# Budget TRACK

Volume 2, Track 3, May 2005

A publication by:
Centre for Budget and Governance Accountability

for private circulation only


National Centre for Advocacy Studies
www.ncasindia.org

Budget TRACK
Volume 2, Track 3, May 2005

# Foreword

The present issue of Budget Track is coming out at a time when the government is making introspections of its own role in the overall context of its promises made in the NCMP. The Finance Minister has taken stock of the Indian Economy during last one year. The civil society has also assessed the role of government in one year of its existence. The recently announced recommendations of Twelfth Finance Commission are being talked about a great deal. The government has already implemented the VAT. The foreign exchange reserves in the country have already been accumulated six times beyond the required threshold. The time is good, politicians-positive and the policymakers-optimistic. But probably down the Parliament Street, the common people are restless-insecure and unsatisfied. The UPA government seems to be suffering from a serious amnesia as regards the provisions contained in the NCMP in favour of the poor and the marginalized, as almost nothing substantial has got translated in terms of concrete policies so far. While well-acknowledged and much admired promises are in place, matching financial commitments is not following these up. 'Resource Constraint' is again and again being recited as the major bottleneck. Tracking these issues in the overall arena of resource mobilisation, the present issue of Budget Track highlights the relevant issues in Union Budget 2005-06, implications of the recommendations of twelfth Finance Commission, the possibilities of garnering more resources through VAT and the issues concerning the burgeoning forex reserves of our country. An attempt has also been made to study the implications of the initiatives proposed by the government in pension sector reforms. A brief summary of the recently published report by the CAG on public expenditure incurred by the previous NDA government on India Shining campaign also highlights the mischievous ways in which our rulers have used the public money.

## IN THIS ISSUE

**Of Unfounded Optimism and Unreasonable Legislation**

**Value Added Tax: Issues and Challenges Ahead**

**Pension Reforms: Hyped Up Claims Vs. Grim Reality**

**Mounting Foreign Exchange Reserves: Crown or a Cross**

**Twelfth Finance Commission Recommendations (for 2005-06 to 2009-10)**

***Guest Column***
**Twelfth Finance Commission: Advancing Second Generation Reform**

**A Campaign that was Fundamentally Flawed**

# Of Unfounded Optimism and Unreasonable Legislation

- Subrat Das

In the Union Budget for 2005-06, the Finance Minister has proposed an increase in the Gross Budgetary Support for Plan outlay on rural development, health and education (priority areas outlined in the National Common Minimum Programme) by Rs. 25,000 Crore. However, the UPA Government, like its predecessor, has adhered to conservative fiscal thinking, which has been legalized in the form of the Fiscal Responsibility and Budget Management (FRBM) Act. Now, the FRBM Act (through the targets of revenue and fiscal deficits documented in it) has imposed a one-to-one relationship between revenue and expenditure of the Government. As a result, if the expectations of the Government on the revenue side are not realized, it will be forced to curtail its expenditure, and in that situation most vulnerable to cuts would be social sector expenditures. Therefore, it is important to highlight that all the allocations or expenditure proposals made in this Budget, especially those in the social sector, need to be assessed keeping in mind the fact that the FM expects a substantial increase in Gross Tax Revenue in the coming fiscal, and that the tax revenue estimates for 2005-06 have been seen by many as being too optimistic.

## BUDGET 2005-06: OVER-OPTIMISM IN TAX PROJECTIONS

In Budget 2005-06, the Finance Minister has projected an increase in the Gross Tax Revenue by roughly 20-21 percent (i.e. Rs. 54000 crore) over Revised Estimates (RE) of 2004-05. Gross Tax Revenue of the Central Government (including States' share) has been estimated to reach Rs. 3,70,024 crore as against Rs. 3,06,020 crore for 2004-05 RE. On many counts the tax revenue projections of the Finance Minister seem to be too optimistic. The additional tax revenue of Rs. 54,000 crore is to come mainly from two sources– an expected 34 percent increase in Corporation Tax Revenue and a 21 percent increase in revenue from Union Excise Duties. Now when we consider the gap in actual collections in 2004-05, it is these two taxes where the shortfall is most prominent. 2004-05 Revised Estimates show a shortfall of Rs. 5,000 crore in Corporation Tax Revenue and of Rs. 9,000 crore in Union Excise Duties (in comparison to Budget Estimates). Given that in 2004-05 the Corporate Sector has been reviving, such a significant shortfall should not have come about. Thus, it suggests that the tax revenue projections of Budget 2004-05 were optimistic and the Finance Minister was let down by the actual collections till February 2005.

Prof. Prabhat Patnaik is of the opinion that the expected increase in tax collections (at the existing tax rates) is a gross overestimate. He points out that even if we assume a 9 per cent growth of the real output (i.e., output at constant prices) of the non-agricultural sector during 2005-06 and a 6 per cent rate of inflation, the nominal growth rate of this sector would be 15 per cent. (Since agricultural incomes are mostly non-taxable) At existing tax rates the total tax revenue cannot be expected to increase at a rate much higher than the rate of growth of nominal output of the non-agricultural sector (i.e., 15 %). He also draws attention to the fact that the Finance Minister's claims of revenue neutrality of his indirect tax proposals and that of a small net gain (worth Rs. 6000 crore) from his direct tax proposals are quite untenable, and notable tax revenue losses are likely on both fronts; hence the shortfall in tax revenue in 2005-06 may be even larger than the Rs. 11,000 crore shortfall in RE 2004-05 over BE 2004-05.

It is not the case that only the progressive economists have raised doubts over the tax projections in the latest Budget.

CRISIL is of the view that tax revenue projections for 2005-06 are highly optimistic and they cannot be substantiated with the historical patterns of tax buoyancy in the country. In the last eight years, only twice, in the years 1996-97 and 2003-04, tax revenue projections of the Union Budget were either met with or exceeded in the actual collections. This was because of impressive growth in sales and profits of the corporate sector in those two years. However, the expectation of corporation tax revenue rising by 34 percent in 2005-06 is much too ambitious. As has been pointed out by CRISIL, historically, the Government's net tax revenues have been growing at an average rate of 10 percent per annum.

Of Unfounded Optimism and Unreasonable Legislation

Thus, there are enough reasons to be concerned about the tax revenue projections in Budget 2005-06. Even if we were to completely share the optimism of the Finance Minister, the projected Tax-GDP ratio by Union Government at 10.7 percent would still be one of the lowest in the world. Hence the substantial relief in income taxes given to the salaried class and especially those earning higher incomes was not necessary. Reduction in overall corporate income tax rates on domestic companies again disappoints those in favour of taxing the rich, in order to correct fiscal imbalance.

Besides the fears of tax revenue projections failing, another major concern over Budget 2005-06 has been its lack of transparency. If we compare the Budget Speech of the Finance Minister with the figures given in the Budget documents, we are bound to feel so. One finds several measures taken in the Budget for showing a lower level of fiscal deficit, which did not find any clear mention in the Budget Speech of the Finance Minister.

## BUDGET 2005-06: COMPROMISING TRANSPARENCY FOR THE SAKE OF FISCAL ORTHODOXY

Though fiscal imbalance has been an area of concern in India for long, there have been different positions taken by economists adhering to different schools of thought as to what needs to be done in order to address such imbalance. Amidst severe protests by a section of economists, who questioned the need for and consequences of deflationary fiscal policies in a country like India, the FRBM Act was passed in 2003 to give legal teeth to conservative fiscal thinking. The main motive of the new fiscal legislation is reduction of fiscal deficit (and revenue deficit), which can be achieved in two ways – by expanding revenues or reducing expenditure. Over the last decade, the pro-market philosophy of development pursued by successive Governments at the Centre has led to their failure in mobilising greater tax revenue. So, in order to comply with the constraints of the conservative fiscal policy, Governments have compressed expenditure, especially on socially desirable areas, such as, rural infrastructure, agriculture, health and education. Although, over the same period, Central Government expenditures on defence, interest payments and salaries (per employee) have increased.

The Finance Minister, in Union Budget 2005-06, has projected fiscal deficit of the Union Government for the year 2005-06 at 4.3 percent of the estimated GDP, which is down from 4.5 percent in 2004-05 (RE), while also proposing an increase in the Gross Budgetary Support for Plan outlay on rural development, health and education by Rs. 25, 000 crore. Many progressive economists were surprised at the ability of the Finance Minister to raise socially desirable spending while simultaneously giving tax concessions and yet be able to meet the demands of the FRBM Act. It soon became clear that the reductions in fiscal deficit, as mandated by the FRBM Act, was an outcome of some in-depth financial jugglery and some reductions (in the deficit) by shifting of a part of the Centre's burden on to State Governments. Until now, the Centre used to transfer resources to States for meeting the expenditures of their Annual Plans under an arrangement of- 10 percent loans and 90 percent grants to the Special Category States, and 70 percent loans and 30 percent grants to General Category States. The Twelfth Finance Commission has recommended that the Centre substantially raise its grants to States, but do away completely with the loan component.

The Finance Minister has accepted the proposals of the Twelfth Finance Commission and raised the grants-in-aid to States substantially, and completely stopped loans (meant for financing the Annual Plans of States), thus leaving an amount of Rs. 29,003 crore to be raised by States from the market. Thus, Centre's *Direct Assistance for State and Union Territory Plans from the Budget* has been reduced drastically from Rs. 54,858 crore in RE 2004-05 to Rs. 33,112 crore in BE 2005-06. Centre's *Plan Capital Expenditure* marks a decline from Rs. 47,714 crore in RE 2004-05 to Rs. 27,515 crore in BE 2005-06. This step has enabled the projection of a smaller figure for fiscal deficit of the Union Government in 2005-06.

