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Issues Before the Ninth Finance Commission: A Background Note

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Introduction

The terms of reference (TOR) of the Ninth Finance Commission (NFC) have raised controversies as never before, although this is not the first time that the Presidential Order appointing the Finance Commission has spelled out certain guidelines. While the practice of issuing guidelines to the Finance Commission has come under attack in the past, also what appears to have provoked so much controversy this time is that the present TOR are seen as an attempt to enlarge the ambit of the Finance Commission, purporting to alter the pattern of devolution of federal funds that had emerged in the last two decades; and the manner in which these TOR are finally interpreted is likely to have far reaching consequences for Centre-State financial relations in the country. Ironically, the erosion of the Finance Commission's authority over the federal transfers that has taken place with the emergence of the Planning Commission (and substantial discretionary transfers by the Centre) had been criticised in the past by those who feel uneasy with the present Finance Commission's TOR. However, framed as they are by the Central government, and given the present political environment, the TOR have given rise to misgivings about encroachment on the autonomy of the State governments. The constitutionality of the expansion of the Finance Commission's jurisdiction implied by the TOR of the Ninth Finance Commission and even of the authority of the Presidential Order to issue any guidelines to the Finance

Commission (FC) has been questioned. In the federal framework which the Indian Constitution contemplates, the arrangements for governing the financial relations constitute almost the keystone and in this again the institution of the Finance Commission has a crucial role. For the future of the Indian federation, it is essential that the current controversies are resolved satisfactorily and solutions found to the problems which the working of the Finance Commissions in the past has given rise to or the TOR of the Ninth Finance Commission are likely to create.

For this purpose, it is necessary first to note the significant points of departure of the TOR of the present Finance Commission from those of the previous Commissions and then to examine whether these departures are sustainable from the constitutional angle as also from the angles of equity and economic efficiency. This note seeks to present the issues arising out of the Ninth Finance Commission's TOR in this perspective.

Terms of Reference of Ninth Finance Commission - The Main Points of Departure

The important features of the TOR of Ninth Finance Commission which mark a significant departure from the past are:

- Removal of certain restrictions which had tended to narrow down the scope of the Finance Commission's assessment of the budgetary needs of the Government at the Centre and the States. A comparison of para 4 of TOR of the Ninth Finance Commission with para 5 of the previous one would indicate the areas in which the restrictions have been removed or relaxed. More specifically, the TOR of the Eighth Commission had imposed a restriction which had limited the Finance Commission's recommendation to cover only the non-Plan revenue gap of the States. This has been

the practice since the Fourth Finance Commission. The absence of any reference to the non-Plan component of the revenue account or the commitment of the respective governments on this account has, at one stroke, thrown the requirement for the revenue component of the Plan open to the Finance Commission's scrutiny. Similarly, in the matter of upgradation of standards of administration, whereas the Eighth Finance Commission was expected to make recommendations regarding such upgradation only in respect of items of public services in the non-developmental sectors, the TOR of the Ninth Finance Commission stipulate no such restriction. Absence of any selectivity in this regard will presumably bring capital expenditures required for upgradation in the developmental areas also under the Finance Commission's purview;

- Another point of departure in the TOR of the Finance Commission's ambit lies in the reference to both the Centre's and States' requirements in assessing the receipts and expenditures on the revenue account contrasting with reference only to the Centre's resources and requirements as the first consideration in the previous Finance Commission's TOR;

- Stipulation of a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre, keeping in view the special problems of each State and the special requirements of the Centre such as defence, security, debt servicing and other committed expenditures and liabilities. The TOR of the Eighth Commission drew attention to the "scope for better fiscal management and economy in expenditure consistent with efficiency". The emphasis this time is on the need for "speed,

efficiency and effectiveness of government functioning and of the delivery systems for government programmes";

- Pointed reference to the need for providing incentives for entire resource mobilisation and financial discipline;

- Stipulation of the objective of balancing the receipts and expenditure on revenue account of both the States and the Centre and also generating surpluses for capital investment;

- Calling upon the Finance Commission to examine the feasibility of merger of additional excise in lieu of sales tax with basic excise duties;

- Requiring the Finance Commission to make an assessment of the debt position as on 31.3.1989 and not merely non-Plan capital gap and suggest corrective measures keeping in view the Centre's financial requirements, and with particular reference to investments made in infrastructure projects and linkage with financial and managerial efficiency; and

- Asking the Finance Commission to explore the feasibility of a new way of providing disaster relief to the States, viz., by setting up a National Insurance Fund.

It may be argued that the basic tasks entrusted to the Ninth Finance Commission remain the same as before and as enjoined by Article 280 of the Constitution, viz., to adjudicate the distribution of shareable taxes between the Union and the States and their allocation among the States, and recommend grants-in-aid out of the Consolidated Fund of the Government of India to States in need. Nevertheless, serious misgivings have been expressed over the TOR of the present Finance Commission. The main reasons seem to be the following:

- While, since the Fifth Finance Commission, the TOR have been laying down certain guidelines never before was it incumbent on the Finance Commission to adhere to the considerations stipulated in TOR and therefore the discretion of the Finance Commission was not fettered as seems to be the case now. The wording of the TOR of the present Commission, viz., that "the Commission shall..." seems to have turned the guidelines into directives. This, it has been argued, violates the provision and spirit of Article 280 especially of clause (4) of the Article and of the Finance Commission's (Miscellaneous Provisions) Act, 1951 as amended in 1955 whereby the Commissions are empowered to determine their own procedure and given the power of a Civil Court in the performance of their functions (Vithal and Sastry, 1987).

- While asking the Ninth Finance Commission to adopt a normative approach, the TOR further enjoin that the Commission shall "keep in view the special problems of each State, if any, and the special requirements of the Centre". This, it is apprehended, has left room for the normative approach becoming highly subjective.

- In calling upon the Ninth Finance Commission to adopt a normative approach, the TOR refer to the special requirements and the committed expenditures or liabilities of the Centre while in the case of the States the reference is only to their special problems, if any. This, it is alleged, is discriminatory being loaded against the States.

- Contrasting with the TOR of the earlier Commissions, there is no reference this time to the manner in which emoluments of government employees are to be dealt with. Perhaps, the intention is to leave it to the Commission to apply some norms in the matter of employees'

emoluments as otherwise there was a tendency to raise the emoluments before the cut-off date. But the question arises what would be the norm in this regard? "Will the standards of Central government scales be imposed on the States or will the Ninth Finance Commission also act as a Pay Commission for the States?", it has been asked (Vithal and Sastry, 1987).

- Similarly there is no mention of upgradation of standards of administration or maintenance of capital assets in the Ninth Finance Commission's TOR. How will they be taken care of? Will these also be subsumed under the normative approach?

- Removal of the distinction between Plan and non-Plan together with the direction to ensure generation of surpluses for investment indicates that the Finance Commission would have to assess the dimension of the revenue component of the next Plan. Practical difficulties apart, it is apprehended that this would result in an overlap of the functions of the Planning Commission and the Finance Commission and undermining the Gadgil formula, bypassing the NDC. Planning is an elaborate exercise, it is contended. How can any projection for the Plan be attempted until matters regarding overall outlays, resources, Central assistance, etc. are known? All this has given rise to the feeling that the TOR of the Ninth Finance Commission constitute an attack on the established conventions of the planning process (Godbole, 1987, Hanumantha Rao, 1987 and Bagchi, 1987).

- The accent on efficiency may result in the eclipse of equity considerations in the allocation of federal funds. If efficiency criteria are strictly applied, plan outlays or developmental outlays of weaker States may be adversely affected and they

may have to do without any planning worth the name in the absence of any surplus in their revenue budgets (Hanumantha Rao, 1987).

- There is also an apprehension that the normative approach, if taken in a prescriptive sense, may make the entire quantum of devolution including shared taxes conditional whereas, so long only grants under Article 275 could be tied to specific purposes (Vithal and Sastry, 1987).
- The inclusion of the question of merger of additional excise duties with basic duties is also seen as a threat to the tax powers of the States.
- Reference to population figure of 1971 census as the basis for the assessment of fiscal needs. A view has been expressed that this may be unfair to poorer States having a large population. The Ninth Finance Commission, it is argued, should have been left free to decide its own basis of assessment (Hanumantha Rao, 1987).
- The question of setting up a National Insurance Fund with contribution of the States raised in the TOR only has been taken as an indication of the Centre's attempt to divest itself of any responsibility for sharing the burden of disaster relief.

It has also been said that the manner in which the TOR have been drawn up also shows a bias against and insensitivity to the States and their problems. Against this background, it is contended, unless interpreted in the right spirit, the TOR may accentuate the dependence of the States on the Centre. Attention has been drawn in this context to the debt trap confronting the States, the increasing proportion of total market borrowings accruing to the Centre, the adverse impact of floating of bonds of the public sector undertakings offering incentives for instruments of borrowing by the Centre to the detriment of small savings, the practice of raising resources for the Centre through hikes in administered prices (Lakdawala, 1987, Godbole,

1987), and control over the deployment of the resources of the banks and financial institutions (Gulati and George, 1978).

While the issues raised in the wake of the appointment of the Ninth Finance Commission are wide ranging, it may be useful, for further discussion and finding some directions for moving ahead, to group them under two broad heads, viz., (i) questions of legality or constitutional validity, and (ii) those which need to be looked at on merits from the angle of equity and efficiency in the use of the resources of the public sector and the objectives constituting the *raison-d'etre* of a federal polity.

The Legal Issues

The legal issues which have been brought up by the current debate, though relatively clear-cut, need to be resolved so that doubts are set at rest once for all and the parameters within which the Finance Commissions can function hereafter become clear.

The first set of questions which arise again and again with the issue of guidelines to Finance Commissions through their TOR are:

i) Does the Constitution authorise the President to lay down guidelines for the Finance Commissions whether in a mandatory or in an indicative manner? and

ii) If the answer is no, can the Finance Commission ignore such guidelines or directives?

It has been pointed out in this context that Article 280 of the Constitution which requires the President to appoint a Finance Commission at the expiry of every fifth year does not lay down any restriction on the discretion of the Finance Commissions in the matter of deciding the principles on the basis of which the specified Central taxes are to be shared between the Centre and the States and the share of individual States is to be determined. However, the Presidential orders,

at least since the Fifth Finance Commission, have tended to lay down certain guidelines in the matter. Initially, there was no such attempt. It was for the Fifth Finance Commission that the TOR for the first time after spelling out the provisions of Article 280 (3)(a) and (b), went on to add that in making its recommendations the Commission shall have regard, among other considerations, to a few factors such as, the revenue resources of the States on the basis of the existing levels of taxation, their requirements on revenue account to meet the expenditure on administration, interest charges, maintenance and upkeep of Plan schemes and so on. This practice of laying down certain guidelines has been followed in the formulation of the TOR of the subsequent Commissions.

As noted earlier, one of the significant - and controversial - points of departure of the TOR of the Ninth Finance Commission is that while the guidelines for the earlier Finance Commissions (since the Fifth) only indicated certain factors to be kept in view by the Finance Commissions among other considerations, in the case of Ninth Finance Commission, the TOR enjoins that "In making its recommendations, the Commission shall.....". The word "shall" in the TOR of Ninth Finance Commission, it is said, is in the nature of a directive from the Government of India. The argument that the guidelines given in TOR this time have the tenor of a directive is sought to be reinforced by the fact that para 6 of the TOR stipulates that in making its recommendations on the various matters referred to them, "the Commission shall adopt the population figures of 1971 in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid". There is no doubt over a decision of the Parliament that on all matters where population is taken as the norm, 1971 figures should be used. But it may be asked, can or should the Finance Commission be bound by this decision especially when assessing the fiscal needs of the States?

