was assumed to be 1.0, on the premise that any further deterioration in Central Tax/GDP ratio would not be desirable. With a tax buoyancy of 1.0 and the share SCT fixed at 29.5% as recommended by Eleventh Finance Commission (EFC), the real growth of SCT during the Tenth Plan worked out to 8.1%.

Non- Tax Revenues (NTR)

The real growth of States' Non-Tax Revenue was assumed to be nil..

Interest Payments (IP)

During the Tenth Plan, it was assumed that the Debt-to-GSDP ratio would remain constant at the level that prevailed in 2001-02. The effective rate of interest for 2001-02 worked out to 11%. This was arrived at by dividing Interest Payments in 2001-02 by the Outstanding Debt at the end of 2001. Similarly, it was assumed that the ratio of IP to GSDP as obtained during 2001-02 would remain constant throughout the Plan period. This implied that the real growth rate of IP would equal the real growth rate of GSDP during the Tenth Plan i.e. at 8%.

Pension Payments (PP)

Pension Payments during the Tenth Plan ware assumed to grow at the same nominal rate that obtained during 2001-02, in comparison with 2000-01. . This meant that, in real terms, PP would grow annually at 5.1% during the Tenth Plan.

Non Interest Non Pension Non Plan Revenue Expenditure (ONPRE)

During the Tenth Plan, it was assumed that ONPRE would remain constant in real terms at the same level as obtained in 2001-02.

In view of this, it was assumed that Budgetary Support to State level enterprises and grants-in-aid institutions would also remain constant.

If at all any real increase in ONPRE had been allowed, it was only to the extent of 0.8%, brought about by transfer of committed liability from Plan to Non-Plan. The extent of transfer worked out to 22% of the revenue plan component of 2001-02. This proportion was derived on the basis that the reduced revenue plan component of 2001-02 at 78% of its original size would increase to its original size by the terminal year of the Tenth Plan, at an expected inflation rate of 5%.

3.2 **Aggregate Plan Resources of the States during the Tenth Plan**:

Table 3.1 shows the Aggregate Plan Resources of both the Special Category States (SCS) and non-Special Category States (NSCS) in terms of the projections originally made by the Working Group for the Tenth Plan, and the actuals realized on the basis of the data obtained by this Working Group subsequently.

Table 3.1
Tenth Plan resources

(at 2001-02 prices)

A.	Non-Spl Category States	Proj.	Realisations	Realisation (%)
1	Andhra Pradesh	46614.0	54671.9	117.3
2	Bihar	21000.0	18381.6	87.5
3	Chhattisgarh	11000.0	19472.8	177.0
4	Goa	3200.0	3477.5	108.7
5	Gujarat	40007.0	49228.2	123.0
6	Haryana	10285.2	12289.1	119.5
7	Jharkhand	14632.7	16904.6	115.5
8	Karnataka	43558.2	50649.9	116.3
9	Kerala	24000.0	16996.8	70.8
10	Madhya Pradesh	26189.9	29783.7	113.7
11	Maharashtra	66632.0	46275.6	69.4
12	Orissa	19000.0	13269.0	69.8
13	Punjab	18657.0	12476.6	66.9
14	Rajasthan	27318.0	25253.9	92.4
15	Tamil Nadu	40000.0	37981.5	95.0
16	Uttar Pradesh	59708.0	48961.2	82.0
17	West Bengal	28641.0	19948.3	69.6
	Total-Non-Special Category States	**500443.09**	**476022.30**	95.12
B.	**Special Category States**			
1	Arunachal Pradesh	3888.3	3133.1	80.6
2	Assam	8315.2	8829.5	106.2
3	Himachal Pradesh	10300.0	7518.8	73.0
4	Jammu & Kashmir	14500.0	11273.8	77.8
5	Manipur	2804.0	2781.2	99.2
6	Meghalaya	3009.0	2348.5	78.0
7	Mizoram	2300.0	2503.7	108.9
8	Nagaland	2227.7	2522.6	113.2
9	Sikkim	1655.7	1876.8	113.4
10	Tripura	4500.0	3247.5	72.2
11	Uttaranchal	7630.0	11159.2	146.3
	Total- Special Category States	**61129.97**	**57194.55**	93.6
	Total	**561573.1**	**533216.85**	94.95

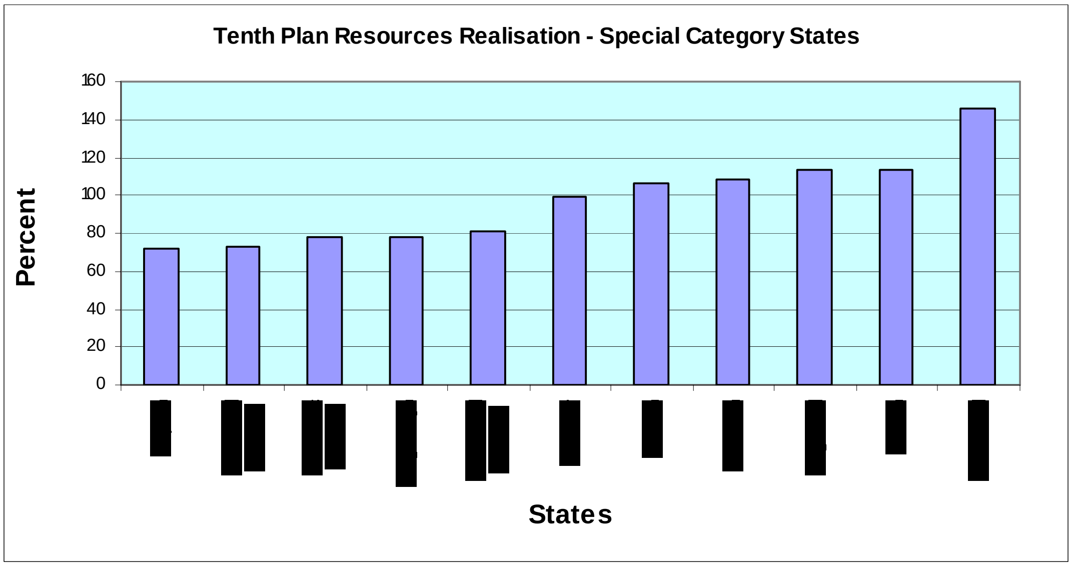
It is evident that the States could realize upto 94.95% of the aggregate Plan Resources originally projected. In this, there are wide variations across the States.

Among the eleven SCS, as many as five States could realize more than what was envisaged by the Working Group for the Tenth Plan. As against this, in HP, J&K, Meghalaya and Tripura, the realization was less than 80%.

Among the NSCS, eight among the seventeen States could exceed 100% of what had been originally projected. As against this, in Maharashtra, Orissa, Punjab, and W. Bengal, the realization was low, less than even 70%. In Kerala, it was only 70.8%.

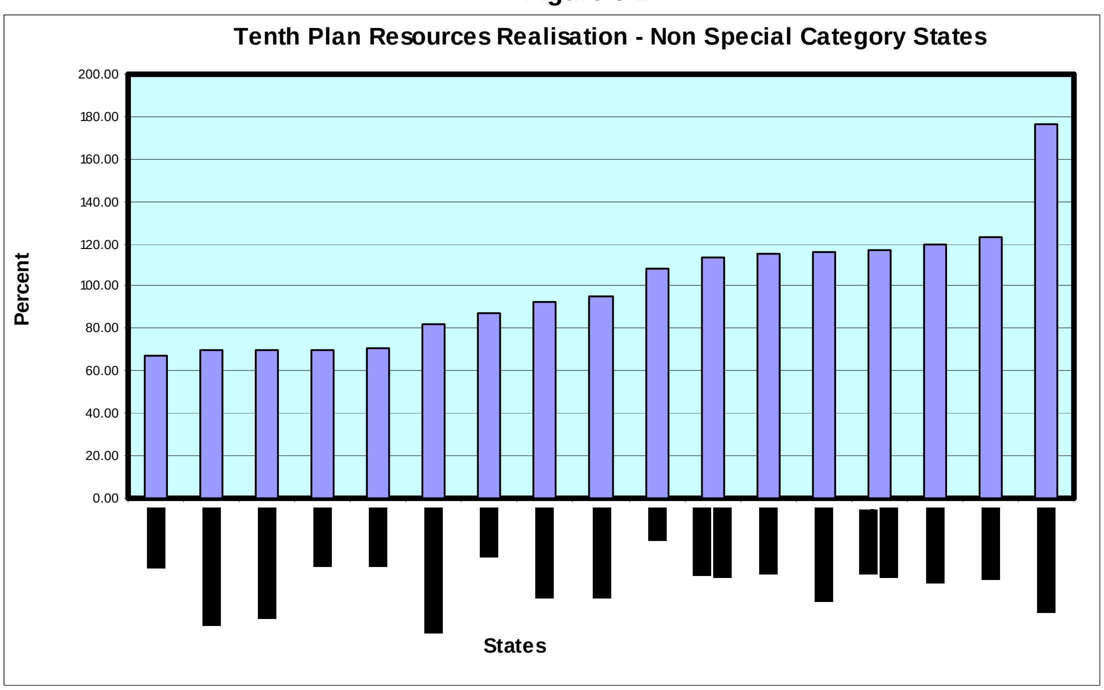
The above position in the case of SCS is depicted graphically in Figure 3.1

Figure 3.1



The position in respect of NSCS is similarly depicted graphically in Figure 3.2

Figure 3.2.