However, for proper comparison of the fiscal deficit figure with those of the previous years, we should exclude the State/U.T. Plan loans intermediated by the Centre from its expenditure figures for each of the years and then calculate the fiscal deficit. And, the result of such an exercise, as presented in the Table below, clearly shows that fiscal deficit of the Centre as percentage of GDP will not fall in 2005-06 from the previous year's level, rather it is likely to rise by 0.6 % of estimated GDP. As long as the Centre finances this rising deficit by borrowing from domestic sources, and puts such money into socially desirable areas and productive activities, there seems to be no strong reason for worry except for those who seek a greater presence of international finance capital in Indian economy.

As has been pointed out by Prof. Prabhat Patnaik, the complete withdrawal of Central loans along with the removal of lower and upper bounds to the Statutory Liquidity ratio for commercial banks (which used to provide a captive market to the Government to borrow from) could spell disaster for poorer States. With the removal of SLR requirements the banks will not be bound to hold

Of Unfounded Optimism and Unreasonable Legislation

**Fiscal Deficit of the Centre as Percentage of GDP (1998-99 to 2005-06)**

| **Fiscal Deficit of the Central Govt. as % of GDP** | 1998-99 | 1999-2000 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|---|---|---|---|
| As per Union Budget 2005-06 (*Budget at a Glance*, Page No. 17) | 5.1 | 5.4 | 5.6 | 6.2 | 5.9 | 4.5 | 4.5 | 4.3 |
| Excluding State/U.T. Plan Loans Intermediated by the Centre in each of the years* (Which has been done in Budget 2005-06) | 4.3 | 4.6 | 4.8 | 5.3 | 5.0 | 3.6 | 3.7 | 4.3 |

Note: 1. *Taken from Errol D'Souza (2005), "Budget 2005-06: The Big Picture", *Economic and Political Weekly*, Vol XL, No. 10.
2. Fiscal Deficit of the Centre is the gap between its total expenditure, including loans net of repayments, and its sum total of revenue receipts and non-debt creating capital receipts. Thus, fiscal deficit indicates the total borrowing requirements of the Government in a year.

State Government securities, and hence only the States with better financial health will be able to borrow significant amounts from the market. This could lead to a crisis for the backward States, whose fiscal health is already quite weak.

Besides this, Budget 2005-06 also incorporates a couple of other steps of shifting the burden of expenditure from the Central Government to one of its agencies, whose financial accounts could be kept outside the purview of Budgets.

For instance, not mentioning the foodgrain component of the National Food for Work Programme and SGRY in the Budget papers hints at a possible shifting of the costs of foodgrain on to the FCI. Prof. Jayati Ghosh points out that the proposed creation of a Special Purpose Vehicle (SPV) to finance infrastructure projects in specified sectors is again an attempt to move certain items of expenditure "off-budget".

So much for the sake of showing a lower figure of fiscal deficit as a percentage of GDP! When most of the arguments put forward by advocates of conservative fiscal policy – that a high fiscal deficit will lead to very high inflation, increased Government borrowing will crowd-out private investors from the debt market or that of a rise in real interest rates affecting investments as a result of higher fiscal deficits – stand hotly debated between economists of different philosophies, the legal powers of fiscal orthodoxy appear to be too costly for the common people of the country. In this context, it is unfortunate to note that, though the Congress was initially opposed to the FRBM Bill, it later withdrew its opposition and even notified the FRBM Act soon after coming into power. Did the Congress have no foresight at all that promises laid down in the NCMP and the fiscal restrictions of the FRBM Act will clash, when it cannot think of generating greater tax revenues from the rich and industrialist class?

# Value Added Tax: Issues and Challenges Ahead

-Ramanand Ram

The state level value added tax has been implemented in twenty-one states except the BJP ruled states of Rajasthan, Madhya Pradesh, Chattisgarh, and Gujarat. Jharkhand has not come up with a law to implement VAT. The chief Ministers of Uttar Pradesh and Tamil Nadu have expressed strong reservations against the implementation of VAT. The implementation of VAT has received varying reactions from the academicians, state governments, traders and the people. The implementation of Value Added Tax has serious consequences for the state finances and guaranteeing autonomy to the states in matters of levying taxes.

The state level value added tax would now replace the existing sales tax. The process of introducing this new tax regime was started much before the UPA government came in power last year. This initiative was taken by Dr. Manmohan singh, the Union Finance Minister in 1994, regarding implementation of VAT in India. There have been successive meetings of the Chief Ministers or the Finance Ministers of the states in December 1995, in November 1999, in June 2000 to adopt VAT. After several meetings the Empowered Committee of State Finance Ministers, chaired by the Finance Minister of West Bengal, Dr. Asim Das Gupta, was set up in July 2000. The state level value added tax was supposed to be implemented from April 1, 2003 but it failed to start because few states were prepared with the legislative requirements as well as administrative infrastructure required for implementing VAT. Also, some states did not consider it politically favourable. Finally, in the meeting of the Empowered Committee on June 2004, it was decided that VAT would be implemented from April 1, 2005.

## WHAT IS A VALUE ADDED TAX?

It is a form of taxation where tax is levied on the value added at each stage of production to avoid the multiplying effect of taxes as the product passes through different stages of production. The value added tax is based on the difference between the value of the output and the value of the inputs used to produce it. The aim is to tax a firm only for the value added by it to the inputs it is using for manufacturing its output. In principle, although the tax is levied on the value added at each stage of production, it is intended to tax only the final consumer.

The essence of VAT lies in the provision of tax credit to the producers i.e., the VAT they pay on the inputs they buy from other firms is recouped when they sell their own output. The system of tax credit works as follows.

**Box 1: The method of tax credit under value added tax**

| Pre VAT Situation | Situation under VAT regime |
|---|---|
| Suppose firm A purchases good X worth Rs 100, paying a tax rate of 10 per cent, and sells it to the firm B at Rs. 110. Consider the value added by Firm B is Rs. 40. The value of the good X becomes Rs 150 (i.e. 110+40). The firm B sells it to the consumer at Rs.165 applying a tax rate of 10 per cent. | Suppose firm A purchases good X worth Rs. 100, paying a tax rate of 10 per cent, and sells it to the firm B. Consider the value added by firm B is Rs. 40. In this case, the value of the good becomes Rs. 140 (i.e., 100+40). The final consumers would pay Rs 154 for the good X. The difference is that firm B gets a tax credit of Rs 10 paid by firm A. |

The Empowered Committee has placed a White Paper on state level value added tax on January 17, 2005. The White paper on State Level Value Added Tax emphasises the following benefits (see left column of the box-2) through implementation of VAT. Our comments are incorporated on the right column of the box.

**Box-2 : Myth and Reality under VAT**

| Myth | Reality |
|---|---|
| 1. A set-off will be given for input tax as well as tax paid on previous purchases. | 1. There will be loss in revenue to the states due to abolition of central sales tax, surcharge and turnover tax (discussed below). |
| 2. Other taxes, such as turnover tax, surcharge, additional surcharge, etc. will be abolished. | 2. A few commodities such as milk products, tea and coffee, electric bulbs, toothpastes etc. fell under tax rate of 8 per cent in sales tax regime, but these commodities will fall under VAT rate of 12.5 per cent. This would lead to increase in prices of such commodities. |
| 3. Overall tax burden will be rationalised. | 3. Inspector Raj would increase due to increased paperwork and traders would face harassments by tax authorities. |
| 4. Prices will in general fall. | 4. Bihar has expressed concern regarding loss of revenue. The neighbouring states Jharkhand and UP is not implementing the floor rates on diesel and petrol, 20 per cent fixed by the empowered committee, causing diversion of revenue from Bihar to Jharkhand and Uttar Pradesh. |
| 5. There will be self-assessment by dealers. | |
| 6. Transparency will increase. | |
| 7. There will be higher revenue growth. | |

## COVERAGE OF GOODS AND RATES UNDER VAT

At present, the system of VAT is expected to cover 550 goods. The white paper states that there will be few goods such as liquor, lottery tickets, diesel, petrol, aviation turbine fuels and other motor spirit which will be outside the ambit of the VAT. Apart from these, life saving drugs and essential items like branded and unbranded salt, bread, gur and all food items distributed via Public Distribution System will be exempted from VAT. There are two basic VAT rates of 4 per cent and 12.5 per cent. The basic VAT rate of 4 per cent will be levied upon 270 goods which covers items of basic necessities such as drugs and medicines, agricultural and industrial inputs, capital goods and declared goods. The rest of the commodities will fall under the VAT rate of 12.5 per cent. This rate would be applied to profit, service tax, insurance, bank draft, freight, loading and unloading etc.

Apart from these two basic VAT rates, there will be a specific category of 46 tax-exempted goods comprising of natural and unprocessed products in the unorganised sector which are legally barred from taxation and have social implications. This exempted category of goods includes a maximum of 10 goods that can be exempted from the VAT by individual states due to local social importance, without having any inter-state implications. Also, there will be a special VAT rate of 1 per cent on gold and silver ornaments etc.

### States Concern Under VAT

Sales tax is the mainstay of the financial health of the states. Sales tax constitutes the most important source of revenue to the states. It follows from Table-1 that the revenue from sales tax is 70 per cent of total collection under indirect taxes over last five years. The revenue from sales tax to the states is 30 per cent of the total revenue over last five years. Looking at the

**Table-1**

**Revenue from Sales Tax (Rs. lakh)**

| Year | Sales Tax | Indirect Tax | Total Revenue (Tax & Non-Tax) | Col-2 as a proportion of Col -3 | Col-2 as a proportion of Col -4 |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| 2000-01 (Accounts) | 7,336,391 | 10,482,358 | 23,795,293 | 69.99 | 30.83 |
| 2001-02 (Accounts) | 7,688,518 | 11,205,439 | 25,567,517 | 68.61 | 30.07 |
| 2002-03 (Accounts) | 8,603,779 | 12,455,616 | 28,033,961 | 69.08 | 30.69 |
| 2003-04 (RE) | 9,837,785 | 14,261,289 | 32992,674 | 68.98 | 29.82 |
| 2004-05 (BE) | 11,206,662 | 16,108,285 | 37,229,864 | 69.57 | 30.10 |

*Source: "State Finances: A Study Of Budgets".*

importance of sales tax to states revenue receipts, a switch from sales tax to VAT may have the adverse implications on state finances.