This view is however not shared by those who feel that, on a careful reading of TOR, the directive implied by the terms "Commission shall" would seem to apply only to the para 4(i)

namely - "adopt a normative approach". In the case of the other paras, the effect is moderated by expressions like "having due regard" or "keeping in view", "take into account, etc." In any case, the guidelines requiring a "normative approach" which is meant for Centre along with States cannot possibly be faulted especially since scholars all along have contended that the Finance Commissions have shirked their responsibility by adopting a "gap- filling" role. On this view, given that the country has landed itself in large deficits in the revenue account of the Government at the national as also federal level, some discipline is called for on the part of both the Centre and the States (Thimmaiah, 1987). The Chairman, Ninth Finance Commission is also reported to have clarified that the discretion of the Commission cannot be curtailed by the TOR. However, the position in law needs to be settled beyond doubt.

The next set of issues involving the interpretation of the Constitution arising out of the enlargement of the Finance Commission's jurisdiction relate to the respective role of the transfers contemplated under Article 275 of the Constitution and those under Article 282 and the roles of the Planning Commission and the Finance Commission. As is well known, with the advent of Planning, Plan grants together with discretionary transfers both of which are made by the Centre under Article 282 have overshadowed the transfers made under the dispensation of the Finance Commissions. The last three Finance Commissions (Sixth, Seventh and Eighth) no doubt gave grants for purposes of capital expenditure also and the term "grants-in-aid" of revenue has been used in a wider sense. But the capital grants were taken as Plan Resource for the Seventh Plan by the Planning Commission. If, as seems contemplated now, the Finance Commission also is to make recommendation for transfers for the Plan, the question arises, should they come under Article 275 only? Or, can the Finance Commission make recommendation under Article 282 also? Conversely, can substantial amounts out of the Consolidated Fund of India be transferred by the Centre under Article 282, thereby restricting the scope of transfers through the Finance Commission as is the case at present? In other words, what precisely was

contemplated by the Constitution makers while providing two parallel channels of transfer? Were both the channels to be used in equal measure or was Article 282 meant only to be a residuary or supplementary to Article 275?

It may be recalled that the question was gone into at some length by the Study Team of the Administrative Reforms Commission on Centre-State relationship. After a detailed inquiry, the Study Team took the view that in the light of the findings of the Expert Committee of the Constituent Assembly which laid the foundations for the present provisions relating to Centre-State financial relations, the legality of the use of Article 282 for transfer in the manner in which they have taken place cannot be questioned.

The question relating to the scope of Article 275 as also the principles which should govern the grants-in-aid of revenues of the States (whether they cover both general grants and grants for broad but specific purpose) had bothered the Finance Commissions also right from the beginning. The First Finance Commission took the view that the grants contemplated under Article 275 covered both types of grants. The Second Finance Commission also had some doubts on the question but on a reference to the President were advised that the Finance Commission could make recommendation only regarding grants-in-aid under clause 1 of Article 275. Nevertheless, the Second Commission, like the First, made a comprehensive assessment of the needs of the States including those arising from the Plan and took the position that its grants-in-aid should serve the requirements of planned development also.

Faced with the same question, the Third Commission too considered it arbitrary to draw a line between Plan and non-Plan expenditure and took the view that the entire revenue budget of a State - both Plan and non-Plan - should be taken as an integral whole. Accordingly, they made recommendations for grant-in-aid which would enable the States along with any surplus out of the devolution to cover 75 per cent of the revenue

component of their Plans. In determining the revenue component the Commission had taken account of the additional resources to be raised by the States as incorporated in the Plan. In making this recommendation, the Third Finance Commission was influenced, amongst other things, by the fact that the Plan contains repetitive schemes. The expenditure on this is unavoidable and is of the nature of committed expenditure. In some States this absorbed almost two- thirds of the revenue component of the Plan. The Member-Secretary of the Third Commission, however, did not accept this view and felt that the practice of making grants from the Centre for the revenue component of the Plan should continue to be made on an yearly appraisal of the requirements of the States and the Centre's ability to meet them. The Government of India accepted the minute of dissent by the Member Secretary and did not accept this part of the recommendations of the Third Finance Commission.

The Fourth and the Fifth Finance Commissions accepted the position which emerged out of the decision of the Government of India to reject the majority view of the Third Commission on this point and restricted themselves to an assessment of non-Plan revenue gap. The Fourth Finance Commission rejected the alternative view on the ground that "it would blur the entire division of functions between this Commission and the Planning Commission".

This is the history behind the limitations which have come to restrict the Finance Commissions' inquiry only to the non-Plan part of the State budgets. Nevertheless, the subsequent Finance Commissions have made some revenue grants for capital expenditures. Thus the Eighth Commission recommended a total grant of Rs 967 crore for upgradation, of which as much as Rs 782 crore was for capital works. But the limitations on the Finance Commissions' role, it appeared, had come to stay. Now that the removal of these limitations has led to a controversy, the questions that need to be answered are:

i) Does Article 282 permit transfer of funds by the

Centre to the States or one State to another for specific public purposes only as a residuary head of transfer as the marginal heading of the Article (viz., "Misc. Financial Provisions") suggests or does it enable the Centre or the States to make transfers freely for purposes outside their respective jurisdictions as defined in the Constitution?

ii) Article 280(3)(b) of the Constitution enjoins on the Finance Commission to make recommendations on the principles which should govern the grants-in-aid of the revenue of the States out of the Consolidated Fund of India. Grants under both Article 275 and Article 282 come out of the Consolidated Fund of India. Can it therefore be argued that the Finance Commission can recommend grants-in-aid under both these provisions?

iii) Does Article 275 authorise general or untied grants or does it also permit specific or conditional grants?

iv) Can grants be given under Article 275 for capital purposes also?

The answer to the questions posed above will also have a bearing on the legality of the TORs of the Fourth to Eighth Commissions which precluded the Commission from looking into the Plan budgets including the capital part. Although asking questions relating to the earlier Commissions' TOR might look academic, now the points have acquired significance in the context of the present Commission's TOR.

It may be recalled in this context that Justice Rajamannar, Chairman, Fourth Finance Commission, in his minute had observed that "There is no legal warrant for excluding from the scope of the Finance Commission all capital grants; even the capital requirements of a State may be properly met by grants-in- aid under Article 275(1) made on the recommendation of the Finance Commission". If a view is taken that there is no such legal bar, then there might be an overlap between the

Planning Commission and the Finance Commission. How are the lines to be demarcated? Can the Finance Commission which have limited time and resources at their disposal take over the functions of the Planning Commission? Or should the Finance Commission merely take the revenue part of the Plan as estimated by the Planning Commission as given? Or can the Finance Commission be created as a permanent body to take over some of the tasks of the Planning Commission and/or oversee the smooth implementation of their recommendations?

What could be the parameters for defining the jurisdiction of the Finance Commission or for that matter any such body should not, however, be judged only by the criterion of legality. It is necessary to see whether the changes sought to be made in the role of the Finance Commissions and the pattern of their awards are not merely permissible in law but also justified on merits from the angles of equity, efficiency and acceptability by the parties concerned. The implications of the apparent enlargement of the TOR's jurisdiction and the tasks set for the Ninth Finance Commission, therefore, should be examined in the light of the working of the mechanism for governing the financial relations between the Centre and the States as laid down in the Constitution and as it has evolved over the years, its strengths and weaknesses.

The Mechanism for Devolution of Federal Funds - Strengths and Weaknesses

Recognising that the allocation of responsibilities or functions and powers between the Centre and States cannot but create a "vertical imbalance", as the States would not have adequate sources of funds to meet their responsibilities, and also drawing on the experience of the pre-independence days, the Indian Constitution provided for transfer of funds from the Centre to the States by (a) permitting the States to collect and retain the proceeds of certain taxes levied by the Centre, (b) assigning some of the taxes to be levied and collected by the Centre to the States, (c) sharing of certain taxes between the Centre and the States, and (d) through grants from the Centre.

In order that the imbalance in the functions and fiscal powers of the States did not affect their autonomy, the Constitution also provided for the appointment of a Finance Commission by the President at least once in every five years. To repeat, the functions to be assigned to the Finance Commission, as envisaged in the Constitution are to make recommendations regarding (a) the distribution between the Centre and the States of the proceeds of taxes which are to be, or may be, shared by the Centre and the allocation between the States of their respective shares; (b) the principles which should govern the grants-in-aid of revenue of the States in need out of the Centre's funds; and (c) any other matter which may be referred by the President "in the interest of sound finances". The Centre can also make grants to the States for "any public purpose".

The mechanism of federal transfers described above was designed also to correct the "horizontal imbalances", that is, the sharp disparities in the scale and level of public services among the States resulting from the difference in their economic structure and level of development. This is a well established goal of all federations and needs to be ensured in the interest of stability and harmonious relations.

While these arrangements have provided a flexible mechanism for the operation of fiscal federalism, there is a widespread feeling that they have proved inadequate and what is more, there has been a trend towards greater centralisation and dependence of the States on the Centre than is conducive to the good federal governance in a country like India. Apart from the political environment, factors which appear to have generated this feeling mainly are:

- Growing dependence of the States on the Centre for financial resources and accentuation of the vertical imbalance;
- Devolution of federal funds through non-statutory channels;
- Encroachment by the Centre into the States'

spheres via the use of concurrent powers especially since the adoption of planning and on the States' powers of taxation in various ways;

- Narrowness of the base of taxes coming within the jurisdiction of the States and exclusion of heads like corporation tax from the shareable pool;

- Reluctance on the part of the Centre to levy and collect taxes which were meant for the State under Articles 268 and 269 of the Constitution;

- Tendency on the part of the centre to avoid raising more revenue from taxes proceeds which are shareable (like personal income tax) and turn more to those which do not go to the divisible pool (like surcharge on income tax, corporation tax and administered prices); and

- Concentration of powers of borrowing and control over banking and capital market in the Centre.

Dissatisfaction with the arrangements for devolution of federal funds is expressed also on the ground that these have not helped to correct the "horizontal imbalance" among the federating units and disparities in their per capita incomes are growing (Gulati and George, 1987).

For a proper appreciation of the validity of these criticisms one has to look at the trends in vertical and horizontal imbalances over a period of time.

Trends in Vertical and Horizontal Imbalances and the Role of the Finance Commissions

While as argued by some, there may be a case for making the entire tax revenue of the Centre shareable so that there is no inducement for concentrating on any one of the tax heads to the relative neglect of others (Datta, 1984), whether there has actually been a trend towards undue centralisation of budgetary resources should be examined with reference to the propor-

tion of resources accruing to and appropriated by the Centre and the proportion flowing to the States, and not by the tally of tax heads going into the divisible pool. For, after all, even if all receipts of the Centre were made shareable, the fraction fixed by the Finance Commission for the division between the Centre and the States would ultimately determine the volume of resources accruing to the respective Governments. What therefore matters is the proportion of revenue raised by the Centre and what is the proportion which is transferred to the States and how. Similarly, the question of accentuation of vertical imbalance also should be examined with reference to the gap between the resources which the States are able to raise on their own and their responsibilities.