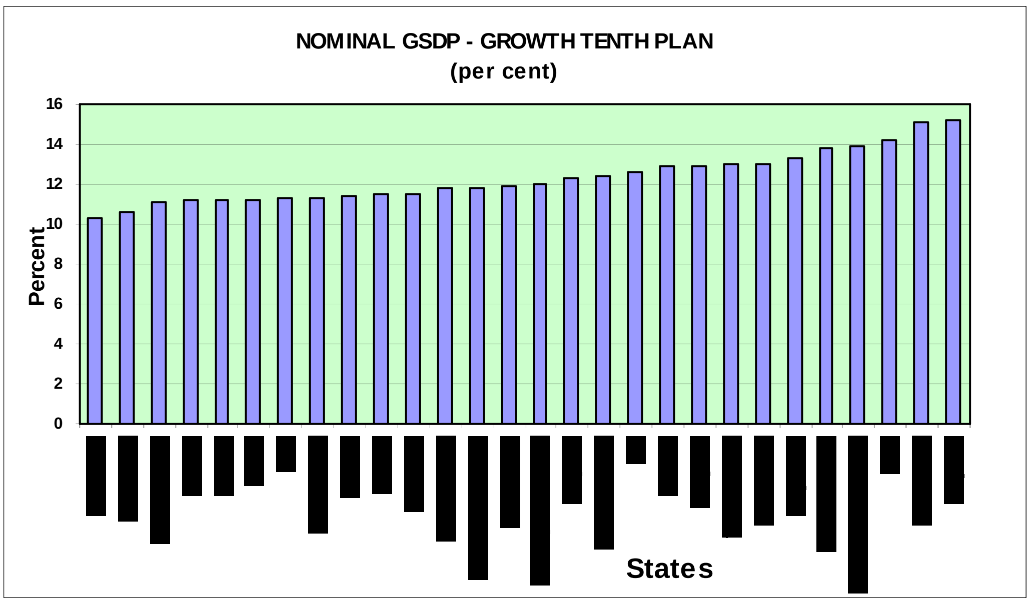


3.4 It is desirable to examine the factors that have contributed to such wide Statewise variance between the original projections and the actuals. The aggregate resource generation depends critically on the rate of growth achieved by each State, the efforts made by it in mobilizing its own resources and the inflow of resources from the Centre under different heads. These are discussed below.

3.5 Trends in the growth of States' GSDP

The GSDP of the States was expected to grow at a nominal rate of 13.4% during the Tenth Plan. As against this, on the basis of the data available on date, only five States could register growth rates exceeding that level. The rest of the States have registered much lower growth rates. This is shown in the following chart.

Figure 3.3



3.6 Tenth Plan Resources of the States- Components

Table 3.2

	Table 3.2 Tenth Plan Resources of States & UTs			
		(Rs. crore at 2001-02 prices)		
	Sources of funding	Projection	Realisation	% realisation
1	Balance from Current Revenues	-15295.0	-25513.9	-166.8
		(-2.6)	***(-4.5)***	
2	Resources of Public Sector Enterprises	82683.9	95715.1	115.8
i)	Internal resources	-7760.1	9653.3	+124.4
		(-1.3)	***(1.7)***	
ii)	Extra-Budgetary resources	90444.0	86060.9	95.2
3	Borrowings	264802.1	299021.8	112.9
		(44.8)	***(52.5)***	
4	State's Own Resources (1 to 3)	332191.0	369222.0	111.1
		(56.2)	***(64.9)***	
5	Central Assistance	258757.0	200011.4	77.3
		(43.8)	***(35.1)***	
6	**Aggregate Plan Resources (4+5)**	**590948.0**	**569233.4**	**96.33**
	Note : Figures in parentheses are percentage to aggregate plan resources.			

It is evident that the shortfall between the projected resources and the actuals are largely attributable to the significant shortfalls in BCR, shortfalls in extra-budgetary resources of the SLPEs and a reduction in the inflow of Central Assistance to the States. To some extent, these shortfalls have been made up by additions to States' Own Resources, additions to resources from SLPEs and additional borrowings.

3.7 Balance from Current Revenues (BCR)

The shortfall in BCR in absolute terms during the Tenth Plan continues to be the major contributing factor in determining the aggregate Plan resources.

The trends in BCR and its components (as a proportion of GSDP) during the Eighth and the Ninth Plans, in comparison with the Tenth Plan, as also the variance between the original estimates and actuals during the Tenth Plan are shown in the following table.

Table 3.3
Trends in BCR

(as percentage to GSDP)

Items	**Eighth Plan Performance**	**Ninth Plan Performance**	**Reference Projections Tenth Plan**	**Actuals 10^{th} Plan**
Share in Central Taxes	3.1	2.9	3.1	3.62
States' Own Tax Revenue	6.3	6.3	6.5	8.39
States' Non-Tax Revenue	2.7	2.3	1.7	2.40
Total (Current Revenues)	12.1	11.5	11.3	14.21
Interest Payments	2.2	2.8	3.1	3.76
Pension Payments	0.8	1.3	1.3	1.70
ONPRE	9.4	9.2	7.4	--
Total (NPRE)	12.4	13.3	11.8	14.54
BCR	**-0.3**	**-1.8**	**-0.5**	**-0.33**

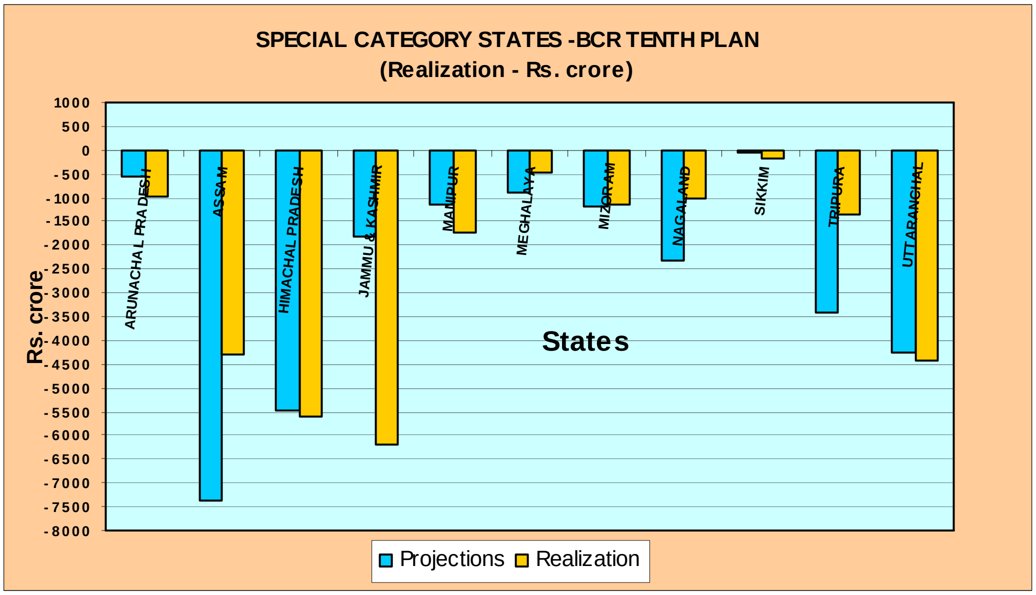
It is evident that BCR, as a percentage of GSDP, continued to be negative during the Tenth Plan, though it has registered some improvement over the position that obtained during the previous years and over the estimates made at the beginning of the Tenth Plan itself. The increases in terms of both interest and pension payments got more than offset by improvements in the other components of BCR.

There are exogenous factors that have positively impacted the BCR of the States. These include the introduction of the debt-swap scheme, larger tax devolution from increased buoyancy of the Central tax revenues and the larger transfers on account of the Tenth Finance Commission's recommendations.

In addition, there has been a significant improvement in the realization of the States' Own Tax Revenues, partly attributable to the introduction of VAT.