- There are serious concerns regarding loss of revenue to the states due to implementation of VAT. This has been even recognised by the empowered committee. It has been clearly stated in the white paper on state level value added tax that some states may lose revenue through the introduction of VAT. This would lead to increase in financial dependence of the state government on the central government.
- Another major area of concern is that the shift from sales tax to value added tax is an encroachment upon the financial autonomy of the states in a federal structure in matter of fixing the tax rates on commodities. In our federal polity, states have been assigned the power to levy and collect sales tax and to fix its own tax rates on commodities suited to local conditions. Under the present tax structure, all states must have the same rate of value added tax for any particular commodity.
- The moot area of concern is that the central government would compensate only for three years, 100 per cent in the first year, 75 per cent in second year and 50 per cent in the third year. It is not clear why the compensation to the states is only for three years if the government is convinced about growth in revenue to the states through implementation of VAT.

## SOURCES OF LOSS OF REVENUE TO THE STATES

The agreed formula for compensation to the states is calculated backwardly. Each state will estimate revenue collection of three best years among five years taking 2004-05 as the base year. The loss will be the difference between the revenue of states if VAT had not been introduced and its revenue collection after the introduction of VAT. It would be too early to say the expected revenue to the states through the implementation of VAT. However, we have made here an attempt to locate factors that would lead to a loss in revenue to the states.

- It has been argued by Prof. Prabhat Patnaik, economist at the Jawaharlal Nehru University, that in order to generate the same revenue to the states, VAT rate should be higher because it is applicable on the value of output that is higher than the value addition at each stages of production. It has been estimated by Amaresh Bagchi, former Director of National Institute for Public Finance and Policy, that a revenue neutral VAT rate (the rate at which states revenue would be the same in post-VAT situation as it was in the sales tax regime) should be at least 14 per cent rather than the basic rate of 4 per cent and 12.5 per cent.
- There will be loss of revenue from various exemptions such as exemption for first-point goods, exemption for last point goods and exemption for exports.
- There will be loss of revenue as Central Sales Tax would be done away with the new tax regime. There will be further loss of revenue accruing due to abolition of turnover tax and surcharge on sales tax. The following Table-2 shows the estimates of loss of revenue to the states due to abolition of these taxes.

The total revenue of all states from central sales tax, surcharge and turnover tax increased from Rs. 10275 crores in 2000-01 to Rs. 13714 crores in 2004-05 (See Table-2). These taxes would be abolished due to switch over from sales tax to VAT and thereby expected shortfall in the revenue receipts of the states. It is to be noticed that the Ministry of Finance, under Demand No. 42, has allocated just Rs. 5000 crores for compensation to the states if there is loss in revenue to the states under VAT. Therefore, it follows that the compensation amount of Rs. 5000 crores falls short of the revenue receipts of all states on account of these taxes. Thus, the government would compensate even less than half the amount collected from Central Sales Tax, Surcharge and Turnover Tax.

**Table-2**

**Projected Estimates of loss**

*(Rs. crores)*

| Tax Items | 2004-05 BE | 2003-04 RE | 2002-03 Accounts | 2001-02 Accounts | 2000-01 Accounts |
|---|---|---|---|---|---|
| Central sales tax | 13655.57 | 12537.79 | 10721.08 | 10985.68 | 10221.29 |
| Surcharge on sales tax | 23.10 | 17.05 | 26.64 | 44.72 | 48.66 |
| Turnover tax | 36.21 | 6.14 | 5.71 | 10.72 | 4.73 |
| Total | 13714.88 | 12560.98 | 10753.43 | 11040.67 | 10274.68 |

## TRADERS CONCERN IN INDIA

There are many issues that are of central importance to the traders that directly affect them through the implementation of VAT. Small traders have protested strongly all over the country against the implementation of VAT as their concerns have not been incorporated.

- Transporters are demanding that diesel should also be brought into the uniform rate of 4 per cent across the country. Even though the diesel is used as an input for their operations, credit against purchase of diesel could not be used as a set-off against service tax paid by them.
- All India Motor Transport Association is arguing that the transporters would still continue to pay octroi, toll tax and cross-state entry charges. This goes against the objective of phasing out of all indirect taxes before introducing VAT as promised by the government.
- There is no provision for abolishing multiple checkpoints while traders are transporting goods. With these multiple checkpoints there would be increase in the paper work and more delays if paper work were not in proper order. They are concerned with removal of all checkpoints while transporting goods.
- Transporters are liable to pay heavy penalties if there is any drawback in sales or purchase paper.

It is up to the academicians, state governments and civil society to watch the possible consequences of VAT on common man. The civil society and the state governments should pressurise the central government to reconsider compensation principle to the states. The central government must assure compensation by the full magnitude of the loss in revenue to the states.

**Box-3: Limitations of VAT**

As matters of tax policy, this new tax system i.e., VAT has some serious limitations.

- It is not a progressive tax and scores low on the equity criterion. A comprehensive single rate VAT is a proportional tax on consumption and, therefore, VAT is not a progressive tax.
- Value Added Tax is very complicated to be administratively workable in a developing country like India. It requires maintaining a lot of records.
- Implementation of VAT is an encroachment upon the powers of the states in a federal country where there is a division of tax powers between the federal and the state governments.

# Pension Reforms: Hyped Up Claims Vs. Grim Reality

-Vineet Kohli

Pensions are a way of securing minimum standard of living for people in their old age, when they are not working and thus do not have any current income. There can be two ways of doing this. First, government can use tax contributions of working people to pay pensions. If these tax contributions are insufficient then government can increase its borrowings to meet its pension liabilities. The system of paying pensions from the tax revenue of the government is known as Pay As You Go (PAYG). A desirable feature of government sponsored pension programmes is guarantee of minimum benefit. For example, in India all government employees were paid pensions that were equal to one-half of the average salary earned in the last 12 months of service. This feature of government sponsored pension programme is known as Defined Benefit. Pension reforms that came into effect in India from 1st Jan 2004 have replaced a PAYG, defined benefit programme with a Fully Funded (FF), defined contribution programme. Under the fully funded programme, workers do not contribute to the pensions of their elderly, rather they save through their working years and use these accumulated savings to consume in old age. These savings are kept with pension fund managers, who in turn invest them in capital markets. In the new system post retirement incomes of workers will depend on the amount they manage to save and the rate of return on these savings. Thus, unlike in the government sponsored defined benefit system, there is no guarantee of minimum post retirement income in the new scheme. In the following, we shall discuss the rationale for such reforms, present their critique, and also draw from the international experience to substantiate my arguments.

## RATIONALE FOR PENSION REFORMS

The standard argument against government run pension system is that demographic changes, involving ever-increasing proportion of retired people in total population due to increased life expectancy and falling birth rates, will impose heavy fiscal burdens on the government, if it continues with its pensions' system. While India is, as yet, not going through any such demographic transition, sooner or later it will have to face the challenge of ageing population. In India, only 8.9% of the population is expected to be above the age of 60 years in 2016. This fraction is expected to increase to 13.3% in 2026. Since the proportion of retired in population is increasing, the government will either need to impose higher tax burdens on the working population or it will need to increase its deficit. Passing the responsibility of providing pensions into private hands can avert this looming fiscal crisis. In addition to this, it is claimed that pension reforms will benefit workers through higher returns on stock market investments made by pension fund managers. Thus, it is argued that pension fund reforms are a win-win game: they reduce fiscal burden of the government and benefit the workers through directing their savings into stock markets.

## HYPED UP CLAIMS

The above arguments in favour of pension reforms crumble when put to test of standard economic logic. It is not at all clear why a shift to fully funded pension scheme should be able to avert the problems created by demographic transition. The fallacy of arguments supporting pension reforms on the grounds of increasing share of pensioners in total population becomes apparent when we start viewing pensions as a transfer of goods and services from working population to pensioners. During demographic transition same number of workers will have to provide consumption goods for a larger number of pensioners i.e., the size of transfer from workers to pensioners will somehow have to be increased. If total output in the economy remains constant, then this larger transfer can be ensured only through an equal reduction in the consumption of working population. Thus, irrespective of how the pensions are financed, demographic transition will require a larger transfer of real goods and services to be made from workers to pensioners, and so long as output per head of working population does not increase to make up for the increased proportion of pensioners in population, this transfer can only be made at the cost of consumption per head of working population. It follows then that just as the government can meet the challenge of demographic transition only through higher tax contributions of the workers, a pension fund manager can meet this challenge only by raising the savings contribution of workers. (Tax is a part of total output that is seized from workers by the government; saving is a part of total output that workers willingly do not consume. However both are identical in the sense that both release current output for consumption by retired. In the discussion I have assumed away production of investment goods. Introducing production of investment goods in the above discussion would require the workers producing consumption goods to release surplus for pensioners as well as workers producing investment goods.)

One can understand the logic of previous paragraph through a simple analogy of a family comprising of the young and the old. The young make a cake and share it with the old. To fix ideas, further assume that there are four members in a family, two young and two old. Also assume that everyone gets to eat the same amount, so cake is divided into four equal slices. Now assume that one more old person enters the family but the size of the cake remains the same. If every old person gets to eat the same amount as he/she was eating before, i.e. one-fourth of a cake, then three-fourth of the total cake should now go to the old. This can however happen only if the young cut smaller slices for themselves. This basic fact should hold irrespective of how the cake is transferred from the young to the old. Thus just as the government can maintain the cake consumption of the old in the face of changing age composition of the family by raising the tax contribution of the young from one-half of the cake to three-fourth of a cake, pension fund manager can do so by asking the young to raise their savings contribution to money equivalent of three-fourth of a cake. Workers do not keep cake with a pension fund manager because cake is a perishable commodity. Rather they sell three-fourth of a cake to the old and get paper claims to cake (money) in return. The young keep these paper claims with a pension fund manager and withdraw them in their old age to purchase cake. The only way to overcome this problem without reducing the cake consumption of either the young or the old is to increase the size of the cake itself. Since the number of the young has remained the same, this increase in the size of the cake can happen only if cake output per head of young person is increased.