In judging the degree of vertical imbalance or the gap between the revenue of the States raised by themselves and their responsibilities one should compare the ratios of their revenue expenditure to the aggregate revenue expenditure of the Centre and the States taken together with that of their own revenue in the aggregate revenue. Whether the gap has increased or not over the years can be seen from the time trend of these ratios. Another way of looking at the degree of the States' dependence is to take the proportion of revenue expenditure of the States financed by their own source revenue and their time trend. Relevant ratios for five yearly periods beginning 1960-65 and ending 1980-85 along with those for the year 1985-86 are given in Tables 1 and 2. The tables also give the ratios of the States' share to total expenditure (revenue plus capital) of the Government, States' tax revenue to aggregate tax revenue and States' own total tax revenue to their aggregate tax revenue.

It will be seen that the proportion of States' revenue expenditure in the aggregate revenue expenditure of the government in India has remained around 56 to 58 per cent in the last 25 years or so while their own revenue receipts have formed only around 35 per cent. The stability of these ratios would, on the face of it, suggest that while there is a gap between the responsibilities of the States in the matter of provision of

public services and their share in the aggregate revenue of the Government, there has not been any appreciable increase in the imbalance over the years. However, the proportion of the States' revenue expenditure financed by their own revenue receipts has registered a decline in recent years from 68 per cent in 1975-80 to 60 per cent in 1980-85 and 56 per cent in 1984-85. Evidently, the gap between expenditure and receipts has increased and this is being made up by devolution from the Centre. Viewed thus, the dependence on the Centre has increased.

However, it is also relevant to note that the States' share in the aggregate tax revenue has not declined; rather it has registered an almost steady increase for about 42-43 per cent in the 1960s to over 50 per cent in the 1980s; reflecting a larger accretion of tax revenue to the States via devolution through the Finance Commission's adjudication. Conversely, even though the Centre has been raising resources through revision of administered prices and so on, the share of total revenue receipts appropriated by it, that is, after devolution to the States has not shown any appreciable rise. If anything, there has been a slight decline. This is evidenced further by Table 3 which shows that current transfers as a proportion of gross Central revenue has not come down, rather has registered an increase since the early Seventies.

It may be argued that the degree of vertical imbalance and States' dependence suggested by the ratios presented here is misleading since the figures of revenue and expenditures taken for these ratios include those on Centrally sponsored schemes which are really of the Centre's choice, and for a proper assessment of the trends the figures relating to these schemes should be taken out. The proportion of amounts meant for the Centrally sponsored schemes in the total expenditures of the States was, however, not more than 2 per cent or so until recently. Hence the conclusion drawn here would seem to hold good even if adjustments are made to exclude the expenditures on account of these schemes though it must be added that, of late (since 1980-81), the proportion of expenditure on these

schemes in the total expenditure of the States has shown a sharp rise going up to nearly 10 per cent (double the proportion of grants for these schemes vide Table 4).

Although apparently the degree of vertical imbalance has not increased appreciably, it seems that the dependence of the States on the Central funds has increased since the proportion of these expenditures financed out of their own revenue has declined and currently about 44 per cent is met out of transfers while in 1950s the proportion was only about 25-30 per cent. Though paradoxical, this phenomenon may be due to the fact that though the States have been able to maintain their share in the total revenue receipts, their expenditures have grown faster than their revenue growth and this has been the case at the Centre too. The degree of dependence on the Centre noticeable here is not uncommon among federations. Considerations of efficiency and economy of scale suggest centralisation of certain tax powers while decentralisation is indicated in several areas of provision of public services. While theoretically one can think of an optimum degree of vertical imbalance, what should be the optimum in a given situation is not easy to specify. Given that, some degree of dependence on the federal transfers is perhaps unavoidable, the question to ask is, are the transfers decided on the basis of objectively defined and accepted principles and by an authority whose impartiality is above question?

An important reason for unhappiness with the existing system of federal transfers seems to be that contrary to what was probably intended the bulk of the federal transfers is taking place through channels other than the Finance Commission's awards or "statutory transfers" as they have come to be known. As Table 5 will show, more than 50 per cent of the total federal transfer takes the form of "Plan assistance" and discretionary grants. The proportion of statutory transfers has gone up over the years from 31 per cent in the First Plan period to over 40 per cent at present but even so, Plan transfers account for 42 per cent and discretionary grants about 17 per cent. While transfers for the Plan are guided now by the Gadgil formula, they do not have

any Constitutional sanction of the kind which the devolution through Finance Commission's awards carry. The same applies all the more to discretionary transfers. Dependence as such might not be so objectionable had the transfers been made through statutory channels on the basis of equitable principles and not through the Planning Commission which is a creature of the Centre (Dandekar, 1987).

Another point of criticism of the federal transfers especially those made through the Planning Commission has been that they have not helped in the equalisation of income levels or fiscal capacities and public services to the desired extent.

It is pointed out that the rank correlation between per capita State income in 1973-76 and statutory transfers to 14 major States (excluding Assam) during the year 1979-84 turns out to be (-) 0.746 as against (-) 0.363 for Plan assistance and (+) 0.552 for non-statutory, non-Plan transfers (Gulati and George, 1987). Exercises carried out in the NIPFP show that while there is a high (and statistically significant) degree of rank correlation between SDP of the major States and their total revenue (all per capita), this is primarily traceable to the high correlation between own revenue and SDP per capita (Table 6). As is to be expected the rank correlation between SDP and total revenue (that is, including devolution) is less than that between SDP and own revenue, reflecting the equalising effect of the federal transfers. Moreover, the correlation has decreased over the years although there seems to be a reversal of the trend in 1985-86. It is to be noted that the rank correlation between SDP and total devolution has been negative only for 1980-81 and 1985-86 and not significant, while devolutions through Finance Commissions' awards for these two years have been negative throughout and significant. It is also noteworthy that the rank correlation of tax devolution turns out to be negative and significant and also stronger than that for statutory grants in recent years. The findings given here suggest that in the award of the last two Finance Commissions, shared taxes have been more equalising than the statutory

grants. On the face of it, this looks somewhat surprising. What probably explains this phenomenon is the higher weightage given to the inverse of per capita SDP in the formulae for tax sharing in these two Commissions' awards.

Rank correlation coefficients between own revenue and federal transfers show that there is strong negative association between own revenue and total devolution but the correlation is significant and more pronounced for devolution through Finance Commissions' awards (Table 7). These exercises confirm that the federal transfers have on the whole had an equalising effect on the revenue capacity of the States and that the transfers through Finance Commission awards have exercised a stronger influence on equalisation than transfers through other channels. It is also clear that the awards of the last two Finance Commissions have had a more pronounced equalising effect than before. That federal transfers have had some equalising effect is evidenced also by the finding of another NIPFP study that while inter-State variation in own revenue has increased, that in per capita revenue expenditure of the government at the State level has not worsened (Rao, 1987).

While the Finance Commissions are complimented on their role in securing a more equitable transfer of federal funds than those occurring through the other channels, two features of the awards of the Commission have been commented upon as having exerted an unhealthy influence on the Indian fiscal system as a whole. These are: first, since the Fourth Finance Commission the task of the Finance Commissions has been viewed as one of assessing the non-Plan revenue gap of the States and ensuring that the States can begin their Plan exercise without any shortfall in their current account. This approach - viz., "gap-filling" - is believed to be responsible for generating an environment of fiscal indiscipline in India all round. The large deficits appearing on the Government's revenue budgets are attributed in the case of the Centre, partly to the rise in the devolutions occurring since the Seventh Finance Commission's recommendation and in the case of States, to the practice of virtually underwriting the revenue gaps by the Finance Com-

missions. In enjoining on the Ninth Finance Commission to keep in view the objective of not only balancing receipts and expenditures on revenue account of both the States and the Centre, but also generating surpluses for capital investment, the TOR of Ninth Finance Commission reflect the anxiety of policy makers over the imbalance in Government budgets which has been almost chronic and which if allowed to go unchecked might jeopardise planning itself.

Secondly, there has been a decrease in the proportion of grants-in-aid and a rise in the tax devolution component in the Finance Commissions' awards. This is presumably because in terms of Article 270, the Central income tax revenues have to be compulsorily shared while Union excise duties can be and are actually being shared. In other words, some devolution of taxes to all States no matter whether or not they are in need of such devolution is built into the system and, as may be seen from Table 5, the proportion of "shared taxes" in the statutory devolution has tended to increase In the Sixth Plan period in particular which is covered by the award of the Eighth Finance Commission, tax devolution constituted nearly 94 per cent of the total statutory transfer as against 76 per cent in the preceding five years. This, it is felt, affects the equalising impact of the statutory transfers.

Successive Finance Commissions have tried to achieve equalisation by making the tax sharing formula more progressive. For Union excise duties, backwardness is given substantial weightage but income tax was for a long time shared on the basis of population (80-90 per cent) and contribution or collection (20 to 10 per cent). It was only the Eighth Finance Commission which unified the sharing formula with 25 per cent on the basis of population, 25 per cent on the basis of income adjusted total population (inverse of per capita income x population) and 50 per cent on the basis of distance of per capita income from the per capita income of the richest State multiplied by population. Even under the Eighth Finance Commission's awards, 10 per cent of the divisible pool of income tax is to be distributed on the basis of collection or contribution and 1/

9 of the excise duties on the basis of deficits of the States. But as noted above, the equalising effect of transfers under the Eighth Commission is more pronounced than before. The enlargement of the Finance Commission's role in federal transfers, therefore, should not cause undue concern.

Nevertheless, the fact remains that disparities in per capita SDP among the States are growing and the federal transfers do not seem to have matched this trend. That the equalisation of federal transfers or even statutory transfers has not proceeded in step with the growing disparity in the per capita insomes (and so fiscal capacity of the States) can be seen from a comparison of changes in co-efficient of variation in per capita SDP and own revenue with those in total devolution and Finance Commission devolution (Table 8). While there is a clear indication of reduction in inequalities in the revenues of the State government by virtue of the tax devolution (coefficient of variation has increased and is strongly negative), this impact seems to have been neutralised by transfers through other channels.

Another cause for anxiety over the expanded role of the Finance Commission is that despite attempts to scrutinise and adjust the projections of revenue and expenditures of the States (and since the Eighth Commission, of the Centre also) by applying certain objective criteria or norms and to assess the likely non-Plan revenue gap on their own, the Finance Commissions have invariably ended up by mostly accepting what the States present as *fait accompli* with minor changes and recommending transfers which leave large revenue surpluses in the hands of some States while some are able to just bridge their gap. The surplus left on revenue account after discretionary devolution has increased elevenfold in the course of a decade between the period covered by the Sixth Finance Commission and that by the Eighth Commission (Lakdawala, 1984). This is perhaps unavoidable so long as there is some compulsory sharing of tax revenue and grants-in-aid play a relatively minor role in the statutory transfers.

What has added to these concerns is that there have

been inroads into the tax jurisdiction of the States (e.g., through the expansion of the base of Central excise which ideally should have been selective) and the Centre has pre-empted the States' share of excise by raising resources through administered price rise. While as shown earlier even with all this the Centre's share in the aggregate tax revenue of the Centre and the States has not gone up (Table 2), it has to be recognised that the tax revenue of the States has suffered because of the reluctance on the part of the Centre to levy and collect some of the taxes, the proceeds of which would under the Constitution, have accrued to them by virtue of Article 269.