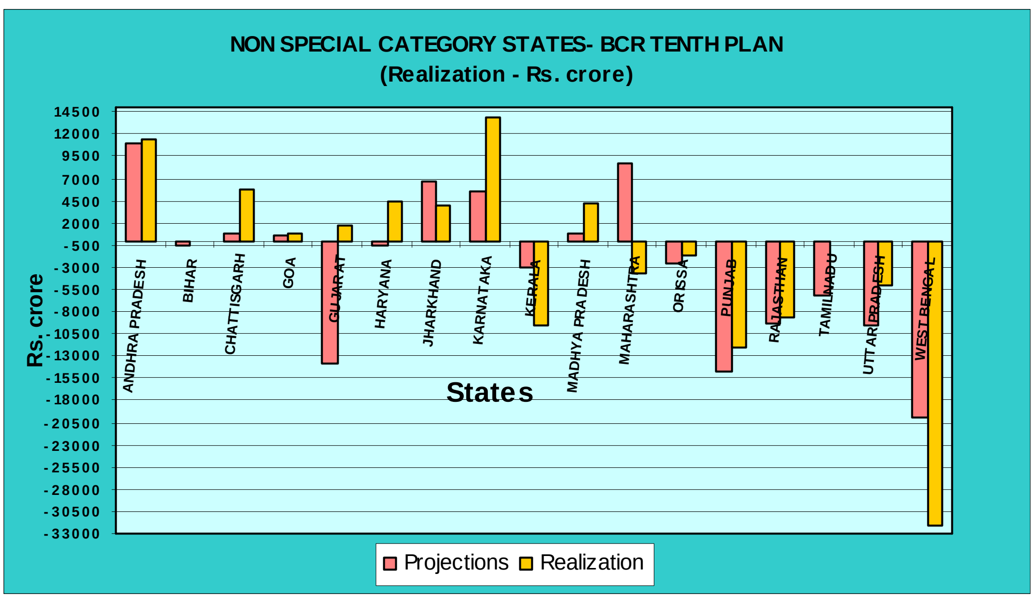
The BCR realizations, in terms of the projections and the actuals, Statewise in the case of SCS, are shown schematically in the following chart.

Figure 3.4



The corresponding position for NSCS is shown schematically as follows.

Figure 3.5



3.8 **States' Borrowings**

Table 3.4 shows the borrowings made by the States during the Tenth Plan, in terms of the original projections and the actuals.

Table 3.4
Tenth Plan Borrowings

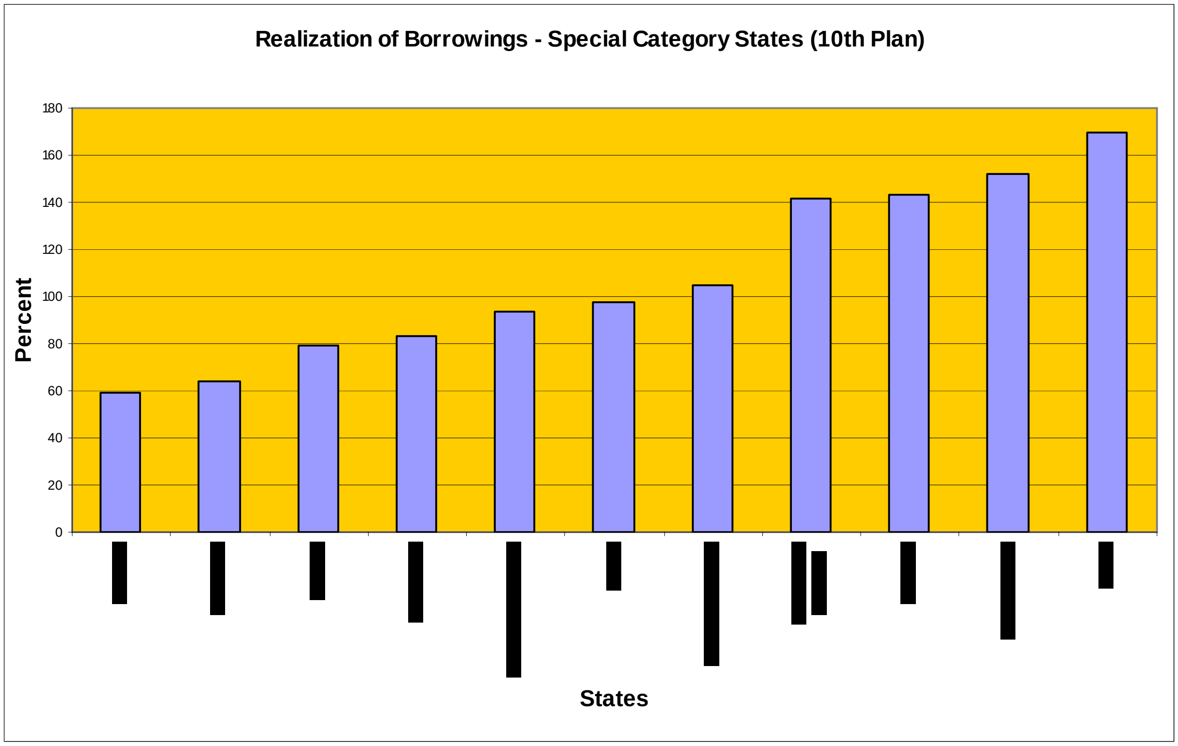
(at 2001-02 prices)

States	States borrowings		
	Projections	**Realisation**	**% Realization**
	(Rs. crore)		
Non Special Category States			
KERALA	11319.33	18965.51	167.55
GOA	1567.41	2351.71	150.04
JHARKHAND	7695.63	10621.88	138.02
GUJARAT	34091.75	45733.91	134.15
CHATTISGARH	5669.61	7255.30	127.97
ANDHRA PRADESH	26457.82	33341.38	126.02
WEST BENGAL	45594.12	56795.20	124.57
KARNATAKA	24829.09	30481.85	122.77
UTTAR PRADESH	36222.34	39552.18	109.19
TAMILNADU	31960.64	34061.07	106.57
BIHAR	12441.38	12890.08	103.61
MAHARASHTRA	68726.35	70951.37	103.24
MADHYA PRADESH	16022.30	16513.48	103.07
HARYANA	10374.66	9957.09	95.98
ORISSA	10627.67	9914.83	93.29
RAJASTHAN	29579.16	26348.15	89.08
PUNJAB	30564.14	24259.79	79.37
Total Non Special Category States	**403743.40**	**449994.77**	111.46
SIKKIM	311.70	527.65	169.28
UTTARANCHAL	4581.98	6949.70	151.67
MIZORAM	883.39	1262.49	142.91
ARUNACHAL PRADESH	596.32	845.63	141.81
JAMMU & KASHMIR	5842.93	6137.07	105.03
ASSAM	8104.48	7897.98	97.45
HIMACHAL PRADESH	12581.24	11741.11	93.32
MEGHALAYA	1386.79	1157.86	83.49
TRIPURA	2595.93	2056.95	79.24
NAGALAND	2285.19	1467.29	64.21
MANIPUR	746.39	442.19	59.24
Total-Special Category States	39916.34	40485.90	101.43
All States	**443659.74**	**490480.67**	110.55

Except in the case of six SCS (Assam, HP, Meghalaya, Tripura, Nagaland and Manipur) and four NSCS (Haryana, Orissa, Rajasthan and Punjab), all other States borrowed more than projected. The overall position is that the States have exceeded the originally projected level by more than 10%.

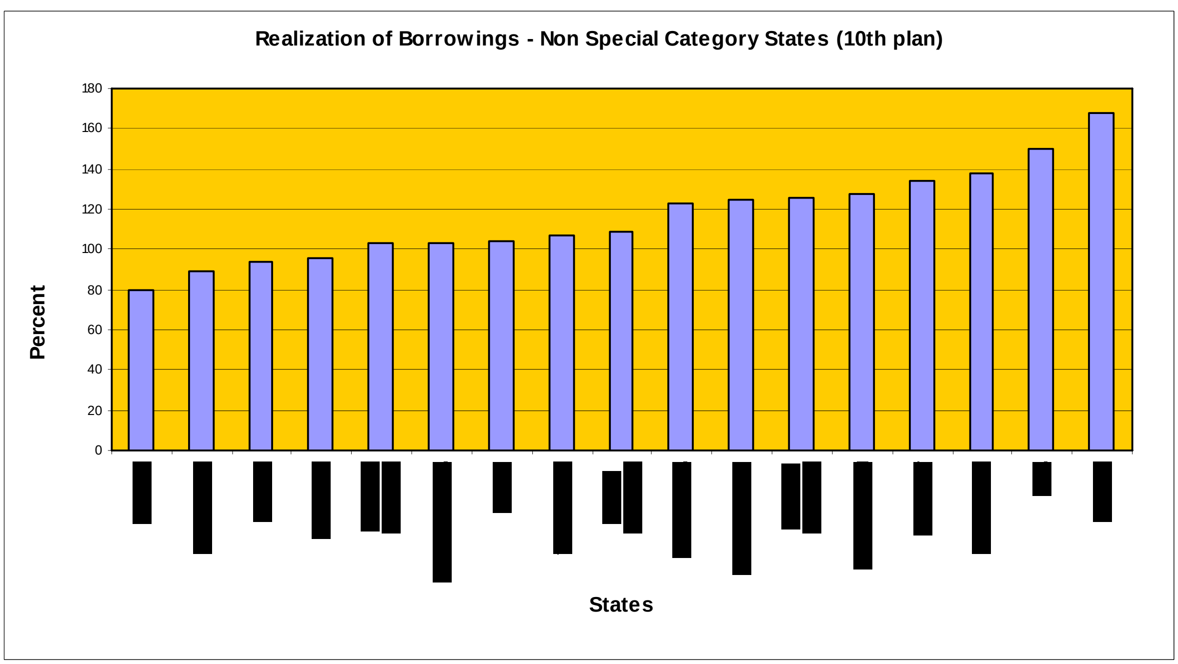
The position for SCS is illustrated in the following chart.