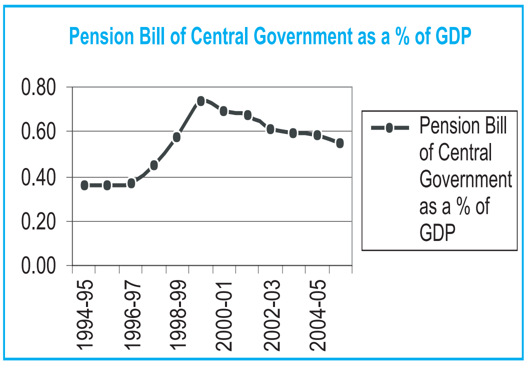
The arguments developed in the last two paragraphs also suggest that the claim of higher returns on workers' savings by pension fund managers is untenable. Higher returns on savings have the same effect as the increase in the number of pensioners. Both increase the pension liabilities of the pension fund manager and thus both require a larger transfer of goods and services to be made from workers to pensioners. The government through higher tax contributions can equally well attain this larger transfer from the workers. One does not need a private pension fund manager to guarantee a larger transfer of goods and services from workers to pensioners. Thus the current obsession with pension fund reforms is completely misplaced. Countries that are privatising their pension schemes in the hope that this will help them ward off the problems caused by demographic changes or help them earn higher returns on workers' savings are only deluding themselves and are avoiding the more difficult but more relevant question of increasing labour productivity in their economies.

## GRIM REALITY

While the proposed benefits of pension reforms stand on shaky ground, there are definite costs involved in such reforms.

### 1. Fiscal Burden of the Shift to a Fully Funded Scheme

Firstly, instead of reducing the fiscal burden of the government, the reforms might actually increase this burden in the transition period when government has to contribute to the individual accounts of new entrants even as its liabilities from the earlier system remain intact. According to the Report of High Level Expert Group on New Pension System, government expenditure on pension will go up for the next 38 years before the new scheme starts showing reduced government expenditure. More importantly government is going to assume this extra fiscal cost in a period when pension expenditure as a proportion of GDP is falling. It is, without doubt a bad idea to assume these extra (and indeed




***Source:*** 1. Pension expenditure taken from Annual Financial Statement for various years. 2. GDP at mp figures till 2003 taken from Economic Survey. 3. GDP for 2004-05 calculated using 6% rate of inflation and 6.9% rate of growth of real GDP; GDP for 2005-06 calculated using a 5% rate of inflation and a 7% rate of growth of real GDP.

impotent with respect to the stated objective of solving the problems created by ageing) budgetary commitments when one considers that commitments, mentioned in CMP, of higher spending on rural development, social sectors, employment guarantee etc. remain largely unfulfilled.

## 2. Lessons from Argentina

It will be useful to discuss Argentinean experience with pension reforms in this context. Argentinean crisis was in part an outcome of its decision to switch from a PAYG system to FF system of social security. In Argentina the magnitude of tax loss due to diversion of social security tax to individual account was greater than its central government budget deficit in 2001. In other words, if Argentina had not privatised its Social Security system in 1994, and done everything else exactly the same, it would have run a budget surplus in 2001. Given their negative opinion on government running a deficit, financial markets reacted adversely to this increase in Argentina's budget deficit in the transition period (in spite of the long term reduction in government's pension liabilities). What ensued is a well-known story: a full blown financial crisis and a collapse of the entire Argentinean economy. **Ironically, to appease financial markets the Argentinean government paid off the increased liabilities caused by transition from PAYG to FF system by seizing private accounts**. The Argentinean experience clearly shows that the move to create private accounts may prove to be self-defeating due to high fiscal costs of switching from PAYG to FF system.

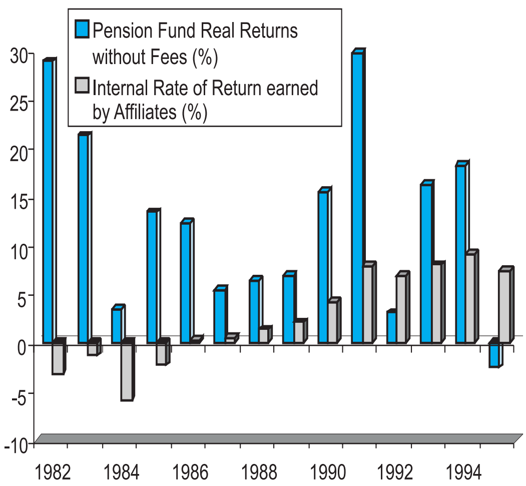
## 3. High Returns Or Increased Risks?

Secondly, private pension fund managers hold a very high proportion of their portfolio in equity, thus exposing the pension benefits of employees to irrational swings in share prices. An irrational decline in share prices can erode the lifetime savings of workers and leave them high and dry after retirement. Gary Burtless highlighted risks embodied in stock market investments in a study, using U.S. data, in which he tried to calculate replacement rates (percentage of previous wages that would be attained by converting accumulated savings into annuity after retirement) for workers who consistently saved two percent of their incomes for 40 years in a stock index fund and converted these savings into annuity at retirement. He found that workers reaching retirement age in 1968 would have enjoyed a replacement rate of 39%. Those who retired in 1974 would have received a replacement rate of just 17%! These figures may be for a different country but they demonstrate our objection to pension reforms quite well: pension reforms will make old age security of government employees dependent on the state of stock markets leaving them with considerable uncertainty regarding their post retirement incomes and standards of living.

## 4. Fund Managers Can Fleece Workers

Finally the biggest problem that workers face in a regime of individual pension fund accounts is the high fees charged by pension fund managers. In addition to the regular fees charged for maintaining accounts, fund-managers also charge trading fees. It is well-known fact that fund-managers trade too much to generate soft commission and trading fee. These high fees charged by pension fund managers significantly reduce the value of workers savings by the time of retirement. That these high fees can significantly reduce the value of workers accumulated savings is highlighted by the Chilean experience. In Chile, high fees charged by fund managers have caused a huge divergence between the real returns earned by the pension fund managers and internal rate of return earned by workers after taking into account the commissions charged by fund manager. For the period 1982 to 1995, average real return on pension fund investments was 12.7%, the rate of return earned by an affiliate was just 7.4%. The difference in these two rates of return is due to the expenses and profits of private fund managers. If we just look at the first four years from 1982 to 1985, the rates of return earned by affiliates was negative even as investments made by private pension funds earned high positive returns. This was a neat transfer of workers' income to private fund managers. Chilean experience suggests that there is a need to be wary of the activities of these private fund managers. Instead of solving the problems of old age security of government employees, they may add to them through exorbitant pricing of their services.

**Chilean Pension Fund Returns Net of Commissions**




*Source:* Hemant Shah, "Towards Better Regulation of Private Pension Funds", World Bank.

Pension Reforms: Hyped Up Claims Vs. Grim Reality

## CONCLUSION

- Pension fund reforms cannot be defended on the grounds of ageing of population. Ageing creates fundamental problems of distribution of output between workers and pensioners, which can only be solved through an offsetting increase in output per head of working population.
- Switch from PAYG to FF system will create additional fiscal strains in the transition period. These strains may not only negatively impact the fulfilment of promises made in CMP but may also generate an adverse reaction from financial markets.
- It is an unwise idea to direct post retirement savings of workers into stock markets because stock market investments are risky. The impact of these risks will be felt when workers are old and have very little option of fending for themselves through an alternative source of employment. Safer investments, in which benefits are more certain, are more suitable from the point of view post retirement planning and security.
- High fee and commission charged by private fund managers can significantly eat into the returns on workers' savings.

# Mounting Foreign Exchange Reserves: Crown or a Cross

-Siba Sankar Mohanty, Deepak L. Xavier

Mounting foreign exchange reserves is being cited for portraying India as an economic superpower. While the people in the government have been using it as an indicator of India's strength, many economists argue that accumulation of forex in such large scale is actually useless and to some extent an indication of a forthcoming crisis keeping in mind the composition of such a reserve and the role of finance capital involved in the process in the form of hot money inflow. In this issue of Budget Track, we have tried to assess the fundamental flaws in the mainstream argument in favour of maintaining huge reserve. An attempt is also made to link it with the broader issue of resource mobilisation for the creation of social overhead capital in the economy.

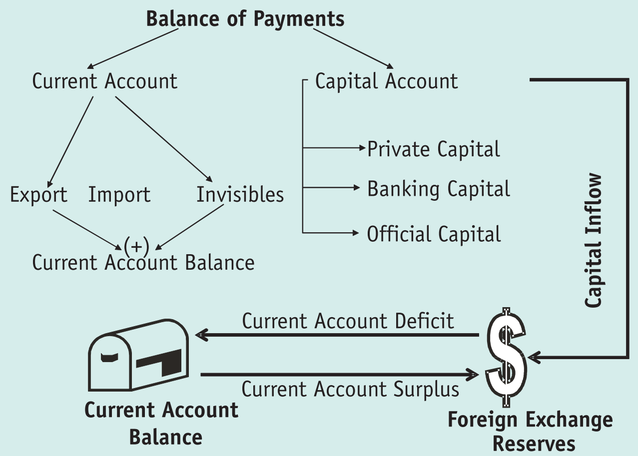
In India, foreign exchange reserve has been an instrument of national economic policy since 1939. The main objective behind this has been to conserve and make the most effective use of the available forex resources for the fulfilment of the country's planned development programmes. Countries need forex not only to pay for the imports they incur but also for the sake of absorbing external shocks. It creates an image in the international arena that the economy is well placed to meet all external obligations.