Another important factor which seems to have contributed to the feeling of unfairness on the part of the Centre is the cornering of the market loans and borrowings and the control exercised over the allocation of internal loans. As a result of the control over borrowing by States, the States have come to rely primarily on the Centre for loans for financing investments. As of 1984-85, loans from the Centre constituted nearly 54 per cent of the gross capital receipts of the States and 45 per cent of the net receipts. For 1985-86, the proportions work out to 62 per cent and 56 per cent respectively (Table 9). As on 31st March, 1986 the total outstanding debt of the States from the Centre formed 71 per cent of their outstanding debt. In 1950-51, this proportion was 29 per cent. Considerable disparities mark the distribution of Central loans among the States; some of the richer States getting a larger share than the poorer ones and the logic behind the distribution is not clear (Chelliah, 1983).

There is a similar feeling of unfairness in the matter of access to external loans. The practice of the Centre retaining 30 per cent of external assistance given for projects and lending 70 per cent to be repaid in fifteen years at a much higher rate of interest than payable by the Centre has also been a bone of contention.

Because of the onerous terms, it is said, several States are already in the debt trap and many are close to it.

Tasks for the Ninth Finance Commission

Viewed in this background, the enlargement of the tasks set for the Ninth Finance Commission might not look unreasonable, and they might not have raised such a controversy had there been a prior formal consultation with the States and the draft TOR published in advance for our open debate. Questions of legal and procedural propriety apart (though these are also equally important in a federal set up), the substantive issues that the TOR of the Ninth Finance Commission have raised may be summed up as follows:

- How to formulate the principle of a normative approach which will be fair and at the same time not amount to imposition of subjective judgement? Should the Ninth Finance Commission accept all expenditure of the States and Centre at the present level as committed and apply brakes on some for the future or should they set up physical and financial norms for selected or common items of expenditure leaving out the uncommon items as some have suggested? Or should the norms be formulated only in aggregative terms as suggested by some (Lakdawala, 1987)?
- How will the Ninth Finance Commission go about the task of not only balancing the revenue budgets of both the Centre and the States but also generating surpluses for investment? In a way this seems to be the most challenging task set for the Ninth Finance Commission and the end result of the Ninth Finance Commission's determination will probably be judged by the extent to which this objective is met.
- In the course of their inquiry into how surpluses can be generated for capital investment, can the Ninth Finance Commission suggest or impose judgements about the propriety of certain expenditures or call for a curtailment of investment?

- Will the Ninth Finance Commission accept the Centre's expenditure on items like defence, interest and subsidy as committed?

- Are the norms relied upon by the Finance Commission going to be enforced? If so, what would be the mechanism? What would be the sanction against violation of the norms? Will it be left to the States and the Centre to do what they like once the Finance Commission's awards become operative? Or will there be monitoring? Or is it the idea that the norms used by the Finance Commission will also be applied by the Planning Commission?

- In making out norms for assessing the revenue potential, will the Ninth Finance Commission take into account the potential for raising the available taxes particularly direct taxes (income tax in the case of the Centre and property and agricultural taxes in the case of the States)? Will they also look into the merits of various exemptions and concessions given in the tax system of both the Centre and the States?

- Will the Ninth Finance Commission assess the tax revenue potential of the States already taking note of the possible yield of taxes which the Centre can levy and collect but the proceeds of which are to go to the States (e.g., the taxes on sale and purchase of newspapers and advertisements and the consignment tax)?

- What should be the relative weights of tax devolution and grants-in-aid in the statutory transfers? If, as is urged by some, the divisible pool should be taken as one, resources being fungible, should the distribution be made more through grants-in-aid so that the bias inherent in tax devolution in favour of richer States is avoided (Sarma, 1987)? Or is it possible to introduce a

greater degree of progressivity in the formula for allocation of shared taxes than before, so that the ends of equity are met without allowing too much intrusion of subjective elements? The pronounced equalising effect of the Eighth Finance Commission's formula seems to suggest that this is possible though how far this can be carried needs investigation.

- How will the Ninth Finance Commission assess the Plan component of the revenue budget of the States until the Plan is finalised? Will they undertake the task themselves or will they obtain an estimate from the Planning Commission?

- Will the Ninth Finance Commission assess the debt position of the States after taking into account the requirement of Plan programmes and if so how will they go about it? Can they take over the functions of the Planning Commission?

- Will the Ninth Finance Commission make recommendation for transfers under Article 282 also? If so, what would be the role of the Planning Commission in the future?

- As for debt and borrowing, the past Finance Commissions have been making recommendations for debt relief of the States by rescheduling and so on but this does not seem to have yielded a satisfactory solution and it also tends to breed an unhealthy attitude towards debt on the part of the States. The problem has become intractable, as there is no source from which even the richest States can repay their loans to the Centre. It has been suggested that the terms and conditions might be more liberal right at the beginning (Lakdawala, 1984). What could be the right lines of solution to this problem? Or should the task of overseeing the loan problem and allocation of

loans be given to National Loans Council as is sometimes suggested (Chelliah, 1983)?

- Among the items in the TOR which have raised strong protests, a prominent one is the suggestion for merger of additional excise in lieu of sales tax in basic excise. Can the Ninth Finance Commission ignore this in case they feel inclined to do so?

- Can the Ninth Finance Commission devise a way of tackling disaster relief which will be fair and acceptable and at the same time avoid the unhealthy tendencies which the existing systems seem to have given rise to?

- The constitutional mechanisms for inter-governmental transfers in the Indian system have taken no account of the requirements of local governments. Many of the local bodies including large municipal corporations have come to depend heavily on subventions from their respective State governments. These subventions are given mostly by way of gap-filling and not based on any sound principle. As a result, there has been a tendency towards lack of effort to raise resources on the part of local governments. Also, it has led to disparities and inequities between urban areas (Datta, Abhijit, 1982). There is no specific reference to these deficiencies in the TOR of the Ninth Finance Commission. But finances of local bodies may have to be gone into in assessing the budgetary requirements of the States. Will the Ninth Finance Commission look into local finances also and if so, how?

In conclusion it needs to be added that for evolving a satisfactory institutional arrangement to take care of the problems in Centre-State financial relations, and correcting the deficiencies which have come to notice, one has to look

beyond the Constitutional provisions as they exist at the moment. For it should be kept in mind that after all the basic framework of financial relations between the Centre and the States was drawn up largely on the pattern of the government of India Act 1935 and our Constitution-makers probably had not anticipated the demands on the public sector which the planning and development effort might entail (Datta, 1984). Therefore, if the institutions which have evolved over the years and come to play an important role in the nation's economic development (like the Planning Commission and the NDC) are found lacking in Constitutional sanction, it may not be right to reject all that has been done by them as illegal but to find ways in which their role can be defined with some clarity and regulated by law. Similarly, there are matters in which new institutions might need to be created, e.g., a National Loans Council. Even with the best of intentions the Ninth Finance Commission may not be able to meet all the requirements or deficiencies of the existing situation as some of them would call for actions not within their purview (e.g., amendment of the Constitution to give legal backing for Planning Commission and evolving a satisfactory mechanism for devolution of resources to local governments). But with the relaxation of some of the constraints which had tended to narrow down the ambit of previous Commissions' jurisdiction, the Ninth Finance Commission has opportunity to give a new direction to the evolution of Centre- State financial relations, which the previous Finance Commissions possibly did not have or did not feel inclined to seize. How the Ninth Finance Commission goes about the challenging tasks set for it will be watched with keen interest by all who are interested in the healthy development of the federal relations in India and the country's economic development.

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TABLE 1

***States' Share in Revenue Expenditure and Total Expenditure of the Government and Proportion of States' Expenditure Financed by States' Own Resources and Total Receipts**

(Per cent)

Average for the period	States' revenue expenditure/ aggregate revenue expenditure	States' total expenditure/ aggregate government expenditure	States' own revenue receipts/States' revenue expenditure	States' own total receipts/ States' total expenditure
1960-65	55.56	51.28	65.57	54.76
1965-70	58.83	53.80	61.40	54.50
1970-75	59.46	49.16	58.62	56.23
1975-80	55.79	51.42	68.00	57.49
1980-85	58.17	53.58	60.21	53.08
1985-86 (R.E.)	56.61	52.08	56.34	52.21

* Includes Union Territories.

Source: Government of India, Ministry of Finance, Public Finance Statistics.

TABLE 2

***States' Share in Tax Receipts, Revenue Receipts and Aggregate Receipts**

(Per cent)

Average for the period	State's total tax receipts/ aggregate tax revenue	States' own revenue/ aggregate tax revenue	States' own revenue receipts/ aggregate revenue receipts	States' own source of total receipts/ aggregate Govt. receipts
1960-65	42.65	31.23	33.98	28.70
1965-70	43.76	31.58	34.84	31.51
1970-75	46.87	31.19	33.84	33.26
1975-80	47.17	32.49	34.63	31.68
1980-85	51.53	34.33	35.88	32.11
1985-86 (R.E.)	50.02	33.48	35.41	26.18

* Includes Union Territories.

Source: Government of India, Ministry of Finance, Public Finance Statistics.

TABLE 3

Current Transfers to States as Per cent of Gross Central Revenues

(Per cent)

Averages of	Current Central transfers
1970-71 to 1974-75	32.78
1975-76 to 1979-80	31.96
1980-81 to 1984-85	32.78
1985-86 to 1986-87	34.70

Source: Government of India, Ministry of Finance, Public Finance Statistics, Part II (Annual).

TABLE 4

Share of Centrally Sponsored Schemes in the Total Expenditure of the States

(Rs crore)

Year	Grants under Centrally Sponsored Schemes	Total Revenue Expenditure	Col (2) as a per cent of Col (3)
1973-74	147.7	8260.8	1.79
1975-76	157.2	10457.3	1.50
1980-81	389.5	22769.9	1.71
1984-85	1310.9	39745.7	3.30
1985-86 (R.E.)	2216.0	45770.9	4.84

Source: RBI Bulletin.

TABLE 5

Devolution of Federal Funds from Centre to States in India

(Rs. million)

	Plan	Statutory Shared taxes	Transfers Total	Plan transfers	Discre-tionary transfers	Total
1.	First Plan (1951-56)	3440 (24.04)	4470 (31.24)	3500 (24.46)	6340 (44.30)	14310 (100.00)
2.	Second Plan (1956-61)	6680 (23.29)	9180 (32.29)	10580 (36.89)	8920 (31.10)	28680 (100.00)
3.	Third Plan (1961-66)	11960 (21.36)	15900 (28.39)	27380 (48.89)	12720 (22.71)	56000 (100.00)
4.	Annual Plan (1966-69)	12820 (23.98)	17820 (33.33)	19170 (35.85)	16480 (30.82)	53470 (100.00)
5.	Fourth Plan (1969-74)	45620 (30.21)	54210 (35.90)	47310 (31.33)	49490 (32.77)	151010 (100.00)
6.	Fifth Plan (1975-79)	82720 (32.62)	109360 (43.13)	103750 (40.92)	40440 (15.95)	253550 (100.00)
7.	Sixth Plan (1980-85)	269520 (38.20)	287770 (40.79)	294790 (41.78)	122950 (17.43)	705510 (100.00)

Note: Figures in parentheses represent percentage to total. **Source:** Rao (1987)

TABLE 6

Rank Correlation Between SDP And Revenues of Major States

	Total Revenue	Own Revenue	Plan Grants	Total Grants	Finance Commission Devolution	Shared Taxes	Statutory Grants	Other Grants
Rank Correlation 1970-71	0.84*	0.87*	-0.22	0.19	-0.27	-0.09	-0.23	-0.31
Rank Correlation 1975-76	0.85*	0.88*	-0.38	0.03	-0.45#	0.15	-0.37	0.72*
Rank Correlation 1980-81	0.58*	0.65*	-0.29	-0.42	-0.40	-0.45#	-0.22	-0.27
Rank Correlation 1985-86	0.73*	0.79*	-0.24	-0.37	-0.57**	-0.55**	-0.47#	0.05

Notes: * Significant at 1 per cent level.
** Significant at 5 per cent level.
# Significant at 10 per cent level.