Figure 3.6



The position in the case of NSCS is shown in the following chart.

Figure 3.7



Excess borrowings by some States have been the result of the inability of those States to compress their non-plan expenditure. The impact of the Fifth Pay Commission award has had a heavy toll on the States' finances. A study carried out by Dr. M. Govinda Rao of NIPFP has shown that this alone has increased the States' revenue expenditure by 2% of their GSDP.

3.9 Central Assistance

The **Table 3.5 explains** the variation between the flows of Central Assistance as originally projected and actually realized during the Tenth Plan.

Table 3.5

Central Assistance - Projection & Realization during 10th Plan period

(Rs. crore)

	Central Assistance		
	Projections	Realisation	% Realization
ANDHRA PRADESH	22241.89	15615.91	70.21
BIHAR	11721.41	9914.61	84.59
CHATTISGARH	4103.57	3853.71	93.91
GOA	652.40	784.43	120.24
GUJARAT	13156.34	12055.04	91.63
HARYANA	3180.00	1944.08	61.13
JHARKHAND	4066.41	4963.00	122.05
KARNATAKA	17992.82	9610.26	53.41
KERALA	7736.15	6359.49	82.20
MADHYA PRADESH	10168.13	10475.56	103.02
MAHARASHTRA	9770.39	8751.02	89.57
ORISSA	14607.72	7484.56	51.24
PUNJAB	3979.00	2838.07	71.33
RAJASTHAN	9640.56	9329.27	96.77
TAMILNADU	15006.13	9048.16	60.30
UTTAR PRADESH	35410.12	18070.49	51.03
WEST BENGAL	14345.50	9798.71	68.31
Total (NSC)	**197778.54**	**140896.37**	**71.24**
ARUNACHAL PRADESH	*3396.25*	*3243.09*	*95.49*
ASSAM	*9527.61*	*10525.70*	*110.48*
HIMACHAL PRADESH	*5540.00*	*6225.36*	*112.37*
JAMMU & KASHMIR	*11820.55*	*13123.41*	*111.02*
MANIPUR	*3166.42*	*3565.51*	*112.60*
MEGHALAYA	*2323.15*	*2298.63*	*98.94*
MIZORAM	*2646.94*	*2590.89*	*97.88*
NAGALAND	*2594.47*	*2634.49*	*101.54*
SIKKIM	*1560.24*	*1635.06*	*104.80*
TRIPURA	*4008.45*	*3422.53*	*85.38*
UTTARANCHAL	*6626.50*	*6947.96*	*104.85*
Total (Spl. Category)	***53210.58***	***56212.63***	***105.64***
Total all States	**250989.12**	**197109.00**	**78.53**

The position regarding the inflow of Central Assistance is illustrated in the following chart.

Figure 3.8

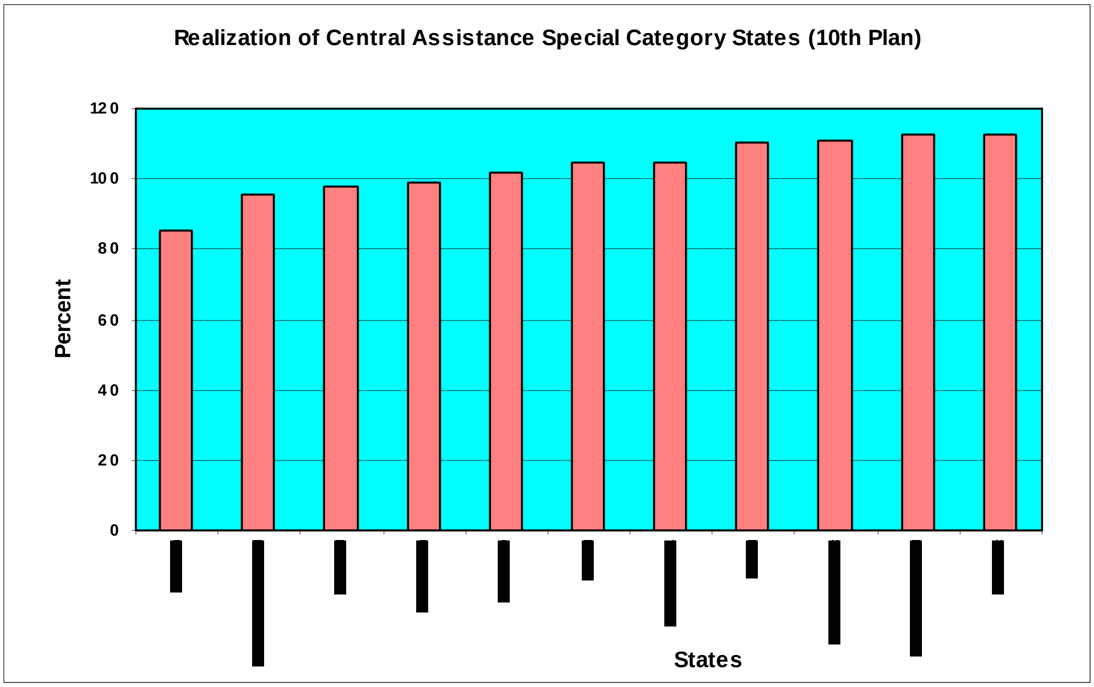
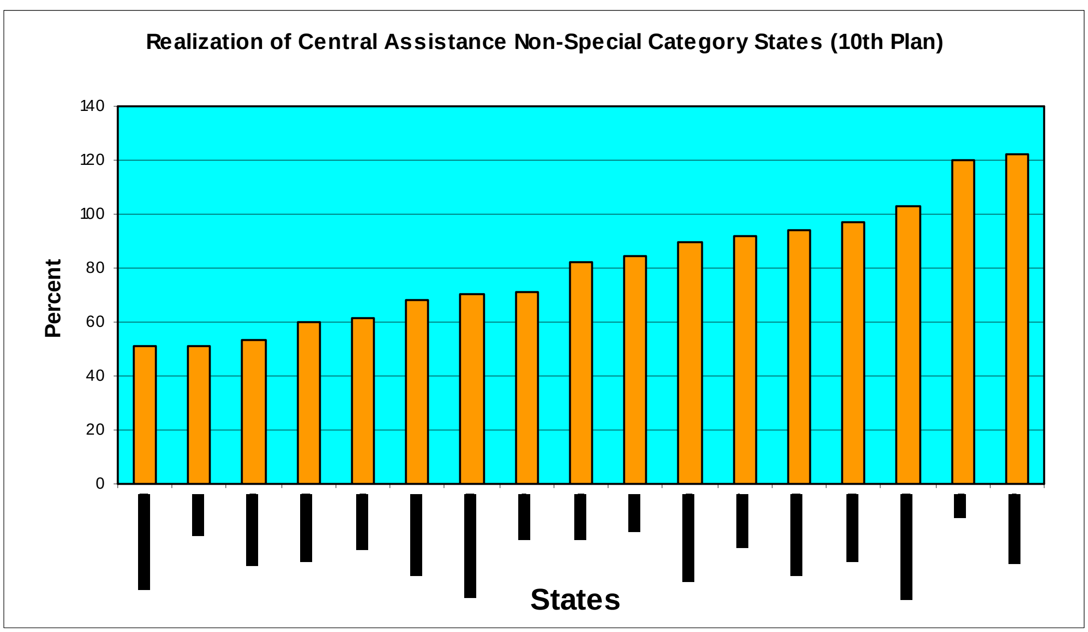


Figure 3.9



It is evident that the actual flow of Central Assistance to all the States during the Tenth Plan was only 79% of the projected levels. In the case of SCS, the level of realization was as low as 71%.