Holding foreign currencies is necessary to meet the deficits that may arise in the country's balance of payments (Box-1). But the question is how much foreign currency a country like India should hold to meet the balance of payments (BOP) deficits. Since, India needs to either borrow (that involves an interest rate) or to divert productive resources (which has an opportunity cost) for an unforeseen and unnecessary purpose for acquisition of forex, it is not advisable to go on accumulating forex for the sake of holding reserves only. It is like someone borrowing money with interest or reducing consumption to have a surplus and hoards that borrowed money or surplus in a trunk or almirah for self-assurance during crisis period. Therefore, the government and the

**Box-1**

**Structure of Balance of Payments (BOP) in India**

All the economic transactions (including export-import of goods and services and the flow of money from-to abroad), carried out in a year are recorded in a double entry book keeping system – where the 'debit' and 'credit' accounts ultimately get balanced (debit +credit=0). This record, which shows the economic strength of our country's' relation with rest of the world, is called the Balance of Payments. A general structure of the Balance of Payments is as follows. (See Table-1 for India's BOP position in 2004)



monetary authorities need to have a control over these forex reserves especially the inflow of foreign currencies into the economy, which does not have a use in the production process in the country.

**Table-1**

**India's Balance of Payments Position: April-December 2004**

| Sl | | April-December 2004 |
|---|---|---|
| A | Exports | 57485 |
| B | Imports | 85841 |
| C | (I) Trade Balance = Imports -Exports | -28356 |
| D | (II) Invisible, Net | 21005 |
| E | Current Account = I+II | -7351 |
| F | Capital Account | 20835 |
| G | Change in Reserves | -13484 |

*Source:* Reserve Bank of India

## FOREX RESERVE POSITION IN INDIA

### PRE INDEPENDENCE PERIOD:

Exchange control mechanisms were introduced in India, in September 1939, as means of increasing India's contribution to the war efforts led by the Allied forces. At that time, India was running two kinds of reserves-one in the form of Sterling balances and the other in the form of Dollar balances. Large demands for Indian resources, by the Allied Governments, enabled India to establish huge surplus in its external transactions. During the War period, the exchange control was confined to transactions with non-sterling regions and their currencies especially US dollars which needed to be conserved for purchasing essential raw materials. By the end of war, India had a substantial sterling balance equivalent to around Rs. 1, 733 crore.

In the post war period, large demand for imported goods and services created a BOP deficit whose financing had necessarily to come from existing sterling balances. The situation came to an end by 1950 with the withdrawal of Sterling Balances.

### POST INDEPENDENCE PERIOD UPTO 1991:

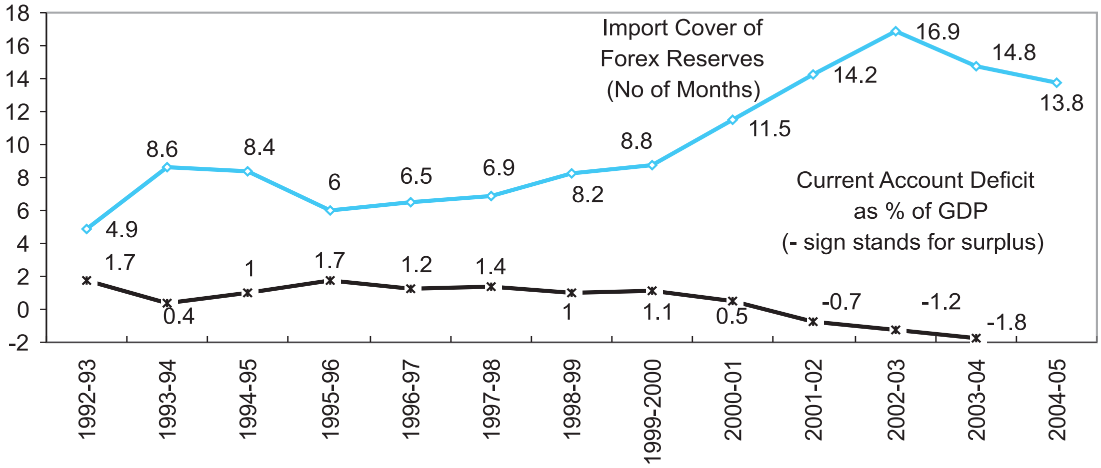
The meaning and purpose of maintaining exchange reserves had undergone some structural changes with the Five Year Plans. It was since then, till the beginning of 1990s, India's developmental efforts that needed large imports of technology, which necessitated the use of exchange control as an instrument for the fulfilment of the plan programmes. Throughout the period till 1991, except the years 1976-80, the current account deficits were more than 1% of GDP and in most of the years it was less than sufficient to meet three months imports. Many economists put some rough indications of a problematic BOP situation as (a) the current account deficit is more than 1 percent of GDP and (b) the forex reserves are less than what is needed to sustain approximately the cost of three months' imports.

### ERA OF LIBERALISATION

The year 1991-92 was an entirely different year characterised by high political volatility in the country and a forex crisis. This was the year when in order to procure necessary forex the caretaker government headed by Mr. Chandrasekhar had to mortgage country's gold reserves. Perhaps this incidence created a feeling that accumulation of forex is of prime importance for the country. In the year 1992-93, the accumulated reserves were sufficient to meet the import cover of around five months. By the year 2001-02, the current account started showing surplus meaning an additional inflow of forex to an already burgeoning reserve. By the end of 2003, India had an exchange reserve to cover around 17 months of imports (Chart-2). As on 1st April 2005, India has

**Chart-2**

**Current Account Deficit and Import Cover in the Era of Liberalisation**




*Source:* Economic Survey 2004-05

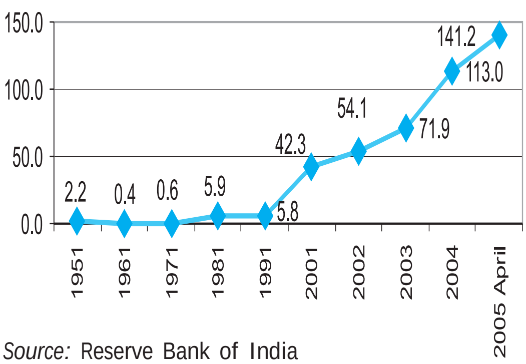
accumulated around US $ 141.2 billions of forex (Chart-3). This makes India hold the sixth largest stock of international reserve assets in the world.

## SOURCES OF ACCRETION TO FOREX RESERVES IN INDIA

The RBI report on Forex Reserves states that the accretion to the reserves in the recent period has been mainly on account of capital inflows. Table-2 lists out the sources of accretion to forex reserves since 1991. At least 106 % of the total forex reserves have come from the capital inflows including (a) foreign investment (b) external commercial borrowings (c) short term credit and (d) other items under capital account.

In August 1998, RBI issued Resurgent India Bonds (RIB) in collaboration with the State Bank of India in which foreign currency required by State Bank of India (SBI) for payment to the investors was to be sold by the RBI to SBI at the prevailing market rates on the date of maturity in exchange for rupee. These RIBs were issued in US dollars, Pound sterling and euros (then Deutsche Mark) for a tenure of five years in order to attract NRIs to invest in India. The foreign currency required for the purpose was to be supplied from the forwards foreign currency assets accumulated by RBI from the domestic market. It may be noted here that forward foreign exchange is a traditional risk management tool used by RBI to obtain protection against adverse exchange rate movements. In November 2000, RBI introduced India Millennium Bonds as a follow up of RIBs. It is interesting to note that both these resulted in an inflow of close to $9 billion in forex.

**Chart-3**




*Source:* Reserve Bank of India

The result has been an appreciation of Indian Rupee vis-à-vis these exchange currencies and especially US$, which RBI does not want to happen. Though, currency appreciation reflects the strength of rupee vis-à-vis US$, in a flexible exchange rate regime (managed float) as the case is in India, appreciation of rupee is not a good sign as it has potential to reduce the aggregate export in the country. In last 15 years, India never witnessed a major leap forward in terms of exports. At a time when a major item in our import basket are petroleum products and at the global level the prices of petroleum products are on the rise. Hence, appreciation can have deleterious impact on the balance of trade.

Despite a major appreciation of Indian rupee in recent past, it has not created a major problem in India because of substantial increase in the invisibles in the BOP. These invisibles include private transfers in the form of remittances, miscellaneous factor services in the form of business service exports etc. However, this appreciation of rupee over last one and half decades have resulted in an accretion to the tune of around US$ 6.7 billions out of a total US$ 113.8 billions accretion to the overall reserve between 1991-92 and September 2004 (Table-2).

**Table-2**

**Sources of Accretion to Foreign Exchange Reserves in India (In US$ Million)**

| | | Items | 1991-92 to 2004-05 (upto end September) | As % of Total |
|---|---|---|---|---|
| A | | Reserve Outstanding as on end march 1991 | 5.8 | 4.8 |
| B.I | | Current Account Balance | -19.6 | -16.4 |
| B.II | | Capital Account (net A to E) | 126.7 | 105.9 |
| | A | Foreign Investment | 67.9 | 56.8 |
| | B | NRI Deposit | 22.2 | 18.6 |
| | C | External Assistance | 9.0 | 7.5 |
| | D | External Commercial Borrowings | 17.2 | 14.4 |
| | E | Other Items in Capital Account | 10.5 | 8.8 |
| B.III | | Valuation Change | 6.7 | 5.6 |
| | | Total (A+B.I+B.II+B.III) | 119.6 | 100.0 |

*Source:* RBI

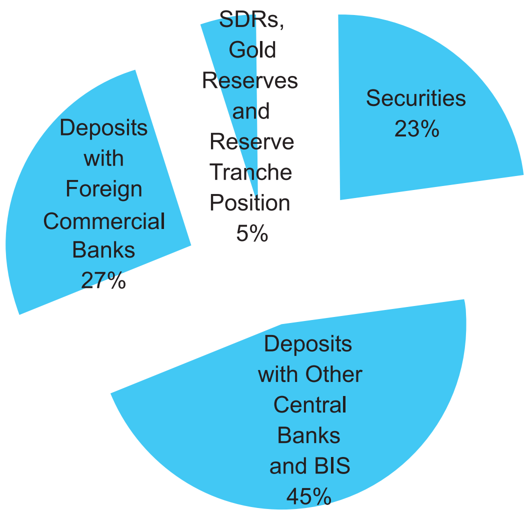
Mounting Foreign Exchange Reserves: Crown or a Cross

## PROBLEMS ASSOCIATED WITH HUGE CAPITAL INFLOWS

Capital inflows are considered to be a mixed blessing. In some countries, these flows (in the form of FDI) permitted higher levels of investment and facilitated the transfer of technology and enhanced management skills and enlarged market access as happened in the East Asian countries before the crisis. However, in many Latin American countries despite huge capital inflows (mainly in the form of hot money inflow or portfolio investment which can be withdrawn at any time as per the whims of the investor), investment ratios have not increased, savings fell and the countries went into a crisis. One of the problems created by huge inflow of capital is of 'overheating' of the economy characterised by galloping inflation, and worsening current account balance (as experienced in Latin American and East Asian Economies). In countries like India, it can also lead to multiple problems of resource crunch and unemployment.