TABLE 7

Rank Correlation Between Own Revenue and Grants/Devolution

Rank correlation	Shared taxes	Statutory grant	Other grants	Plan grants	Total Devolution	Finance Commission Devolution
1970-71	-0.87	-0.41	-0.55**	-0.29	-0.17	-0.45#
1975-76	0.13	-0.59**	0.72*	-0.44#	-0.22	-0.65*
1980-81	-0.34	-0.71*	-0.38	-0.22	-0.28	-0.49#
1985-86	-0.76*	-0.71*	-0.04	-0.18	-0.64**	-0.81*

Notes: * Significant at 1 per cent level.
** Significant at 5 per cent level.
# Significant at 10 per cent level.

TABLE 8

Coefficient of Variation in Per Capita SDP, Revenue and Federal Transfers

Year	State Domestic Product	Total Revenue	Own Revenue	Shared Taxes	Total Grants	Plan Grants	Statutory Grants	Other Grants	Total Devolution	Finance Commission Devolution
1970-71	27.09	26.41	44.04	7.09	60.92	58.03	133.48	79.43	25.25	22.48
1975-76	30.16	26.62	42.38	4.76	55.12	33.37	124.82	71.96	22.19	27.53
1980-81	31.54	21.49	36.09	9.27	42.63	51.23	207.01	53.30	16.85	11.60
1985-86	32.18	23.12	42.90	18.39	37.20	47.60	160.01	39.54	23.28	24.59

TABLE 9

Borrowings of State Governments

(Rs. crore)

	1984-85	1985-86(RE)
1. Capital Receipts (Gross) of which:	102.82	131.77
Loans from Centre (Gross)	59.10 (54.3)	81.95 (62.2)
2. Repayments		
(i) Discharge of Internal Debt	5.97	5.48
(ii) Repayments to Centre	23.30	25.06
(iii) Total of (i) and (ii)	29.27	30.54
3. Net Borrowing of States of which	79.55	101.23
From Centre	35.80 (45.1)	56.89 (56.2)

Note : Figures in brackets indicate percentages to respective totals.

Source: RBI Bulletin, November, 1986.

Issues Before the Ninth Finance Commission: On Closing Pandora's Box

S. Guhan*

The Basic Mandate

Articles 280(3) (a) and (b) of the Constitution, which contain the basic mandate for Finance Commissions, require that they shall be called upon to recommend the distribution between the Union and the States, and between the States, of shareable taxes under Articles 270 (income taxes other than the Corporation tax) and 272 (Union excise duties) and to recommend grants-in-aid to States which may be "in need of assistance" under Article 275. Paragraph 3 of the Presidential notification of 17 June 1987 constituting the Ninth Finance Commission repeats this mandate and paragraph 4 sets forth a set of considerations which the Commission shall bear in mind while discharging.

Article 280(3) (c) enables "other matters" to be referred to Finance Commissions 'in the interests of sound finance'; and, in the case of the Ninth Commission, terms of reference relating to additional excise duties, grants in lieu of the repealed railway passenger tax, debt relief, and financing of expenditures on natural calamities have been included under this category in paragraphs 5,7,8 and 9 of the notification. Leaving aside these important but subsidiary matters, we shall confine this paper to an examination of the issues involved in the manner in which the Ninth Commission has been called upon to approach its basic mandate of transfers under Articles 270, 272 and 275.

The Guidelines

According to the considerations set forth in paragraph 4 of the notification, the Commission, in formulating its scheme for transfers, is to confine itself to the revenue account of the Centre and the States. The entire revenue account of the States and the Centre has been brought under the purview of its exercise (albeit implicitly) since, in contrast with the past practice, no distinction has been made in these guidelines between Plan and non-Plan categories of revenue receipts and expenditures. The stated objectives will be not only to balance revenue receipts and expenditures in the federal system as a whole comprising the States and the Centre but also to generate revenue surpluses that can be available for financing capital investments at both levels. In evaluating the potential of the Centre to effect transfers and the needs of the States (as a whole and individually) to be met from transfers, the Commission is to apply the following considerations:

(a) adopt a normative approach to assess receipts and expenditures

(b) keep in view special problems, inescapable requirements, and committed expenditures and liabilities

(c) provide adequate incentives for better resource mobilisation and financial discipline, and

(d) bring about closer linking of expenditure and revenue- raising decisions.

The necessity, desirability, legality, and propriety of the Centre issuing guidelines to Finance Commissions have all been questioned[1]. These issues are important but we shall desist from entering into them within the scope of this paper. Doubts have also been raised whether the considerations listed in the previous paragraph are meant to be, or will in fact be, applied in a non-discriminatory manner to both the Centre and the States[2]. We shall assume that the Ninth Commission will reasonably

interpret the guidelines and apply them uniformly to the Centre and the States.

Our departure point is that in substance the considerations, which have been laid down in the form of guidelines to the Ninth Commission, are to be unreservedly welcomed from the standpoint of 'sound finance'. It is only appropriate that the Commission should have been required to assess the needs of the Centre and the States on the basis of normative yardsticks for receipts and expenditures while also taking account of their special problems and requirements. Incentives for financial discipline and for better resource mobilisation are obviously desirable. The objective of securing revenue surpluses in the Centre and the States is particularly wholesome. Revenue surpluses are needed in budgets to reduce and/or retire debt which, when invested on public investments such as infrastructure, power, and irrigation, does not generate adequate internal returns for amortisation. Revenue deficits in so far as they are met by borrowing tend to escalate by entailing increased interest payments and, if unchecked, can result in a debt-trap[3]. If 'sound finance' thus underlines the importance of revenue surpluses, it is equally important to generate them, if possible, at the levels of the Centre and each of the States in the interests of equity, accountability and financial discipline.

Plan and Non-Plan

Some explanation is, however, necessary about the guideline which extends the scope of the Finance Commission's exercise to the entire revenue account, Plan as well as non-Plan. By way of background, it is necessary to recall that while the Constitution specified the shareable taxes under Articles 270 and 272 and grants-in-aid under Articles 275 as the sources of revenue which fell within the purview of the Finance Commission's award, it did not delimit the nature of the needs - revenue and/or capital, Plan and/or non-Plan - to be covered by Finance Commission transfers for the simple reason that the planning process, which began with the First

Five Year Plan in 1951, had not been initiated when the Constitution came into force in 1949. The first three Finance Commissions (1952-57, 1957-62 and 1962-66), while drawing up their scheme for transfers under Articles 270, 272 and 275, took note of requirements on account of the Plan as well as on the revenue side and, in fact, the terms of reference for the Second and the Third Commissions specifically required them to do so. This position, however, changed since the Fourth Commission (1966-69) and the circumstances under which it happened have been succinctly summarized in the following extract from the report of the Fourth Commission (pp 8-9):

> "When the provisions regarding the Union-State financial relations were incorporated into the Constitution, it was not possible for any one to anticipate the importance and magnitude of our successive Five Year Plans. There was no reference to Plan expenditure as such in the terms of reference of the First Finance Commission (November 1951-December 1952) and that body did not find it necessary to draw a line of distinction between Plan and non-Plan expenditure. In fact, it emphasised the need for taking into account development expenditure of various types in determining the transfer of resources from the Centre to the States. The Second Finance Commission (June 1956- September 1957) was, however, specifically asked to take into account both the requirements of the Second Five Year Plan and the efforts made by States to raise additional resources....... The Third Finance Commission (December 1960-December 1961) recommended grants under Article 275 to cover 75 per cent of the States revenue expenditure on the Third Plan but the Government of India did not accept this recommendation.
>
> The terms of reference of the Fourth Finance Commission do not expressly mention Plan

> expenditure. The Constitution does not make any distinction between Plan and non-Plan expenditures and it is not unconstitutional for the Finance Commission to go into the whole question of the total revenue expenditure of the States.... It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of Plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new Plan expenditure".

This position was formalised in the terms of reference provided to successive Finance Commissions from the Fifth (1969-74) to the Eighth (1984-89). Accordingly, for more than two decades now (1966-89), the Finance Commissions have directed their transfers with reference to the States' needs on the non-Plan revenue account while the Planning Commission has mediated Plan grants to States as part of overall Plan assistance from the Centre.

The erasure of the distinction between the Plan and non-Plan segments of the revenue account, therefore, marks an important break with past practice but it can not be argued on this ground alone that it is inappropriate to extend the scope of the Finance Commission's exercise to the Plan revenue account as well. On the contrary, an integrated view of the Plan and non-Plan revenue account is desirable; and, in fact, necessary for reasons which have been well-stated in the following words from the report of the Third Commission (pp 30-31):

> "It seems to us that to draw a line necessarily arbitrary on the basis of Plan and non-Plan expenditure in their treatment is not really sound. We see little merit in inducing a State to

continue to incur expenditure on objects however desirable, when the rest of its resources are insufficient to meet the basic requirements of its administration and the more pressing needs of other programmes which fall outside the Plan. It has to be remembered that a high proportion of what is classified as non-Plan expenditure is itself due to projects launched in previous Plan periods for which maintenance and upkeep becomes a non-Plan liability of the States. There is yet another reason why we are inclined to regard the entire revenue budget of a State - whether Plan or non-Plan - as an integral whole. Some of the States will, as a result of the devolution, which we are proposing, have a surplus position in the non-Plan sector of their revenue budget. It is but legitimate that this surplus should be earmarked for the purposes of the Plan. On all these considerations, we see considerable advantage in devising a machinery for taking an integrated view of Plan and non-Plan expenditure of the State as a whole".

Having said this, it can be readily seen that the terms of reference for the Ninth Commission carry an important implication for the Gadgil formula for Central Plan assistance to the States. This formula was adopted by the National Development Council (NDC) in 1968 and modified since then in 1976 and 1980, on each occasion by the NDC. In extending the scope of the Finance Commission's exercise to the Plan revenue account, the Gadgil formula has been superseded at least as far as transfers on the Plan revenue account are concerned: the Finance Commission has not been required to keep the Gadgil formula in mind and is free to recommend its scheme of devolution as if the formula did not exist. In effect, the Centre has, in one stroke and unilaterally, wiped out a set of decisions arrived at in the federal conclave of the NDC over a period of two decades. This has been done without notice to, not to speak of consultation with the States and amounts to a major infringement of the proprieties of Centre-State relations as they have evolved. Seven

non-Congress(I) Chief Ministers, who met in Calcutta on December 15, 1987, have decided to take up this matter with the Centre and we will have to let this controversy take its course.