The Twelfth Finance Commission recommendation to exclude the loans being extended by the Centre to the States has resulted in a sizable reduction in the Central Assistance. Another important reason for the shortfall is the shortfall in the utilization of EAP funds and also in the Other Central Assistance approved in the case of Non Special Category States. For example, the level of drawal of EAP funds and Other Central Assistance in the case of UP stands at 28% and 58% respectively.

3.10 The utilization of Central assistance looks somewhat better in the case of Special Category States. Realization of other Central assistance is far better in the case of J&K, Whereas, the improved performance of Assam is due to utilization of EAP funds at a significantly high level.

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Chapter 4

States' Resources for The Eleventh Plan (2007-12)

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This Working Group, with the help of its three Sub-Groups has tried to analyse the past trends in tax and non-tax revenues and the trends in the various components of expenditure on the basis of the historical data. However, the Working Group has found it difficult to obtain accurate data on a comparable basis for the States. In view of this, the Working Group has had to make a number of assumptions in arriving at the projections for the Eleventh Plan. These are explained below.

A. Assumptions underlying the Working Group's Projections:

4.1 In working out its resource projections for the Eleventh Plan, the Working Group has had to necessarily make assumptions on the likely trends in the growth of GDP and the GSDPs of the individual States. Similarly, the Working Group has made assumptions on the expenditures of the States.These assumptions are spelt out below.

(i) GSDP FOR 2006-07:

CSO estimates of GSDP were available only till 2004-05 (covering the first three years of the Tenth Plan period). The Working Group has taken the originally envisaged growth target for the Tenth Plan period for each State and has estimated the GSDP for 2006-07 (the final year of the Tenth Plan and the base year for the Eleventh Five Year Plan) in such a manner as to yield an average growth rate for the Tenth Plan period that is consistent with the target fixed for each State for the 10^{th} Five Year Plan.

(ii) Eleventh Plan GSDP Projections:

The nominal GSDP for each State for the Eleventh Plan period has been calculated based on an overall GDP growth rate 9% and an inflation rate of 4%. The Statewise GSDP estimates have been arrived at based on the growth target for each State that has been provided by the Perspective Planning Division (PPD) of the Planning Commission.

(iii) States' Tax Revenues:

The Sub-Group on Tax Revenues has regressed the ratios of tax to GSDP against time in respect of all important taxes. The tax-to-GSDP ratios have been projected based on the trend equations, with the 2004-05 level as the base level. In the specific case of Profession Tax, the revenues are projected to grow at a constant rate of 3%. The average tax-to-GSDP ratios of the States during the forecast period as assessed by the Working Group on this basis are as follows:

Table 4.1: Tax – GSDP ratio of States

Sl. No.	States	*2006-07 (RE/LE)*	*Average Tax to GSDP ratio (2007-12)*
1	Andhra Pradesh	***8.4***	***9.0***
2	Arunachal Pradesh	***1.9***	***2.1***
3	Assam	***6.1***	***6.1***
4	Bihar	***6.2***	***6.7***
5	Chhattisgarh	***8.0***	***8.4***
6	Goa	***8.6***	***9.4***
7	Gujarat	***7.2***	***7.3***
8	Haryana	***8.9***	***9.0***
9	Himachal Pradesh	***5.9***	***5.9***
10	Jammu & Kashmir	***6.7***	***6.7***
11	Jharkhand	***5.7***	***6.0***
12	Karnataka	***11.0***	***11.5***
13	Kerala	***9.2***	***9.6***
14	Madhya Pradesh	***7.8***	***8.2***
15	Maharashtra	***7.7***	***7.8***
16	Manipur	***1.9***	***2.0***
17	Meghalaya	***4.0***	***4.4***
18	Mizoram	***1.4***	***1.5***
19	Nagaland	***1.6***	***1.6***
20	Orissa	***7.2***	***7.5***
21	Punjab	***7.9***	***8.2***
22	Rajasthan	***7.9***	***8.2***
23	Sikkim	***5.5***	***5.7***
24	Tamil Nadu	***10.1***	***10.2***
25	Tripura	***3.0***	***3.1***
26	Uttaranchal	***7.5***	***7.9***
27	Uttar Pradesh	***6.9***	***7.3***
28	West Bengal	***4.8***	***5.2***
	Total	***7.7***	***8.0***

The year-on-year tax-to-GSDP ratios computed have been applied to the projected GSDP (as explained under Sl. No. (ii) above) to work out the projected tax revenues for each State for each year.

On the above basis, the average tax-GSDP ratio for the Eleventh Plan period works out to 8 per cent. This would be lower than the average for the Tenth Plan. There is perhaps some scope to reach at least the Tenth Plan growth, if not higher, during the Eleventh Plan. An increase of 0.5 per cent in tax-GDP ratio over and above the projected 8 per cent during the Eleventh Plan will generate additional tax revenues of **Rs. 1,04,347 crore**.

(iv) Share of Central Tax Revenues:

The share of each State in the Central tax revenues, as per BE 2007-08 of the Centre, has been adopted as the base. In arriving at the growth of Central tax revenues during the Eleventh Plan, the growth rates indicated by the Working Group on the Centre's Resources have been applied.

(v) Non-Tax Revenues:

The States have provided their estimates for the year, 2007-08 to the Planning Commission during the Annual Plan Discussions. These estimates have been adopted as the base level figures.

Even though it was felt that the non-tax revenues could have a growth of 10 to 15% for different States, the estimates assume a growth of 10%.

(vi) Non-Plan Grants:

These have been taken at the absolute levels provided by the Finance Commission in its report for the period upto 2009-10. Even though it would not be possible to project the kind of transfers that are likely to be recommended by the Thirteenth Finance Commission, the estimates assume the same level of transfers as in 2009-10 for the next two years.

(vii) Plan Grants :

Under this head projections are made only for Normal Central Assistance (including 7.5% that is allocated for one time ACA). The amount actually provided for 2007-08 has been taken as the base figure and an average annual growth rate of 10% adopted for subsequent years.

(viii) Non-Plan Revenue Expenditure:

Salary Expenditure :-

a) The attrition rate in the case of the strength of the employees has been assumed to be zero.

b) In working out the projections, the BE estimates for 2006-07 have been adopted as the base level
c) Keeping in view the likely increases on account of annual increments and the periodic adjustments to the Dearness Allowances, the salary expenditure is assumed to grow at an annual rate of 7% during 2007-08 and 8 % during 2009-10 to 2011-12
d) The likely impact of the Sixth Pay Commission has been built into the projections. It is assumed that the impact of this will be felt in 2008-09 with an increase of 20% in the salary expenditure in that year over the previous year.

Pension Expenditure :

a) Pension Expenditure is assumed to grow by 15% in 2007-08 over 2006-07 (BE) to include the normal increase in pension liabilities, periodic adjustment to the dearness allowance and the residual impact of the Sixth Pay Commission's recommendations.

Interest Expenditure:

a) The Interest Expenditure has been estimated on the basis of an average annual rate of 10%on the total of the outstanding stock of the existing debt and the fresh debt added during the year.

Other NPRE :

a) The other non-plan revenue expenditure (excluding salaries, pensions and interest) is assumed to increase by 12% to 13% during 2007-08 to 2011-12. This includes the maintenance expenditure, the committed liabilities and the transfers to the local bodies.

(ix) Borrowings :

In working out the borrowing limit for each State, the level obtaining in 2006-07 (BE) has been adopted as the base. The GFD as percentage of GSDP has been estimated to reach 3% by 2008-09, assuming a uniform rate of decline in the case of States which currently have GFDs above 3%. For States which have already brought down the GFD to below 3% , the GFD has been assumed to remain steady at 3% of GSDP.

(x) Central Assistance:

The Central Assistance estimates for the Eleventh Plan assume 10% increase in the Normal Central Assistance (including 'Others' under the Central Assistance) every year for most of the States. However, some of the Special Category States have been provided higher central assistance during the five year period to ensure that the States' estimates are nearer to the 2007-08 (Annual Plan) resources finalized and also their Eleventh Plan resource estimates nearer to the States' projections for the five year plan.

This underlines the weak resource position of these States and the need to strengthen their resource base.

B. Projection of States' Resources for the Eleventh Five Year Plan

4.2 The Terms of Reference require this Working Group is to suggest the basis for estimating the resources and expenditure of the States during the Eleventh Plan period and propose the pattern of financing the Plan for all the States (including the UTs with legislature) individually and collectively.