**Chart-4**

**Deployment of Foreign Exchange Reserves as on 30 September 2004**




Indian Economy is operating in a flexible exchange rate or a managed float regime. Under managed float regime, RBI is committed to a stable exchange rate through its own interventions in the forex market through buying and selling of dollars. When there are huge capital inflows, the domestic currency tends to appreciate, as the investors will demand more rupee. To check this in the short run the RBI enters into the exchange market and buys forex. The monetarists apprehend that RBI buys dollar and increases the money supply in the economy, which may lead to inflation at any point of time if the productive resources in the economy are not put to use. This may again lead to the appreciation of real effective exchange rate (REER) or the exchange rate after adjusting for inflation, despite a stable nominal exchange rate. This may worsen the current account balance by making imports cheap and exports expensive. There are theoretical flaws in these sequencing of the situations. For example, buying of dollars can lead to inflation if and only there is no excess capacity in the economy (which is not true in the case of India). Again, Real Effective Exchange Rate causes current account deterioration if and only the sum of price elasticities of the domestic and foreign demand for imports is greater than one (i.e., Marshall Lerner Condition holds true).

Let us not get into the controversies and debates involved in the theoretical paradigm. The moot question is that, we cry for resources for every possible social and economic activity and we have huge balance lying idle in the form of forex reserves, which at current prices counts around 20 percent of the national GDP. We need only around US$ 25 billion as reserve for three-month import cover. The interest at which we borrow from foreign investors is much higher than the interest we are getting on these idle resources. RBI Report states that the forex reserves should not be treated as an instrument of import cover only, but an additional instrument to face external shocks and avoid risk. But is it justifiable to hold around six times the amount needed as idle resources just to avoid risk of external shock?

## THE RISKS

The RBI in past have tried several ways to control the accumulation of embarrassingly high forex reserve. Such ways include granting easier access to forex for travel, education and other consumption purposes, giving larger access to forex for companies who want to invest abroad, encouraging use of international credit cards, increase in the limits of importers to use forex without clearance etc. Efforts were also made to move towards full convertibility of Indian rupee. However, nothing seems to work as a solution. These neo-liberal ways of handling forex ultimately result in more and more inflow of foreign capital owing to the nature of Indian economy. It has been pointed out by renowned economists like Prof. C.P. Chandrasekhar and Prof. Jayati Ghosh that in a situation when domestic currency appreciates, the investors get more interested in investment activities related to production and provisioning of non-tradable goods and services like speculation, real estate etc., rather than investing in those items which facilitate import substitution.

All these generally create virtual booms in the stock market and real estate markets and make the economy vulnerable to shocks and uncontrolled capital mobility. Under such situation, the abundant reserves which is an apparent symbol of the strength of the economy may dry up within a couple of minutes and the government shall have no control over such crisis as has been the case with ASEAN currency turmoil and Latin American economies. Therefore, the dangers of maintaining such huge reserve and the associated neo-liberal policy framework have multiple implications. It keeps the financial system away from the compass of accountability before the people of India, as any related crisis would be spontaneous and automatic. The common people can only react to the changed dynamics as they did in ASEAN countries by involving themselves in food riots and criminal activities. There is absolutely no scope for them to influence the happenings. Secondly, the needs of the productive sectors from the financial sector cannot be fulfilled, as the bulls in the stock market and single large international players would largely govern the latter. Thirdly, it will increase the vulnerability of the economy towards shocks. Finally, it always creates a volatile atmosphere of false self –assertion that will hinder the economy's preparedness for such situations.

## THE WAY OUT

Possibly there are two ways to avert this risk and to some extent both are complementary to each other. One measure may be to control capital inflows in a systematic manner. However, many of such efforts would antagonise the engineers of present day policy framework including the Brettenwoods institutions. We have learnt from the Brazilian experience that the world monopoly capitalists would not allow such capital control and shall try to demolish all such efforts. But such an apprehension is unfound in Indian case as the share of such monopoly capitalists is not substantial unlike many other countries, which went into crisis due to capital mobility.

The above table suggests that the total portfolio investment in India is just 23.8 percent of the total foreign liabilities. The Government can easily employ measures for capital control in the form of Tobin taxes or in the form of some qualitative and quantitative restrictions on capital mobility. With 23.8 % share in total foreign liabilities, and around 39 % in the total foreign exchange reserves (US$ 112.959 bn as of March 2004), the economy can very well manage any shock induced by these players. Therefore the inaction of the government is nothing but a lack of political will necessary in this direction.

Probably, the best way to influence capital inflow is to create an atmosphere where private players could crowd in for productive investment. The second method therefore is to invest heavily on productive sectors like agriculture and manufacturing and to go in for import of technology, raw materials etc for the purpose.

**Table-4**

**International Investment Position of India (US $ million)**

| | Item | As on March 2004 in UD$ Mn (Provisional) | In % of Total |
|---|---|---|---|
| **A** | **Assets** | | |
| 1 | Direct investment abroad | 6,592 | 4.8 |
| 2 | Portfolio investment | 732 | 0.5 |
| 3 | Other investments | 15,697 | 11.5 |
| 4 | Foreign Exchange Reserves | 112,959 | 83.1 |
| | **Total Foreign Assets** | **135,980** | 100.0 |
| **B** | **Liabilities** | | |
| 1 | Direct investment in India | 38,676 | 21.0 |
| 2 | Portfolio investment | 43,856 | 23.8 |
| 3 | Other investments | 102,043 | 55.3 |
| | **Total Foreign Liabilities** | **184,575** | 100.0 |
| | **Net Foreign Liabilities (B-A)** | **48,595** | |

*Source:* RBI Report on Foreign Exchange Reserves 2003-04 (Covering period September 2004)

Rapid development of rural infrastructure would induce private investors to invest in agro-based industries. It will also not be a bad idea if government undertakes such production activities through cooperatives and create sufficient employment opportunity in the economy. All these efforts would require huge government investments and even if government meets this requirement through external borrowing, it can pay it back from the forex reserves. Once the economy is in the path of full employment, by utilising the excess capacity created by these initiatives, then possibly, the country can absorb any kind of shock generated by finance capital. However, this is not a sustainable solution as it may instantly provoke the hot money to go out of our country. So the ultimate solution lies in the capital control mechanisms.

Of late, the Planning Commission has come out with similar ideas of utilising the idle forex in building rural infrastructure. The Prime Minister has also announced a massive rural infrastructure programme though the resource part of it is not yet very clear. But the cliques of neo-liberal ideas in the Government of India are apprehensive of huge capital outflows as a result of using these forex reserves. It is up to the popular pressure exerted by our representatives on our behalf in the Parliament that the future of such initiatives might be drawn.

# Twelfth Finance Commission Recommendations

## (for 2005-06 to 2009-10) -Nandan Jha

### FINANCE COMMISSION

Article 280 of the Constitution of India requires the formation of a Finance Commission by the President of the country, at the interval of every five years. The primary objective of a Finance Commission is to give recommendations about the distribution of non-plan revenue resources between the Centre and the States. The recommendations of a Finance Commission, usually applicable for a period of five years, deal with the following:

- Distribution of the net tax proceeds (divisible between Centre and States)- share to be given to States and distribution across States
- Principles governing the grants-in-aid to the States out of the Consolidated Fund of India
- Measures for augmenting the Consolidated Funds of the States and
- Any other matter as referred to it by the President.

Beginning with 1952, we had had eleven Finance Commissions till 2004-05.

### SIGNIFICANCE OF THE FINANCE COMMISSION RECOMMENDATIONS

Under the federal fiscal system in our country, a greater amount of resources have been assigned with the Centre where as the States have been made (primarily) responsible for providing a wide array of services which has enlarged their expenditure commitments significantly vis-à-vis the Centre. Thus, there is a 'vertical imbalance' between the Centre and the States relating to resources for public expenditure. Again, the economic activities, natural and human resources, and other relevant factors vary across the States and consequently we have wide disparity in the economic abilities of the States. Therefore, we have 'horizontal imbalance' across the States. Now, the vertical imbalance in the fiscal arrangement of the country is expected to help in ensuring- (a) equity in distribution of resources across States (i.e., rectifying the horizontal imbalance relating to resources), and (b) effective utilization of resources in the country. And, these crucial tasks are performed through the recommendations of the successive Finance Commissions.

During the last decade, the already weak fiscal health of most of the States deteriorated considerably, leaving most of them in the midst of a fiscal crisis. This mounting crisis in the States' finances increased substantially the relevance of the recommendations of the Twelfth Finance Commission. For, most of the State Governments, policy analysts, economists and informed citizens of the country were looking forward to this Finance Commission to pave the way for significant improvements in the fiscal health of the States.

### TWELFTH FINANCE COMMISSION (TFC)

The Twelfth Finance Commission was constituted on November 1, 2002, under the Chairmanship of Dr. C. Rangarajan.