However, in approaching its received terms of reference, the Ninth Finance Commission need share no part of the guilt inherent in the Centre's misdemeanour. It can, in fact, feel pleased that the lost glory of the 1952-66 era has been restored to the Finance Commissions. As far as the current Finance Commission itself is concerned, the critical issues involved in its terms of reference do not lie in their content or origin but in their feasibility. The central problems that the Commission will have to worry about relate to the extent to which it is feasible, as part of a Finance Commission's report, to arrive at, or at least to promote, a scheme for Centre-State revenue transfers that generates revenue surpluses in all the States and in the Centre, takes account of committed or inescapable liabilities, employs normative yardsticks for receipts and expenditures whether Plan or non-Plan, and is designed to promote additional resource mobilisation, financial discipline, and the linking of expenditure and revenue-raising decisions. The feasibility of doing all this has first to be evaluated against the magnitudes and trends in recent years relating to revenues, revenue expenditures, and transfers on the revenue account (Plan and non-Plan) in the Centre-State financial system. On this basis, the lessons that emerge could be expected to suggest the lines on which the Finance Commission could usefully approach its mandate.

Scope of the Paper

To put it differently, the terms of reference for the Finance Commission have opened a Pandora's box: according to Hesiod's myth, Jupiter gave Pandora a box and when she opened it out of curiousity all human ills flew forth and only Hope remained. In what follows we shall dwell on the pestilential contents of the box and, thereafter, draw some pointers on what it will involve to close the box so that hope may continue to remain within.

Section II provides an analysis of the revenue account position in the Centre and in the States (treated as a group) in 1974-87. Section III extends the discussion to an examination of the position in each of the 15 major States in 1979-84. Section IV, which begins with an overview of the trends in 1979-87, defines the Ninth Finance Commission's tasks against that background and proceeds to suggest an integrated formula for effecting vertical and horizontal transfers from the Centre to the States and between the States. Section V sums up the discussion and draws the implications for the interface between the Ninth Finance Commission and the Planning Commission.

Revised Estimates (RE) for the States, and figures for 1986-87 are RE for the Centre and Budget Estimates (BE) for the States.

The following trends can be noted from this table:

(i) During 1974-79, surpluses were recorded in each year in the revenue accounts of both the States (as a whole) and the Centre. Taking the States and the Centre together the annual average revenue surplus was Rs. 1460 crore enabling about 72 per cent of the capital deficit to be financed from revenue surpluses.

(ii) Following the award of the Seventh Finance Commission, which doubled excise-sharing from 20 to 40 per cent, the Centre's revenue account went into a deficit of Rs. 976 crore in 1979-80. It remained in the red in each of the years between 1979-84 with the deficit reaching a level of Rs. 2540 crore in 1983-84. The combined revenue surpluses of the States peaked at Rs. 1548 crore in 1979-80, as a result of the quantum jump in the tax transfers effected in the Seventh Commission's award, but since then these surpluses dwindled reaching a figure of Rs. 210 crore in 1983-84. Taking the States and the Centre together, the overall revenue position was in deficit in 3 out of the 5 years during 1979-84; and for the five-year period as a whole the average annual combined revenue deficit was Rs. 347 crore, which along with the deficit on capital

transactions, had to be financed through monetary expansion.

(iii) Revenue deficits in the Centre have sharply escalated to Rs. 4224 crore in 1984-85, Rs. 5565 crore in 1985-86 and Rs. 7233 crore in 1986-87 (RE). Turning to the States, their small combined revenue surplus of Rs. 210 crore in 1983-84 turned into a deficit of Rs. 924 crore in 1984-85. Small revenue surpluses in the States' sector have been recorded in the RE for 1985-86 and BE for 1986-87 but the correct position will be known only when actuals are available. For 1984-87 as a whole, there has been a dramatic worsening in the combined revenue position of the Centre and the States with the overall revenue deficit being as high as an annual average of Rs. 5798 crore in the Centre-State budgetary system as a whole (hereafter, referred to as the system).

Thus the quinquennium of 1979-84 represents a turning point. The award of the Seventh Commission created a revenue deficit in the Centre's account and a countervailing revenue surplus in the States' sector at the beginning of the period. Since then, the Centre's revenue deficits have generally tended to widen while the combined revenue surplus with the States has tended to be whittled down. In the period starting with 1984-85, there has been a striking increase in the levels of the Centre's revenue deficits while the States have been just about able to balance their revenue account; and, in the system as a whole, overall revenue deficits reflect the large deficits in the Centre.

The following table will help to appreciate in one view the deterioration in the revenue account position that has taken place between 1979-84 and 1984-87 in the combined position of the Centre and the States revenues, total revenue expenditures,

	1979-84 Annual	1984-87 Annual Average
1. Aggregate Centre & State revenue deficit (Rs.crore)	347	5798
2. Above as per cent of aggregate revenues	1.1	10.5
3. 1. above as per cent of aggregate revenue expenditure	1.1	9.5
4. 1. above as per cent of aggregate revenues and revenue expenditure taken together	0.6	5.0

and the sum of the two; the last of these provides a compact measure of the resource mobilisation-cum-economy effort needed to restore equilibrium. The relevant ratios were 7.5 per cent, 7.0 per cent and 3.6 per cent in 1979-84. These indicators have nearly all doubled to 15.9 per cent, 13.7 per cent, and 7.4 per cent, respectively in 1984-87 with the absolute size of the average annual deficit nearly quadrupling from Rs. 1449 crore in 1979-84 to Rs. 5674 crore in 1984-87. This large relative increase is the result of the disparity in the rates of growth of expenditures (98.4 per cent between the two periods) and revenues (84 per cent).

Throughout 1979-84, the States enjoyed a revenue surplus but its level steadily declined during the period and a revenue deficit emerged in 1984-85. A surplus was re-established in 1985-86 (RE) as the result of a good additional mobilisation effort in that year but its level declined again in 1986-87(BE). In 1984-87 as a whole, on an annual average basis, the States were in revenue deficit but the size of the deficit was quite small in relation to their revenues (0.4 per cent), expenditures (0.4 per cent) and the sum of the two (0.2 per cent). In terms of absolute figures, the deterioration was from an average annual surplus of Rs. 1102 crore in 1979-84 to an average annual deficit of Rs. 124 crore in 1984-87 reflecting the slower growth in revenues (73 per cent) vis-a-vis, expenditures (84.7 per cent) between the two periods.

The composite picture for the Centre and the States taken together (Table 3) shows a dramatic increase, nearly 16-fold, in the combined revenue deficit from Rs. 347 crore (annual average) in 1979-84 to Rs. 5798 crore (annual average) in 1984-87. Between 1979-84 and 1984-87 gross revenues in the system increased by 78.3 per cent and total revenue expenditures at the significantly faster pace of 94.9 per cent. The ratios of the overall revenue deficit to overall revenues, expenditures, and their sum increased from 1.1 per cent, 1.1 per cent and 0.6 per cent in 1979-84 to 10.5 per cent, 9.5 per cent and 5 per cent in 1984-87. This has happened because revenue surpluses were available in the States during 1979-84 to offset deficits in the Centre whereas in 1984-87 the Centre's deficits escalated and the States' surplus was wiped out.

Revenues

In comparison with the buoyancy in the Centre's gross revenues (84 per cent), the growth in gross revenues in the States (including Central transfers) between 1979-84 and 1984-87 was sluggish (73 per cent), and the growth in States own revenues (net of Central transfers) even more so (68.7 per cent).

Gross revenues in Tables 2,3 and 4 include additional resource mobilisation (ARM) which has served to augment the revenue base. In order to give a measure of ARM in the Centre and the States, we have in Table 5 related ARM to the revenue base and to GNP (current prices). It can be seen that overall ARM has improved somewhat between 1979-84 and 1984-87 in absolute figures but there is a deceleration in the ratio of ARM to the relevant revenue base. In relation to their own-revenue base the States have shown a lesser ARM effort than the Centre in 1979-84 but a much better effort in 1984-87.

Non-tax revenues have accounted for 18 to 20 per cent of total revenues in the Centre and for 27 to 29 per cent in the States. The structure of non-tax revenues at both levels is brought out in Table 6. Interest receipts dominate in the Centre partly because receipts from commercial departmental under-

takings (such as P&T) have been netted out in the Centre's budgetary data along with expenditures on them. The States obtain most of their non-tax revenues from forest receipts, mineral and oil royalties, irrigation charges, agricultural recoveries, receipts from Departmental schemes such as dairy projects. At both levels, profits and dividends from public sector are a very small proportion of total non-tax revenues; in the Centre's case they appear somewhat larger because of the inclusion of the profits of the RBI. Between the two periods, non-tax revenues have grown faster than tax revenues in the Centre while the trend has been the reverse in the States.

Central Revenue Transfers

Transfers from the Centre to the States on the revenue account take place in the following ways: (a) tax-sharing and statutory grants under the awards of the Finance Commission. We shall call this FC transfers or devolution (b) Plan grants, whether for State Plan schemes under the Gadgil formula (as modified from time to time) or for Central and Centrally-sponsored schemes implemented by the States (c) non-Plan, non-statutory grants which are mainly made for financing the relief of natural calamities. Because the latter are specific and fluctuating, we have netted them out of the States' non-Plan expenditures and added them to the Centre's. Accordingly, Tables 2 and 3 have shown only FC transfers and Plan grants and their total has been referred to as Central revenue transfers.

Revenue transfers are an important element in the revenue accounts of both the Centre and the States. FC transfers were 65.3 per cent of total transfers in 1979-84 with the balance being Plan grants. But, with a much faster growth in the latter (103 per cent) vis-a-vis, the former (67.9 per cent), this proportion has declined to 60.9 per cent in 1984-87. The growth in FC transfers in 1984-87 was only slightly above the buoyancy in the shareable taxes (66.4 per cent) indicating that the award of the Eighth Finance Commission represented only a marginal improvement over that of the Seventh; besides, since 1981-82 itself, the Centre has been following a policy of tax concessions

which have reduced the States' share in shareable taxes[4]. Even so total transfers (net of additional excise duties in lieu of sales taxes which are to be treated as tax-rentals) have amounted to large proportions of the Centre's gross receipts (net of additional excise) from income-tax and Union excise duties - the two "shareable" taxes under Articles 270 and 272 of the Constitution being 79.7 per cent in 1984-87[5]. In other words, a very large proportion of the two taxes which, under the Constitution, `are to be, or may be', shared are already being made over to the States in one form or another.

Revenue transfers accounted for 35.4 per cent of gross revenues and for 32.9 per cent of expenditures in the Centre's revenue account in 1979-84. Because of a slower growth in transfers, vis-a-vis, the Centre's revenues or expenditures, these proportions declined in 1984-87 to 34.6 per cent and 29.9 per cent, respectively. Viewing transfers from the angle of the State's revenue account, their importance is borne out by the fact that they amounted to 59.6 per cent of States' own revenues and to 39.7 per cent of States' total expenditures in 1979-84. On account of the sluggish growth in States' own revenues, the former ratio increased to 63.6 per cent in 1984-87, while, because of a faster growth in States' expenditures, the latter ratio declined somewhat to 38.7 per cent.