4.3 The Group has had the benefit of examining the reports of the three Sub-Groups that were constituted for this purpose, namely,

1) Sub-Group on Tax Revenues of the States chaired by Dr. Kavita Rao of NIPFP; (Report at Annex A)
2) Sub-Group on resources other than tax revenues chaired by Dr.A.K. Singh; (Report at Annex B)
3) Sub-Group on non-plan revenue expenditure chaired by Shri Valluri Narayan. (Report at Annex C)

An Overview:

4.4 In general, the finances of the States have shown a significant turn around since 2002-03. A number of factors have contributed to such a turn around.

4.5 First and foremost is the overall improvement in the rate of growth of the economy. This has imparted greater buoyancy to the tax revenues of the Centre and the States. Introduction of VAT and restructuring of the State taxes in many States have further helped them in their effort to mobilize additional resources. Buoyancy in Central tax revenues has resulted in a significant increase in the transfer of resources by way of States' share in the Central tax revenues.

4.6 There are other equally important factors that have reinforced the States' efforts in mobilizing resources. For example, the interest rates on States' borrowings have declined. The Debt Swap scheme and the consolidation and restructuring of the States' debt have further provided the much needed relief to the States.

4.7 Thus, the overall improvement in the States' finances has been the combined outcome of matching efforts by the Centre and the States.

4.8 At the aggregate level, for all the States taken together, the budget estimates for 2006-07 as well as the revised estimates for 2005-06 show that the combined revenue deficit has been reduced to zero and the combined fiscal deficit brought down well below 3% of GSDP (that was originally envisaged to be realized by 2008-09). In aggregate terms, therefore, the States are well poised to begin the Eleventh Plan on a fiscally consolidated platform.

4.9 However, there are some States, even amongst the non-special category States, whose finances continue to cause concern. Chief among them are the States of West Bengal, Kerala and Jharkhand. There are also other States which are not subject to fiscal stress ***per-se***, but are clearly not in a position to step up their plan investment to the extent desirable.

Aggregate Estimates:

4.10 The aggregate resources for the Eleventh Five Year Plan period (2007-12), at current prices, have been estimated on the assumptions indicated above.

4.11 ***Non- Special category States***: States' Own Tax Revenues increase from Rs. 2,72,888 crore in 2007-08 to Rs.4,72,787 crore in 2011-12,, while Non-Tax Revenues increase from Rs.52,933 crore in 2007-08 to Rs. 77,499 crore in 2011-12. The aggregate Non-Plan Revenue Expenditure has been estimated to increase from Rs.4,22,224 crore in 2007-08 to Rs.6,83,995 crore in 2011-12. The BCR accordingly is estimated to increase from Rs. 49,837 crore in 2007-08 to Rs.1,41,645 crore in 2011-12.

4.12 ***Special Category States***: The Own Tax Revenues are estimated to increase from Rs.11,111 crore in 2007-08 to Rs.17,760 crore in 2011-12, while Non-Tax Revenues are estimated to increase from Rs.6344 crore in 2007-08 to Rs.9289 crore in 2011-12. The aggregate Non-Plan Revenue Expenditure is estimated to increase from Rs.44,277 crore in 2007-08 to Rs. 68,771 crore in 2011-12. The BCR is estimated to decline from Rs. (-)3308 crore in 2007-08 to Rs. (-)7557 crore in 2011-12.

4.13 The Aggregate Resources for the 28 States is estimated to increase from Rs.1,99,384 crore in 2007-08 to Rs.3,65,922 crore in 2011-12. The Aggregate Resources for the Eleventh Plan period for the States is estimated at Rs.13,25,552 crore.

4.14 The resources for the Union Territories with Legislature viz., Delhi and Puducherry have been estimated, taking into account the 2007-08 (Annual Plan) estimates as the base level. Accordingly, the total aggregate resources for States and UTs (with legislature) have been estimated at Rs.13,98,223 crore for 2007-12 (at current prices).

Table 4.2

	Resources projections for States and UTs for XI Plan (2007-12)				
	At current prices				
		(Rs. crore)			
		SCS	**NSCS**	**Total**	**Total States & UTs #**
	Aggregate Plan Resources:	**137913**	**1187639**	**1325552**	**1409160**
1	**BCR**	**-31216**	**423146**	**391930**	**441742**
	Of which:				
	(a) Own Tax Revenues	71196	1829885	1901082	1985801
	(b) Non-Tax Revenues	38733	323161	361894	373617
	(c) Share in Central Taxes	81946	936635	1018581	1022231
	(d) Non-Plan Grants	58090	75679	133770	136392
	(e) Non Plan Revenue Expenditure	281182	2742214	3023396	3075897
2	**Central Assistance**	**127741**	**74453**	**202194**	**220382**
3	**Plan Grants**	**1526**	**9131**	**10656**	**11584**
4	**Net Borrowings**	**39862**	**680909**	**720772**	**735453**

 # UTs includes both with & without legislature.

4.15 The Statewise break up of these aggregate resources are shown below in Table 4.3

Table 4.3

AGGREGATE RESOURCES

States	TENTH PLAN Projections (at 2001-02 prices)	TENTH PLAN Realization (at 2001-02 prices)	ELEVENTH PLAN (at current prices)
		(Rs. crore)	
ARUNACHAL PRADESH	3888	3133	8105
ASSAM	8315	8829	22489
HIMACHAL PRADESH	10300	7519	14575
JAMMU & KASHMIR	14500	11274	25357
MANIPUR	2804	2781	9689
MEGHALAYA	3009	2349	6669
MIZORAM	2300	2504	5568
NAGALAND	2228	2523	8369
SIKKIM	1656	1877	8462
TRIPURA	4500	3247	9452
UTTARANCHAL	7630	11159	19176
Special Category States	**61130**	**57195**	**137913**
ANDHRA PRADESH	46614	54672	128036
BIHAR	21000	18382	63293
CHATTISGARH	11000	19473	35694
GOA	3200	3477	14085
GUJARAT	40007	49228	107436
HARYANA	10285	12289	33150
JHARKHAND	14633	16905	38001
KARNATAKA	43558	50650	113406
KERALA	24000	16997	36126
MADHYA PRADESH	26190	29784	73187
MAHARASHTRA	66632	46276	126155
ORISSA	19000	13269	32863
PUNJAB	18657	12477	19584
RAJASTHAN	27318	25254	50901
TAMILNADU	40000	37981	81721
UTTAR PRADESH	59708	48961	170570
WEST BENGAL	28641	19948	63430
Non Special Category States	**500443**	**476022**	**1187639**
All States (28)	**561573**	**533217**	**1325552**
Delhi			66252
Puducherry			6419
Total UTs			72671
Total States & UTs	**561573**	**533217**	**1398223**

Comparison with the Tenth Five Year Plan

Comparison with the Tenth Five Year Plan

4.16 It would be helpful to compare these projections with the projections made originally for the Tenth Plan and the actual realized. The position is indicated below.

Table 4.4
(All States)

Sl. No.	**Source of Funding**	**Tenth Plan (Rs. Crore at 2001-02 Prices)**		**Eleventh Plan (Rs. Crore at 2006-07 Prices)**
		Projection	Realization	
1	BCR	-15295	-25514	385050
		(-2.6)	***(-4.5)***	***(28.4)***
2	Resources of SLPEs	82684	95715	128824
		(14.0)	***(16.8)***	***(9.5)***
i)	IR	-7760	9653	5692
		(-1.3)	***(1.7)***	***(0.4)***
ii)	EBR	90444	86061	123132
		(15.3)	***(15.1)***	***(9.1)***
3	Borrowings	264802	299022	649423
		(44.8)	***(52.5)***	***(47.8)***
4	States' Own Resources (Sum of Items 1 to 3)	332191	369222	1163296
		(56.2)	***(64.9)***	***(85.7)***
5	Central Assistance	258757	200011	194288
		(43.8)	***(35.1)***	***(14.3)***
6	**Aggregate Plan Resources (Item 4 + Item 5)**	**590948**	**569233**	**1357585**

(Figures in parentheses indicate the amounts as % of the corresponding Aggregate Plan Resources)

4.17 The aggregate Plan Resources for the Eleventh Plan would thus be 2.3 times the corresponding figure for the Tenth Plan. The main factor contributing to this increase is the overall improvement in the States' Own Resources, contributed mainly by the significant improvement expected in the BCR of the States.

Policy Issues to be addressed during the Eleventh Plan:

4.18 Many States have already adopted an FRBM regime similar to the one adopted by the Centre. This augurs well for the States' finance. In the coming years, the States would be required to raise their resources more and more from the market, through non-SLR windows. This would call for further overall improvement in the States' finances and the necessary supportive policy initiatives on the part of the Centre.

4.19 In a way, this opportunity needs to be availed by the Planning Commission to pave the way for greater fiscal autonomy of the States. There is need for greater transparency in the matter of transfer of resources from the Centre to the States and also in the matter of fixing the ceilings on States' borrowings.