#### TERMS OF REFERENCE OF THE TFC

The terms of reference of the TFC required it to make recommendations on a number of issues/ aspects in the domain of public finance, which included the following:

- The distribution of the net proceeds of shareable taxes between the Centre and the States at the aggregate level, and also the shares of the individual States (within the aggregate share of the States).
- The principles which should govern the grants-in-aid of the revenues of States from the Consolidated Fund of India, and the measures needed to augment the Consolidated Funds of the States to supplement the resources of local bodies in the States on the basis of the recommendations made by the respective Finance Commission of the States.
- TFC was also entrusted with the task of reviewing the fiscal health of the Union and States and suggesting steps to be taken by the Governments, individually as well as collectively, to restore budgetary balance, achieve macroeconomic stability and debt reduction along with equitable growth.
- It was further asked to suggest remedial measures for debt sustainability and to review the Fiscal Reform Facility introduced by the Central Government.

The TFC submitted its Report on 30 November 2004, and its recommendations will be applicable for a period of five years from 2005-06 to 2009-10. The Central Government has accepted all the recommendations of the TFC and tabled it in the Parliament on February 26, 2005 to obtain its approval. Total transfers to States recommended by the TFC amount to Rs. 7,55,752 crore over the five year period 2005-10. Of this, transfers in the form of share in Central taxes and grants-in-aid amount to Rs. 6,13,112 crore and Rs. 1,42,640 Crore, respectively.

### STATES' FISCAL REFORMS FACILITY

Subsequent to the award of the Eleventh Finance Commission (EFC), Government of India had drawn up a scheme called the States' Fiscal Reforms Facility (2000-01 to 2004-05). To this end an Incentive Fund of Rs.10, 607 crore had been earmarked over a period of five years to encourage States to implement monitorable fiscal reforms. Additional amounts by way of open market borrowings etc were allowed if the State concerned were faced with structural adjustment burden, necessitating (i) voluntary retirement / severance payments for downsizing Public Sector Enterprises (PSEs) and (ii) debt swap for bringing down interest payments. Under this facility the State Governments were invited to draw up a Medium Term Fiscal Reforms Programme (MTFRP) with the objectives of bringing down: the consolidated fiscal deficit to sustainable levels by 2005; the consolidated revenue deficit, so that in the aggregate, the revenue deficit is eliminated altogether by 2005; and the Debt / GDP ratio including contingent liabilities to sustainable levels, both in terms of stability and solvency.

The Guest Column, "Twelfth Finance Commission Advancing Second Generation Reforms", in this issue of Budget Track, presents a brief analysis of the possible implications of the recommendations of the TFC for the States. In contrast, in the present article, we restrict our attention only to some of the major recommendations of the TFC.

## SOME OF THE MAJOR RECOMMENDATIONS OF THE TFC

### 1. TFC'S PRESCRIPTIONS FOR RESTRUCTURING PUBLIC FINANCES

- The Governments at the Centre and the States should improve the combined tax-GDP ratio from the current level of 14.4 percent based on the average of last three years (1999-2002) to 17.7 (10.9 percent for the Centre before any transfers to States and 6.8 percent for States before any transfer from the Centre) per cent by 2009-10.
- The combined debt-GDP ratio, which currently stands at 81 percent at the end of 2004-05, with external debt measured at historical exchange rates, should be brought down by at least 75 percent to 56 percent level by 2009-10.
- The TFC showed concern about the fact that ratio of interest payments to revenue receipts was at a very high level. The same was almost 50 percent for the centre, 26 percent for the States, and 37 percent on their combined account by the end of 2002-03. The TFC has recommended these to be brought down to 28 percent for the Centre, 15 percent for the States, and 22 percent on their combined account by 2009-10.
- The Fiscal deficit to GDP targets for the Centre and States have been fixed at 3 per cent each by 2010 from the current combined deficit of over 9 percent (2004-05 estimates). The combined fiscal deficit of the Centre and States has been projected at 6 percent of GDP by 2010.
- Revenue deficit of the Centre and States individually as well as collectively, has to be brought down to zero by 2008-09 from the current level of 4.5 percent (2004-05 estimates).
- The combined capital expenditure of the Centre and States would go up to 6.6 percent of GDP in 2009-10 from the current level of 5.6 percent in 2004-05 estimates. The capital expenditure of the Centre has to increase by 0.5 percent from the present level (2004-05 estimates) of 3 percent of GDP to 3.5 percent of GDP by 2009-10. Similarly, for the States, it would go up to 3.1 percent of GDP by 2009-10 from the current level of 2.6 percent of GDP in 2004-05 estimates.
- Interest payments relative to revenue receipts have to be brought down to 28 per cent and 15 per cent in the case of the Centre and States, respectively.
- The States have been recommended to follow a recruitment policy in a manner so that the total salary bill, relative to revenue expenditure, net of interest payments, does not exceed 35 per cent.
- **Each State has been asked to enact a fiscal responsibility legislation providing for elimination of revenue deficit by 2008-09 and reducing fiscal deficit to 3 per cent of State Domestic Product.**

### 2. STATES' SHARE IN UNION TAX COLLECTIONS RAISED

- The share of States in the net proceeds of shareable Central taxes has been fixed at 30.5 per cent, treating additional excise duties in lieu of sales tax as part of the general pool

Twelfth Finance Commission Recommendations (for 2005-06 to 2009-10) of Central taxes. Share of States would come down to 29.5 per cent, when States are allowed to levy sales tax on sugar, textiles and tobacco.

- In case of any legislation enacted in respect of service tax, after the notification of the eighty eighth amendment to the Constitution, revenue accruing to a State should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool.
- The indicative amount of overall transfers to States has been fixed at 38 per cent of the Centre's gross revenue receipts, which is higher by 0.5 percent over the same as recommended by EFC.

## 3. QUANTUM OF GRANTS RECOMMENDED FOR LOCAL BODIES

- A grant of Rs.20, 000 crore for the Panchayati Raj Institutions and Rs.5, 000 crore for Urban Local Bodies has to be given to States for the period 2005-10. The priority should be given to the expenditure on operation and maintenance (O&M) costs of water supply and sanitation, while utilizing the grants for the Panchayats.
- At least 50 per cent of the grants recommended for urban local bodies have to be earmarked for the scheme of solid waste management through public-private partnership.

## 4. SUBSTANTIAL INCREASE IN GRANTS-IN-AID TO STATES

- The present system of Central assistance for State Plans, comprising grant and loan components, has to be done away with, and the Centre has been told to confine itself to extending plan grants and leaving it to States to decide their borrowings.
- Non-plan revenue deficit grant of Rs.56,856 crore has been recommended to 15 States for the period 2005-10.
- Grants amounting to Rs.10,172 crore has been recommended for the education sector to eight States.
- Grants amounting to Rs.5,887 crore has been recommended for the health sector for seven States. Grants to education and health sectors are additionalities over and above the normal expenditure to be incurred by States.
- A grant of Rs.15,000 crore has been recommended for roads and bridges, which is in addition to the normal expenditure of States.
- Grants recommended for maintenance of public buildings, forests, heritage conservation and specific needs of States are Rs. 500 crore, Rs.1,000 crore, Rs. 625 crore, and Rs.7,100 crore, respectively.
- The total amount of grants-in-aid for the award period of TFC is Rs. 1,42,640 Crore, which is 143.5 percent higher than that recommended by the EFC.

## 5. DISCONTINUATION OF STATES' FISCAL REFORM FACILITY

The TFC has recommended a scheme of debt relief as mentioned below and has said that the fiscal reform facility will not continue over the period 2005-10 as the scheme of debt relief has been put in place.

## 6. DEBT RELIEF AND CORRECTIVE MEASURES SUGGESTED

- Central loans to States contracted till March, 2004 and outstanding on March 31, 2005 amounting to Rs.1, 28,795 crore has to be consolidated and rescheduled for a fresh term of 20 years, and an interest rate of 7.5 per cent will be charged on them. This is conditional on the enactment of fiscal responsibility legislation by a State.
- A debt write-off scheme linked to reduction of revenue deficit of States should be introduced. Under this scheme, repayments due from 2005-06 to 2009-10 on Central loans contracted up to March 31,2004 will be eligible for write-off.
- Central Government will no longer act as an intermediary for future lending to States, except in the case of weak States, which are unable to raise funds from the market.
- External assistance should be transferred to States on the same terms and conditions as attached to such assistance by external funding agencies.
- All the States have to set up sinking funds for amortization of all loans. States should set up guarantee redemption funds through earmarked guarantee fees.

# Guest Column: *Ms. Smita Gupta*

# Twelfth Finance Commission: Advancing Second Generation Reform

The Common Minimum Programme (CMP) had the potential to once again reassert the state's responsibility towards the common people. It made several commitments for employment, food security, education, health and agriculture. Higher spending on pro-people development would have pulled the rural and urban poor out of economic distress. The UPA government instead is using every possible means to subvert its own CMP, beginning with the Fiscal Responsibility and Budgetary Management Act, followed by a travesty of an employment guarantee, a Rural Health programme that will destroy the public health system, etc. The most recent transgression is the Twelfth Finance Commission (TFC), whose recommendations submitted early this year have gone largely unnoticed.

The constitutional mandate of the Finance Commissions is two-fold: to tackle the mismatch in responsibilities and resources between the centre and the states, (with the states having much of the responsibilities and the centre the resources), and reduce the wide inter-state disparities by giving weight to backwardness while determining the revenue shares of different states.

At the end of the nineteen nineties, all states plunged into a fiscal crisis marked by ballooning debt and deficits, with higher rates of interest on government debt relative to the rate of growth of NSDP in nominal terms. While there may be some unique state-specific problems, central policies have played the most significant role in weakening the fiscal health of the states. While the centre reneged on committed devolution, its policies pushed up committed expenditure. The crisis is not on account of profligacy since for most states, the increase in revenue and fiscal deficit has accompanied falling government spending on development (in per capita and real terms as well as in relation to state income). The Eleventh and Twelfth Finance Commissions (EFC and TFC) were expected to address this.