Table 7 sets forth the revenue-expenditure imbalances in the revenue accounts of the Centre and the States, and vis-a-vis each other, in 1979-84 and in 1984-87 prior to Centre-State revenue transfers and the positions that obtained ex-post of transfers. Prior to transfers, the States' own revenues were 37.2 per cent of the total (Central and State) revenues and 55.2 per cent of the total revenue expenditures in 1979-84. Transfers improved the former proportion to 59.4 per cent and created a surplus with the States and a deficit in the Centre. In 1984-87, transfers to the States have been just about adequate to balance their revenue account leaving almost the whole of the overall (Centre and State) deficit to be borne by the Centre in its account. In both periods, the Centre has taken on an unequally high share of the deficit in the system in its accounts with the extent of transfers being the factor leading to this result.

It should also be noted that FC devolutions have been large enough not only to cover the States' non-Plan revenue gaps in 1979-84 but have made a substantial contribution to total resources deployed in the States for Plan revenue expenditures and for building up revenue surpluses thereafter. Table 8 will show that post-devolution surpluses contributed 47.3 per cent to such total financing requirements in 1979-84. With non-Plan expenditures growing faster than devolution, this ratio has declined to 31.3 per cent in 1984-87 but is still significant.

Central Plan grants have amounted to 69.8 per cent of Plan revenue expenditures in the States in 1979-84 and to 67.5 per cent in 1984-87. 41.5 per cent of Plan grants in 1978-84 were for Central and Centrally sponsored schemes (mainly IRDP, NREP, RLEGP and family welfare); this element has grown much faster than Gadgil formula-based grants for State plans with the result that its proportion in total Plan grants increased to 52.2 per cent in 1984-87.

Non-Plan Expenditures

Non-Plan expenditures are the single most important of all expenditures on the revenue account in the Centre (64.9 per cent of the Centre's total expenditures and 92.6 per cent of its 'own expenditures' excluding transfers in 1984-87) as well as in the States (77.6 per cent of total expenditures in 1984-87). Non-Plan expenditures have increased faster in the Centre (105.5 per cent) than in the States (78.5 per cent) although at both levels their growth has been at significantly lower rates than Plan revenue expenditures.

The structure of non-Plan expenditures in the Centre and in the States is reviewed in Table 9. Interest payments, defence revenue expenditures, and subsidies - major (food, fertilisers, export promotion) and other (railways, textiles, interest subsidies, etc.) - accounted for 72.1 per cent of non-Plan expenditures in the Centre in 1979-84 with this proportion going up to 74.1 per cent in 1984-87. Other non-Plan,

non-development expenditures (such as general administration, tax collection, internal security, and non-Plan, non-statutory grants to States) accounted for 18 to 19 per cent and non-Plan development expenditures on social and economic services for 8 to 9 per cent.

The structure of non-Plan expenditures in the States is quite different. They have no commitments on defence and their relative burden on interest payments is much smaller than that of the Centre. On the other hand, the States have to incur large current outlays on the continuation and maintenance of developmental facilities in sectors such as education, health, social welfare, and agriculture. Consequently, non-Plan expenditures of a developmental character accounted for more than 60 per cent of total non-Plan expenditures in their case. The relative proportion of such expenditures however declined from 66.1 per cent in 1979-84 to 62.5 per cent in 1984-87 indicating higher growth meanwhile, mainly in interest payments and, to a smaller extent, in non-Plan non-development expenditures (such as on general administration, police, and subsidies at the State level).

Plan Revenue Expenditures

Tables 2 and 3 have shown that both in the Centre and the States Plan revenue expenditures have grown much faster than non-Plan expenditures between 1979-84 and 1984-87. Looking at it in another way, Plan revenue expenditures were 4.4 per cent of the total revenue expenditures in the Centre and 19.8 per cent in the States in 1979-84; and these proportions increased respectively to 5.2 per cent to 22.4 per cent in 1984-87. This trend is in part a result of the increases in overall Plan outlays (revenue and capital) and in part reflects an increase in the proportion of revenue outlays in the total Plan size[6]. The latter ratio has gone up from 9.7 per cent to 10.9 per cent in the Centre between 1979-84 and 1984-87. In the same period, the corresponding ratios have increased from 49.6 per cent to 52.2 per cent in the States, indicating that current outlays, rather

than investment form a major portion of the Plan in the States' sector.

Table 10 sets out the financing pattern for the Plan on the revenue account in the Centre, the States and the two together. In 1979-84, the Centre was in deficit (ex-post of transfers to States and including its ARM) to the extent of Rs. 536 crore even prior to financing its Plan revenue expenditures and after financing them, its deficit increased to Rs. 1449 crore. On a similar basis, pre-Plan resources available to the States in this period came to Rs. 4509, and after meeting Plan revenue expenditures, they were left with a final surplus of Rs. 1102 crore. In the system as a whole, the final deficit (Rs. 347 crore) was 8 per cent of the Plan revenue expenditure. In 1984-87, pre-Plan resources showed a large deficit of Rs. 3524 crore in the Centre; in the States, the available surplus of Rs. 7024 crore came to 98.3 per cent of Plan revenue expenditures. In the system as a whole available pre-Plan resources (Rs. 3500 crore) were only 37.6 per cent of Plan revenue expenditures (Rs. 9298 crore); or, in other words, Plan revenue expenditures were financed by revenue deficits to as high an extent as 62.4 per cent.

State-wise Analysis

We have discussed in some detail the revenue account in the Centre, the States, and the two together in terms of its components in 1979-84 (the award period of the Seventh Commission) and in 1984-87, which is the most recent period for which published data is available. The magnitudes, trends and relationships which have been brought out in this review, provide an input for a discussion of the tasks involved in any attempt to arrive at a scheme for vertical transfers from the Centre to States as a whole that takes account of their respective commitments and needs and is at the same time capable of balancing the revenue account at both levels. However, our review so far has been only at the level of the States as a whole and in as much as the Finance Commission is concerned not only with vertical transfers but also concurrently with their appropriate horizontal distribution *inter-se* between individual

States, we shall have to complete our framework by looking at how different States have fared. For this purpose, we shall proceed in this section to look into the revenue accounts of the 15 major States,[7] with special reference to the role of Central transfers, in 1979-84 viz., the award period of the Seventh Commission which is the most recent completed award period and is also one for which actuals are entirely available.

Data relating to the revenue account in regard to revenues, expenditures, and the financing pattern are presented in Tables 11, 12 and 13 respectively for the 15 major States in 1979-84. The States have been arranged in descending order of their average per capita incomes (current prices) in 1979-84 i.e., from the 'richest' to the 'poorest'. All figures (unless otherwise stated) have been standardized in terms of per capita averages in 1979-84 using 1981 population figures. Corresponding figures for all 22 States (i.e., including the non-major States of which there were 7 in 1979-84) are provided for comparison.

Revenues

Table 11 will show the considerable variation in per capita tax revenues ranging from about Rs. 48 for Assam and Bihar to Rs. 254 for Punjab. Per capita non-tax revenues have been relatively more convergent with the standard deviation in their case being 22.7 compared to 65.3 in tax revenues. Non-tax revenues have particularly benefitted some of the poorer States (e.g. Rajasthan, Assam, Madhya Pradesh and Orissa). However, because the dominance in all States of tax revenues is also large with a standard deviation of 65.5, the rank correlation coefficients[8] between per capita income on one hand (descending order) and per capita tax (0.8964) and total revenues (0.8750) on the other (descending order) are very high while the coefficient (0.6179) is much smaller in the case of per capita income, vis-a-vis, per capita non-tax revenues (both descending order). In other words, the richer States strongly tend to have relatively high levels of total as well as tax revenues but the association becomes weaker when it comes to non-tax revenues.

Taking per capita income as a surrogate for the 'tax potential' in the State, the ratio of per capita tax revenues to per capita income (T/Y) supplies a simple and straightforward 'first-information' indicator of 'tax effort'. Similarly, the ratio of per capita total revenues to per capita income (R/Y) can be taken as a measure of the overall 'revenue effort'. Table 11 provides the data on these indicators as well. The rank correlation coefficient (0.5679) between per capita income and tax effort (both descending order) is distinctly weaker than that (0.8964) between per capita income and per capita tax revenues (both descending order). The rank correlation (0.4600) between per capita income and overall revenue effort (both descending order) is weaker still. In other words, many of the relatively poorer States have displayed better tax and/or revenue effort than some of the richer States, although the latter enjoy higher levels of tax and total revenues. In particular, the four southern States - Karnataka, Andhra Pradesh, Kerala and Tamil Nadu - have shown a tax effort better than, or comparable to, Punjab, Haryana, Maharashtra and Gujarat which are in the highest income bracket. Madhya Pradesh, which is in the low-income end of the spectrum has a tax effort ratio not far behind that of Punjab, the richest State. Per contra, West Bengal, which is fifth in the income-scale, is 11th among the 15 States when it comes to its tax effort. The association between per capita incomes and overall revenue effort is even more feeble because some of the poorer States, as noted earlier, have been able to garner somewhat larger non-tax revenues.

The revenue figures in Table 11 include additional resource mobilisation (ARM, on the tax and non-tax account) during 1979-84. However, the table shows ARM separately in absolute per capita figures and in terms of the ratio of per capita ARM to per capita income. The rank correlation between per capita incomes and the latter ratio (both descending order) is negative (-0.23) indicating that in general the richer States have not been willing or able or under pressure to raise additional resources in 1979-84. The front-runners in the ARM effort have been Orissa (a very poor State), Tamil Nadu and Karnataka (both middle-income), and West Bengal (a

relatively rich State with a very low initial performance) while the ARM-to-income ratios registered by the richest States (Punjab, Haryana, Maharashtra and Gujarat) have been low and, in fact, below the 22-States average.

Expenditure

We shall now turn to revenue expenditures. Table 12 gives the figures for non-Plan and Plan revenue expenditures. Non-Plan expenditures have been decomposed into non-Plan, non-development expenditures net of interest payments (including appropriations for debt reduction), non-Plan non-developmental expenditures as a whole (netted by non-Plan non-statutory grants from the Centre to allow for the varying impact of expenditures on financing of natural calamities), and non-Plan developmental expenditures. Overall Plan outlays (i.e. including Plan capital expenditures) have also been shown and the proportion of Plan revenue expenditures to them have been indicated.

While there are sizeable differentials among the States in the levels of non-Plan expenditures, the range in this case is much narrower and the standard deviation somewhat lower when compared to revenues. The rank correlation coefficients between per capita incomes on one hand (descending order) and different categories of non-Plan expenditures (whether developmental or non-developmental net of interest or overall, all in descending order) are consistently high (0.8893, 0.8600 and 0.9322 respectively) indicating that the richer States are also the ones to have higher levels of expenditure on developmental, as well as general administrative services. At the same time, the standard deviation is much higher in the case of non-Plan development expenditures (40.07) than in non-Plan, non-development expenditures net of interest (i.e. in expenditures such as on tax collection, police and general administration) (16.29) indicating that per capita expenditures on basic administrative, fiscal, and judicial services tend to be relatively convergent in the major States.