4.20 During the last few years, the share of Central Plan Assistance to the States in proportion of the total Plan transfers has declined, as a result of proliferation of Centrally Sponsored Schemes. As a result, the bulk of the fund transfers to the States has become discretionary, rather than formula-based. In the interest of fiscal federalism, this trend needs to be reversed during the Eleventh Plan period.

4.21 The introduction of VAT in most States and the phased reductions in CST have started yielding the expected improvements in States' tax revenues. The major concern of the States is their inability to tax the services sector whose share in the economy is progressively increasing. The Kelkar Committee has suggested that both the Centre and the States should collectively move in the direction of a Generalised Goods & Services Tax. Concrete steps need to be taken during the Eleventh lan to translate this concept into reality at least by the beginning of the Twelfth Plan. It calls for an all round effort to modernize tax administration and removal of statutory impediments.

4.22 Finally, the distinction between Plan and non-Plan expenditures has become somewhat farcical. It is high time that the Planning Commission addresses this expenditure classification issue once for all and find a more meaningful way of identifying development expenditure.

4.23 These issues are discussed in some detail in the next chapter.

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Chapter 5

Issues in Financing the Eleventh Plan of the States

5.1 State Borrowings under the new FRBM regime:

5.1.1 The Tenth Plan Sub-Group on Revenue and Expenditure noted that the contribution of BCR towards plan financing had been coming down steadily since the 6^{th} Plan. It was also noted that the deterioration had been accelerating over successive plans. Upto the Seventh Plan, the BCR had been positive. However, from the Eighth Plan, the BCR became negative.

5.1.2 During the 9^{th} Plan, the projected BCR for all States was (-) Rs.15,389.86 crores or (-) 4.3% of aggregate resources. However, the actual realization was much worse, at (-) Rs.1,09,775.5 crores.

5.1.3 A negative BCR implies that borrowing is required first to meet the shortfall in current revenues for financing current non-plan expenditure. Thereafter borrowing is required to finance plan expenditures.

5.1.4 The Sub-Group identified the following very important issues relating to financing of plans through borrowing. It is worth reiterating these points in view of their basic significance –

(i) The existing system of financing plan expenditure, where borrowing has no relationship with the credit worthiness of the State and the end-use of funds, is largely responsible for the present fiscal stress that the States are subject . As the Sub-Group put it, the State Government guarantee has become a substitute for evaluating projects on the basis of their own viability. .

(ii) The quality of plan expenditure has deteriorated over the years. At present, the wages and salary component of plan expenditure is significantly high. For State Governments to come out of the present situation, it is necessary to establish an appropriate relationship between their fiscal health and their ability to borrow.

(iii) Among other measures, the total borrowing of a State needs to be limited by determining desirable limits of debt (relative to GSDP) and fiscal deficit. These limits should be determined by taking into account the growth rate, the interest rate, the existing debt to GSDP ratio and the need to limit interest payments relative to revenue receipts to a desirable level so that adequate current resources are available for financing essential, general, social and economic services.

(iv) These limits should be self-determined and self-imposed by the States under Article 293(1) of the Constitution and also separately determined and imposed by the Central Government under Article 293(3). Such limits should duly take into account to contingent liabilities.

(v) The Tenth Plan Sub-Group identified two pre-requisites for that plan: (1) Fiscal reforms that eliminate the negative BCR, if possible, and (2) whatever be the size of the Plan, making the investments sufficiently productive.

The Fiscal Deficit (FD) target for the Centre and the States has been fixed by the TFC on the following basis:

	(percent of GDP)
• Savings of Household Sector in financial assets	10
• Draft on this by the Private Sector	4
• FD Target for the Centre as per the FRBMA	3
• (Balance) FD Target for all States	3

5.1.6 The Debt-GDP ratio, the rate of growth of GDP and the interest rates are inter-related. However, assuming that growth and interest rates are exogenously determined (at 12 % and 7 % respectively), the TFC has calculated the steady-state Debt Ratio, both for the Centre and the States, at 28 % of GDP each, or 56 % of GDP taken together, to be attained over time.

5.1.7. The TFC, at one point, seems to envisage a situation where different States could have different FD targets, which are compatible with the all-States FD to GDP ratio. Appendix 4 of the TFC Report provides the formula for deriving the State-specific FD target, from the all-States target. The state-specific FD to GSDP and Debt Ratios should be lower than the average if (a) its interest rate is higher; (b) the revenue to GSDP ratio is lower; and (c) its growth rate is lower than the average. However, para 4.79 (vii), that lists out the 5 minimum requirements of the FRBM legislations of States, stipulates including a target of reducing FD to 3 % of GSDP (without any year being mentioned for this) or its equivalent defined as the ratio of interest payment to revenue receipts.

5.1.8. The TFC has recommended that the control of the borrowing programmes of States should be through an autonomous regulatory body like a Loan Council. This body, it says, has to be charged with ensuring that the borrowing programme of each state is consistent with the sustainability requirements of that State, as determined on the basis of the relevant State-specific parameters. The regulatory body has to also ensure that the borrowing programme of all States considered together remains consistent with the requirements of macroeconomic stability and fiscal deficit targets of all States.

5.1.9. GOI have not accepted the recommendation to set up a Loan Council.

5.1.10. The implementation of the TFC's recommendations relating to borrowing by the States in now to be carried out under the provisions of the States Debt Consolidation and Relief Facility (DCRF) (2005-06 to 2009-10) issued by the Finance Ministry. A Central Monitoring Committee has been set up under this scheme, chaired by the Secretary, Expenditure, and including representatives of the RBI, Planning Commission, NIPFP etc. The Chief Secretary and Finance Secretary of each State are also included in the deliberations relating to their State. The composition of this body and the method of its working seem heavily weighted in favour of the Finance Ministry. A more balanced composition is considered desirable.

5.1.11. Under the DCRF, States are required to work out their Fiscal Correction Path and give a letter of commitment to the Finance Ministry, showing outcome indicators and process milestones.

5.1.12 The borrowing caps for each year are worked out by the Finance Ministry. The Working Group feels that in the interest of greater transparency, the criteria adopted for fixing such caps are spelt out clearly and conveyed to the States.

5.1.13. The objective behind the TFC recommendation that the Centre should not any longer intermediate the raising of loans by the States was clearly to expose them to the discipline of the market. However, this intention was substantially defeated by the huge flows of funds under the NSSF that were compulsorily passed on to the States during 2005-06 and 2006-07. This is largely due to the high rates of interest permitted on small savings under the administered interest rate regime, particularly in an environment of falling interest rates for comparable investments. As a result, substantial amounts have been mobilized under the Small Saving Schemes. Under the present scheme, the States are required to absorb 100% of the collections.. The accruals on this account are so large that several States could not access the market at all during the last few years. Consequently the disciplining influence of the market that the TFC had envisaged is virtually absent. However, the situation has changed considerably since the latter part of the 2006-07. The net collections under various Small Saving Schemes in the calendar year 2006 was Rs.63,746.05 crores, compared to Rs.89,735.91 crores in 2005, a reduction of 29%. In the recent months, there has been a precipitous fall in the accruals, with the release of loans to States in May, 2007 (based on collections in Feb.,2007) amounting to only Rs.476.4 crores, compared to releases to the tune of Rs.6575.94 crores in May, 2006. Several States seem to have reported net negative collection in February 2007, since no amounts have been released to them. The States have also now been given the option, in terms of the report of the NDC Committee on the NSSF, to restrict their drawal to not more than 80% of the net collections of the States. Whatever may be the amount passed on to the States under the NSSF, it is imperative that the Centre should also exercise the same degree of due diligence and be subject to the same kind of market discipline that the States are subject to.. For this purpose, the NSSO should function as an autonomous lending agency.

5.1.14 The FD to GSDP target is not an ideal one in that the estimates of GSDP f are subject to data deficiencies and questions concerning the methodology of estimation.. Besides, this information comes with a considerable lag of over two years that hampers real time decision making.

5.1.15. Since the objective of specifying targets for FD/GSDP ratio is to promote fiscal prudence, it would be advisable to also consider the ratio of Interest Payments (IP) to Revenue Receipts (RR) that had been referred to in the Report of the TFC. No doubt, the computation of this ratio would involve assumptions being made about the growth rates, rate of interest, revenue receipts etc. The advantage of this ratio over FD/GSDP ratio would arise on account of the following three factors:

Since they are derived from the accounts, these numbers may not be open to questioning.

(ii) They are available in real-time, with many State Governments having gone in for computerization of their treasuries.

(iii) Being items that are completely controllable by the State governments, the ratio would incentivise appropriate behaviour (instead of, for instance, wasteful effort at doctoring GSDP numbers).