Even as the term of the EFC was drawing to an end, an unprecedented attempt was made to alter the original spirit of the constitutional mandate through the Presidential Order of April 28, 2000, which asked the EFC "to draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the states and recommend the manner in which the grants to states to cover the assessed deficit on their non-Plan revenue account may be linked to progress in implementing the programme." This had two far-reaching implications; one, that the "fiscal reform" was constitutionally legitimate: and two, it sought for the centre the right to use assistance to cover non-Plan revenue deficits as an instrument to push unpopular neo-liberal policies.

The terms of reference of the TFC are worse: to suggest "a plan by which the (State) governments, collectively and severally, may bring about a restructuring of the public finances, restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth". In the words of finance secretary S Narayan: "As compared to the terms of reference of the EFC, the terms of the TFC lays emphasis on certain efficiency factors such as adjustment of user charges, relinquishing non-priority enterprises through privatisation or disinvestment and resource mobilization to improve the tax-GDP ratio." The implication is clear: access to resources would depend on raising user charges, privatization and greater financial self-sufficiency.

In a major break with the past, the TFC proposes an increase in the share of grants in total transfers to 19 per cent (from 13.5 per cent under the EFC and 9 per cent under the Tenth Finance Commission), which will increase the powers of the centre since the allocations for 60 per cent of the special-purpose grants are discretionary without a transparent criteria. Norm-guided grants that cover the deficits of the states, are only 40 per cent of all grants, while the rest are linked to conditionalities like 90 per cent cost recovery, public-private partnerships, etc.

The TFC was parsimonious when it increased the states' share of statutory transfers by 0.5 over the EFC's recommendation of 37.5 per cent. Unable or unwilling (or both!) either to impose discipline on the centre to check its abysmal tax-GDP ratio, which then gets partially off-loaded onto the state governments through lower transfers, or to effect a compensatory increase in the states share in central taxes, the TFC adds insult to injury by imposing anti-poor expenditure curtailment and cost recovery on states.

The states are now pushed to the market for loans since the centre agreed with TFC to stop being direct lender or mediate in state government borrowings. Central assistance to state plans is down by a whopping 98 per cent, from Rs 25,002 crore in 2004-05 to Rs 500 crore in the latest budget. This will destroy the prospects of backward and smaller states to borrow. The argument is that if the centre withdraws from its facilitative role and reduces the 'dependence' of states on central government loans, the states will be subject to market 'discipline' resulting in loans only for 'financially viable' projects/governments or at risk-covering high cost, at interest rates that reflect credit worthiness.

The TFC also suggests back-to-back funding of externally funded projects from the likes of Asian Development Bank and the World Bank, with the centre acting as a formal intermediary. This will make conditionality-ridden foreign loans easier to negotiate, and with the withdrawal of central loans, inevitable. One way or the other, states will have no choice but to adopt neo-liberal fiscal restructuring and cut expenditure on public services.

The Commission recommends a debt restructuring and a debt relief scheme, and is willing to consolidate the debt of states at the end of 2004-05 to be repaid at 7.5 per cent over 20 years. However, this debt relief comes with the condition that only those states that enact fiscal responsibility legislation can avail of it. The TFC is therefore ensuring the adoption of the FRBMA all over the country.

As far as the criteria for distribution across states is concerned, the Commission has reduced the weight of the equity factor or "distance" of the state's per capita GDP from national average, and increased the weight to population (which is still the 1971 numbers), tax effort and fiscal discipline. The result is that the high income states of Gujarat, Haryana, Maharashtra and Punjab have improved their allocations the most, followed by the low income states of Bihar, MP, Orissa, Rajasthan and Uttar Pradesh. As in the case of states, even the criteria for local bodies is regressive in that those who are able to collect more resources are rewarded, which may often reflect "prosperity" rather than greater "efficiency".

Thus, the recommendations are inherently regressive and anti-people. This is the sum and substance of the "second generation reforms", which were ushered in through the reduction in the devolution of funds to the state governments and conversion of statutory devolution to reform-linked transfers. The centre is trying to impose the contentious and unpopular neo-liberal policy of fiscal tightening, and the backward states and the poor will be the worse affected, since power, irrigation, education, health, extension services, etc. will become costlier. The spending squeeze involved will not only be disastrous for the poor and marginalized, but also paradoxically worsen the fiscal crisis itself through negative implications on SDP growth rates.

The author is an economist and Fellow, Institute for Human Development, New Delhi.
She can be contacted at smitajee@yahoo.com

# CAG on India Shining Campaign: A Campaign that was Fundamentally Flawed

*- Deepak L. Xavier*

The Comptroller and Auditor General (CAG) could not have chosen a better time to bring out the audit report on the previous governments' expenditure, than on the occasion of the Silver Jubilee celebration of the launching of BJP, the de-facto NDA. It is not uncommon, these days, for the ruling parties to squander public money on political propaganda. But this time the NDA has been pulled up for spending a sum of Rs. 63.23 crore from the exchequer all in the name of 'India Shining' campaign. It is ironical that a campaign that was fundamentally flawed has been brought back to the public for its scrutiny on a serious charge of constitutional violation.

The CAG's report points out an unauthorised expenditure of Rs. 63.23 crore on account of 'India Shining' media campaign through diversion of funds meant for other activities. Moreover, this activity was not contemplated in the annual budget 2003-04. The report squarely pinpoints that the NDA Government had violated the constitution by not getting prior sanction from the Lok Sabha before spending the said money from the 'Consolidated Fund of India'. Prior sanction from the Parliament is a must for any expenditure from the fund created under Article 266 (1) of the Constitution of India.

The NDA has shown an expenditure incurred worth Rs. 63.23 crore, which has been spent for 'India Shining' campaign, by re-appropriating Rs. 68 crore earmarked for 'cooperation with other countries' and 'other expenditures' in Demand No. 31 of Department of Economic Affairs for the year 2003-04.

appropriation. Moreover, the nature and purpose of the campaign did not fit in under the account head, which promoted various promotional activities in relation to ties with other countries, it said. In this case, the NDA Government has also neglected the provision under the constitution, which allows the Government to place before the Parliament a supplementary demand for grant when need arises for expenditure on a new service, not contemplated in the annual budget.

According to the CAG Report, in September 2002 the Finance Ministry had mooted a proposal for launching a media campaign for highlighting the benefits of economic reforms already. In September 2003, an empowered sub-group, set up under the chairmanship of chief economic advisor, for implementation of the publicity programme decided that a full-fledged media campaign be launched and the expenditure met with sponsorship from various stakeholders in the reforms - banks, financial institutions and corporate world. Campaign materials from two advertisement agencies styled as 'India Shining' were approved in October 2003 for release to various newspapers and TV channels in three phases during October 2003, December 2003 to January 2004 and from February 2004 till the Model Code of Conduct of Parliamentary Elections came into effect.

If it was clearly mentioned that the expenditure for the campaign would be met from the beneficiaries of economic reforms, why then did NDA Government use public money towards the campaign expenses – a common wo/man could ask legitimately. Indeed the answer is very simple. The campaign was aimed not to promote economic reforms but to indulge in a pre-election political propaganda for which none of the so-called beneficiaries of economic reforms would be willing to pay the price. The ultimate victim of the unauthorised expenditure is the common wo/man who has no voice over the public resources. How laudable it is to say that a citizen, s/he, is the ultimate owner of these public resources! The NDA's argument that the campaign was to promote

The Finance Ministry, however, in reply to a query said that it had mentioned the expenditure while presenting the demand and treated it as a provision for supporting an overall, general and imaginative promotion of India and its trade and fostering techno-economic and intellectual collaboration with other countries. Hence, it was not treated as a new service. CAG has rejected the above justification of the then Finance Ministry as not tenable in view of the constitutional requirements regarding

CAG on India Shining Campaign: A Campaign that was Fundamentally Flawed

India as a blooming economic super power in the global arena lacked substance. If that was so, why did it choose to advertise in Times of India and Rashtriya Sahara alone and not in New York Times and Guardian Newspaper, which have global reach?

If any violation of constitution is treated as a crime, what could be the right punishment to a Government, elected by the people to protect the constitution, when it disrespects and disregards the provisions of the same constitution? Unless there are severe punishments in place for crimes of these sorts, the violators will never stop laying hands on the common wo/man's resources. There should be a way to collect the money, which was spent on the 'India Shining' campaign, from all the NDA allies with 'interest' to till date to cover the financial damage it has caused to the public exchequer. Legal action should be pursued to punish as well as to recover the ill-spent amount from the parties concerned.

## FOR MORE INFORMATION, CONTACT:


**cbga** Centre for Budget and Governance Accountability

(A programme of NCAS)

B 64, Second Floor, Sarvodaya Enclave, New Delhi – 110 017, India
Tel: 91-11-26537603 Email: cbadelhi@vsnl.net

NCAS FACILITATING SOCIAL CHANGE National Centre for Advocacy Studies

www.ncasindia.org

Serenity Complex, Ramnagar Colony, Pune – 411 021, India
Tel: 91-20-22952003 / 4 Email: ncas@vsnl.com


## CREDITS


**Editorial Advisory Board**
M D Mistry, Vinod Vyasulu, Jayati Ghosh, John Samuel

**Editorial Team**
Amitabh Behar, Praveen Jha

**Advocacy**
Deepak L Xavier, Shivani Sen, Anurag Srivastava

**Research**
Siba Sankar Mohanty, Subrat das, Nandan Kumar Jha, Ramanand Ram, Vineet Kohli

**Circulation**
Shallu Angra, Khwaja Mobeen Ur-Rehman

**Assistance**
Harsh Singh Rawat

**Illustration**
Siba Sankar Mohanty

**Design**
Mayank Bhatnagar

**Layout & Printing**
Kriti Creative Studio