5.1.16 As per the indicators given by the TFC, the all States IP to RR Ratio is to go down from 24.9 % in 2004-05 to 15 % by 2009-10. It may be mentioned that the Finance Ministry had earlier classified States as debt stressed or not, based on a cut off IP/RR ratio of 20 %.

5.1.17. The TFC has also made the availability of benefits under the Debt Waiver Scheme contingent upon the actual levels of fiscal deficit as of 2004-05 not being exceeded during the Award period. Though the TFC report was not clear about whether this was to be taken as a reference to the absolute fiscal deficit in 2004-05 in rupee terms or to the FD to GSDP ratio for that year, the Central Debt Monitoring Committee has subsequently decided that the stipulation will be applied on the basis of the ratio of FD to GSDP only. Even this "liberal" interpretation would work to the detriment of States in peculiar circumstances, like Bihar, where the FD to GSDP in 2004-05 was substantially lower than 3% because of unique circumstances. Given the need to invest in infrastructure in such a State as Bihar, binding the State to the artificially low FD to GSDP ratio in 2004-05 would seriously stifle investment and growth. The TFC's recommendations relating to the annual fiscal deficit must be read as subserving the objective of sustainability of State level debt. This sustainability is sought to be defined as a steady debt to GSDP ratio which itself would be unique to each State depending upon the growth rate, the interest rates it faces and so on. The mechanism of the Loan Council recommended by the TFC is therefore absolutely essential to ensure that the sustainability of State level debt in the case of each State is examined closely by an independent body of experts on a continuing basis instead of being subject to the application of a pre-determined formula in a strait jacketed fashion without any review over a period of five years.

5.1.18 In conclusion, arising from the TFC recommendations, the Working Group feels that the idea of establishing a Loan Council should not be given up altogether. An independent Loan Council, with appropriate representation, could still be considered as such a Council would be in a position to review & monitor sustainability issues on a continuing basis and impart a greater degree of transparency to the process of fixing borrowing caps to the States.

5.1.19 During the last few years, a number of important steps have been taken to provide greater flexibility to the States in the matter of borrowings. In order to move in the direction of greater fiscal autonomy for the States, it would be desirable if the Ministry of Finance fixes global borrowing ceiling each year and permit the State to determine the pattern of raising loan.

5.1.20 In the coming years, the SLR limits for various financial institutions are likely to be lowered and the States may therefore be left with no other option but to raise borrowings from non-SLR sources. Non-SLR borrowings may involve higher rates of interest. This is a matter that needs to be examined carefully by the Ministry of Finance and appropriate steps taken to provide relief, e.g., tax-free non-SLR bonds, to the States. On their part this would also call for greater fiscal prudence to be able to raise borrowings at reasonable rate of interest.

5.4.. . . . . **Implications of Service Tax for the States:**

5.4.. . . . .

5.1.21 The contribution of the services sector to GDP/GSDP has been increasing. But he States are presently not in a position to realize revenue from it since the relevant Constitutional provisions do not permit the States to tax the services. There is a proposal before the Central Government to introduce the necessary amendments to the Constitution to permit the States to a share in the revenue from the services. While this needs to be expedited, in the interest of fiscal federalism, the Working Group recommends that the Planning Commission/ Ministry of Finance should seriously consider pursuing the States to move towards a General Goods & Services Tax (GST) of their own through appropriate Constitutional changes.. It should be possible to introduce such a GST towards the beginning of the 12th Plan.

5.2 . Central Plan Assistance to States

5.2.1 The Sub-Group on Resources other than Tax Revenues felt that the whole exercise of distribution of NCA lacks transparency as the States do not have any information with regard to their share as per the formula or the indicators and base year used for calculation of the share of each State in terms of performance, special problems etc. The Sub-Group therefore felt that the whole process of distribution of Central Plan assistance should be transparent and the formula applied in a non-discretionary manner. In this context, the practice followed by the Finance Commission's reports, where all relevant information with regard to State's share in Central taxes is included in the report itself, was commended for being followed.

The Working Group is fully in agreement with this recommendation of the Sub-Group.

5.2.2 The Sub-Group also felt that the Gadgil Mukherjee formula should be suitably amended to improve inter-State equity in transfers by giving a higher weight to per capita incomes. As an alternative, they suggested that the *inter se* shares recommended by the Finance Commission could be used for the purpose of deciding the share of the State in Central Plan assistance. On this subject, the Working Group is of the opinion that the size of Normal Central Assistance relative to that of the approved Annual Plans has become so low in recent years in the case of the non-special category States that nothing significant will be achieved by making any adjustments in the formula for sharing the amount amongst the States. There also does not appear to be any purpose that will be served by distributing the NCA on the basis of the same formula as that used for the share of Central taxes and yet retaining the NCA as a separate element of resource flows. If the same formula were to be adopted, the NCA might as well be merged with the share of Central Taxes.

5.2.3 The Working Group feels that if NCA is to retain any significance in the 11th Plan period, both as a source of plan finance as well as well as an instrument that is available to the Planning Commission for influencing the pattern of sectoral allocations of resources, the NCA would have to be very substantially stepped up. The current practice of incremental growth by a marginal amount each year (this has been a nominal 10% in recent years, which gives a real growth of 5% or so annually) will have to be replaced by a substantial step up. However, this does not appear to be feasible given the present practice of identifying a few important Centrally Sponsored Schemes as flagship programmes and providing for substantially enhanced allocations each year only, or even primarily, for these programmes. The Working Group therefore recommends that the NCA, if it is to have any significance and needs, therefore, to be retained, should be increased each year at the same rate as the average rate of increase in the allocations for all flagship programmes (whether ACA programmes or CSS). Anything less than this rate of increase would make the whole scheme of NCA substantially, if not wholly, irrelevant in plan financing. These points made above would, however, not apply to the special category. States, in whose case the NCA is a very significant component of Plan as well as Non-Plan financing (the latter, since upto 20% of the NCA can be used to meet the negative BCR). In the case of the SCS, however, the Gadgil-Mukherjee Formula is not applicable and the annual allocations are only on an incremental basis *i.e.,* the base year's share are continued.

5.2.4 This is an issue again where transparency is required, this time on the part of the Ministry of Finance. The scheme of NCA provides that States suffer a cut in the NCA entitlement depending upon the shortfalls in the actual Plan expenditure compared with the approved outlays and in the earmarked outlays compared with the actuals. There are also amounts withheld for non-submission of actual expenditure statements as well as audit certificates relating to Plan expenditure. In theory, these withheld amounts are to be released to the States after the conditions imposed are complied with. However, the practice has been that the Ministry of Finance does not inform the States in a uniform and transparent basis about the calculations based on which the actual releases of NCA are finally determined. It would be desirable for Ministry of Finance to do so at the end of each year on a standard proforma.

The Working Group notes the recommendations of the Sub-group that the Central assistance should be untied and should not be linked with the plan performance and size. The Sub-group has also said that the States should be left free to decide their size of Annual Plan on the basis of their assessment of the total resources available including Central Plan Assistance. The Working Group feels that the Sub-group's recommendation on this point lacks clarity. While Central assistance is not in any manner linked to Plan size and the States are, even now, left free to decide their size of Annual Plan on the basis of their assessment of total resources available including CPA, the final entitlement to NCA is related to Plan performance, both in totality as well as in terms of earmarked outlays. The Working Group feels that this linkage of the entitlement to NCA to actual Plan performance as against the approved Plan, the latter being completely within the domain of the States, is essentially as a means of inducing the minimum amount of discipline required in planning and in fiscal operations if the NCA is continued on the conditions stated above.

5.3. Plan / Non- Plan classification

The Sub-group on Expenditure felt that the present classification into Plan and non-Plan is somewhat inconsistent and it has led to needless distortions in the allocation of resources imposed by an effort to preserve the 'fiction' of a larger plan size and present successively larger Plans. The unanimous view of the Sub-group was that this distinction should be done away with and instead expenditures be classified only as development and non-development expenditures, which classification is also in use. The Working Group fully concurs with this view.

5.4 Classification of Capital Expenditure

The classification of expenditure as "capital" and "revenue" has also been somewhat inconsistent and has introduced many distortions in the interpretation of the end-use of expenditure. The Sub-group on Expenditure has indicated that the C&AG has examined this issue and made some specific recommendations on the subject. Under Article 150, "the accounts of the Union and of the States shall be kept in such form as the President may, on the advice of the Comptroller and Auditor-General of India prescribe"[1]In view of this, the Sub-group decided not to re-visit this issue. The Working Group agrees with this view.

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Sub Group Report

Tax Revenues Annex A
Resources other than Tax Revenues – Annex B
Expenditure Annex-C

[1] Article 150, Constitution of India