Plan revenue expenditures are remarkably convergent as will be evident from the low standard deviation (9.76). This is corroborated by the close-to-zero rank correlation (0.1904) between per capita incomes and per capita Plan revenue expenditures (both descending order). On the other hand, richer States tend to have larger overall Plan outlays (including capital expenditures) on account of their better access to capital receipts: the rank correlation (0.6821) between per capita incomes and per capita Plan outlays (both descending order) is strong. The convergence in Plan revenue expenditures and the weaker association between per capita incomes and per capita Plan revenue expenditures occur because generally the richer States spend a lesser proportion of their Plan on current outlays: the rank correlation (-0.55) between per capita incomes and the ratios of Plan revenue to total Plan outlay (both descending order) illustrates the inverse association.

Central Transfers

We shall now examine the extent to which Central revenue transfers (i.e. devolution and Plan grants) have been redistributive i.e., whether and to what extent they have tended to favour the poorer States. The rank correlation coefficient between per capita incomes (descending order) and per capita devolution (ascending order) is 0.65 suggesting that while devolution has been redistributive it has not been significantly so. The reasons for this are to be found in the following features of the Seventh Commission's award[9]: (a) additional excise duties, which have accounted for about 11 per cent of devolution in 1979-84 have been distributed on the basis of consumption or State incomes. Both criteria tend to be tilted towards the richer States. (b) The weightage of 10 per cent for collection in income-tax sharing is regressive as it essentially benefits the relatively advanced States. (c) The weightage given to population in income-tax sharing (90 per cent) and in excise-sharing (25 per cent) has blunted the redistributive effect of the income-related criteria adopted by the Commission for the rest of excise-sharing. This is because,

per capita population being unity everywhere, the population criterion benefits all States alike, rich and poor: population is merely a scaling criterion that is distributive- neutral. (d) Devolution was so devised that non-Plan gaps would get filled or more-than-covered and tax-sharing was relied upon (to the extent of 92 per cent of devolution) for the purpose. This procedure tended to favour richer States, especially if they also showed large non-Plan gaps (as West Bengal did). (e) In order to be close to the current position we have used 1981 population figures for working out per capita devolution while the Seventh Commission used 1971 population weights. Because of this, the poorer States which have registered above-average population growth in 1971-81 (Assam, Madhya Pradesh, Rajasthan and Uttar Pradesh) have fared worse in our presentation but such is also the case with the richer States (Gujarat and Haryana) in the same boat.

As far as Plan grants are concerned, the rank correlation coefficient (0.3482) between per capita incomes (descending order) and per capita Plan grants (ascending order) indicates that they have been distinctly less redistributive than devolution. A number of factors are responsible for this outcome. We had noted already that Central grants for State Plan schemes accounted for 58.5 per cent of Central Plan grants to States in 1979-84 with the balance of 41.5 per cent being grants for Central and Centrally-sponsored schemes. The former category (i.e. grants for State Plan schemes) was regulated in the Sixth Plan (1980-85) according to a set of criteria which, after setting apart amounts for hill and tribal areas, the North-Eastern Council, externally-aided projects and special category States (in which Assam among the major States is included), distributed the balance according to the modified Gadgil formula[10]. The modified Gadgil formula is not particularly redistributive because its population weight is as high as 60 per cent. Besides, the 10 per cent reservation in the formula for tax effort also does not tend to help the poorer States. The balance of 41.5 per cent of Central Plan grants which is for Central and Centrally-sponsored schemes have been transferred according to diverse criteria. In the IRDP for instance,

uniform allocations are made to each development block and this is largely likely to correspond to population again. In family welfare schemes, allocations based on targets and achievements are likely to reflect implementation capacity. The net impact, resulting from the varying quantum-mix of Plan grants under different categories to individual States compounded by the diverse criteria employed category-wise is difficult to disentangle but the redistributive effect of Plan grants as a whole has been rather weak.

Financing Patterns

We can now proceed to sum up the net effect of all the receipt and expenditure transactions in the revenue account of the major States. Table 13 presents the final financing pattern in the revenue account for the major States in 1979-84. The starting point is the "net non-Plan gap" which is the difference between revenues (tax and non-tax but without additional resource mobilisation) and non-Plan expenditures (other than expenditures financed from non-statutory, non-Plan grants from the Centre). The next entry is the Finance Commission's revenue transfers (or devolution) comprising tax transfers (from the shareable taxes and additional excise duties in lieu of sales taxes) and statutory grants. The sum of the net non-Plan gap and devolution results in post-devolution surpluses. Two other types of resources which are available along with post-devolution surpluses for Plan financing are (a) Plan grants and (b) additional resource mobilisation (ARM). The total revenue resources thus available - from post-devolution surpluses, Plan grants, and ARM - finance Plan revenue expenditures and thereafter may yield a revenue surplus for financing capital investments in the Plan. On the other hand, if the total resources are inadequate to finance Plan revenue expenditures, the resultant revenue deficit will have to be covered through borrowing (including temporary overdrafts from the RBI) because the States, unlike the Centre are not in a position to print notes.

Table 13 shows that net non-Plan gaps among the major States in 1979-84 spanned a wide range. Haryana actually started with a pre-devolution net non-Plan surplus while West Bengal, Assam and Orissa were at the other end of the spectrum with large net non-Plan gaps. Devolution however produced post-devolution surpluses in 13 out of the 15 major States, the exceptions being West Bengal and Assam. Adding Plan grants and ARM, the same 13 States were not only able to meet their Plan revenue expenditures in full but were also left with revenue surpluses at varying levels. These financed their Plan capital investments to varying extents, ranging from 12 per cent in Kerala to 46 per cent in Madhya Pradesh. In the case of West Bengal and Assam, the total revenue resources available including Plan grants and ARM fell short of Plan revenue expenditures resulting in final revenue deficits on the entire (non-Plan and Plan) revenue account.

The rank correlation coefficient (0.5964) between per capita incomes (descending order) and the size of the net non-Plan gaps (ascending order) is reasonably strong suggesting, as might be expected that the richer States tend to register smaller pre-devolution deficits on their non-Plan accounts. Coming next to total transfers (devolution and Plan grants), we find that in sum they have been strongly redistributive: the rank correlation between per capita incomes (descending order) and per capita transfers (ascending order) is 0.85. However, the total impact all-together of devolution, Plan grants and ARM, when super- imposed on this initial position has been far less redistributive: the rank correlation coefficient between per capita incomes (descending order) and resources available for the Plan (revenue and capital) ex-post of Central transfers and ARM (descending order) has come down to 0.47. Proceeding further we find that the distribution of Plan revenue expenditures among the States has been such that in terms of the final surpluses left after meeting Plan revenue expenditures, individual States have come out remarkably close to the initial pre-devolution position with which they started. This is evidenced by the close-to-unity rank correlation coefficient (0.96) between net non-Plan gaps (ascending order) and final

revenue surpluses available for Plan capital financing (descending order). In other words, while Central revenue transfers have no doubt upgraded Plan resources for the poorer States, they have basically not been able to alter the inherent pattern of inequalities in fiscal strength among the constituents of the Union.

Typology of Major States

The foregoing discussion has explored in overall terms the relationship between per capita incomes and the components of the revenue account in the major States in the award period of the Seventh Commission. It is possible to flesh out the picture with some categorization of the major States. The broad typologies that emerge are the following:

I. Punjab, Haryana, Maharashtra, and Gujarat were the richest States with per capita incomes that were 25 per cent or above the all-India average in 1979-84. Given reasonably good tax and revenue efforts, they enjoy relatively high levels of revenue. These have enabled them to sustain relatively high levels of non-Plan expenditures, the bulk of which are for maintaining developmental facilities already established over time in these advanced States. Both devolution and Plan grants to these States were less than the 15 State averages. Plan revenue expenditures in Punjab and Maharashtra were around the average while Haryana and Gujarat have had high revenue outlays in their Plan, with Haryana showing the highest per capita Plan revenue expenditures among all the major States. All the four States have ended up with good final revenue surpluses equivalent to about 20 to 30 per cent of their Plan capital expenditures. Basically, high incomes, a good revenue potential, and good fiscal management characterise this group.

II. Karnataka, Andhra Pradesh, Kerala, and Tamil Nadu are in the middle-income range with per capita incomes that were around 90 per cent of the all-India average in 1979-84. As a group these four States have shown the best tax and revenue

effort. Among all major States, Tamil Nadu has had the highest tax-effort[11] ratio and Karnataka the highest revenue-effort ratio. Devolution has been more than average in the case of Kerala and Tamil Nadu and a little less in Karnataka and Andhra Pradesh but Plan grants have tended to be around or below average. Generally, non-Plan expenditures have been commensurate with revenue receipts. Plan revenue expenditures were around the average in Andhra Pradesh and Kerala but higher in Karnataka and distinctly so in Tamil Nadu. Because of relatively low overall Plan outlays, Plan revenue outlays have amounted to about 40 to 50 per cent of the Plan. This group of States have ended up with modest-to-reasonable final revenue supluses which have helped to finance varying proportions of Plan capital expenditures; 12 per cent in Kerala, 25 per cent in Andhra Pradesh, and as much as 33 per cent in Karnataka and Tamil Nadu. Basically, reasonable income levels and outstanding revenue efforts characterise the four Southern States.

III. Rajasthan, Assam, Uttar Pradesh, Madhya Pradesh, Orissa and Bihar are the poorer States. Per capita incomes in the first five of this group were roughly in the range of 70 to 80 per cent of the all-India average while in the case of Bihar, the poorest State, it was only 59 per cent of the National average. These six States have shown varying revenue-expenditure patterns which can be broadly grouped into the following:

(i) Madhya Pradesh has shown an excellent tax effort for its level of income and, because of high non-tax revenues as well, its overall revenue effort is impressive. Non-Plan expenditures have been contained at a reasonable level, devolution is above average, and Plan grants and Plan revenue expenditures have been around the 15-States average. Basically because of its good revenues in relation to expenditures, supplemented with a somewhat favourable level of devolution, Madhya Pradesh has been able to have a fairly large final revenue surplus which has amounted to as much as 46 per cent of its Plan capital expenditures, the highest proportion for any major State.

(ii) In Rajasthan and Uttar Pradesh, tax and revenue effort are poor with Uttar Pradesh being a worse performer than Rajasthan. Non-Plan expenditures have been commensurate with revenues. For both States devolution has been below the average, Plan grants have been higher than average for Rajasthan but close to it for Uttar Pradesh, and Plan revenue expenditures were below average in both cases. Both States have ended up with modest final revenue surpluses equivalent to 20 to 30 per cent of Plan capital expenditures. This is the same range as the one registered by the richest States in Group I but has resulted at a much lower level of transactions.

(iii) Orissa and Bihar are at the bottom of the income-scale. They also suffer from particularly low indicators of tax and revenue effort. Orissa has however undertaken a strong ARM effort in 1979-84. Non-Plan expenditures tend to be relatively high in Orissa but are low in Bihar. Devolution is high in both cases, in fact the highest for any of the 15 States in the case of Orissa. Orissa has also received a high level of Plan grants while, on the other hand, Plan grants to Bihar have been lower than average. Plan revenue expenditures are on the high side in Orissa while they are the lowest among all 15 States in the case of Bihar. Through different trajectories both States have ended up with low levels of final revenue surpluses. Given their low overall Plan sizes, their revenue surpluses have been equivalent to about 20 per cent of Plan capital expenditures.

(iv) Assam is a problem State. Income-wise, it ranks above Uttar Pradesh, Madhya Pradesh, Orissa and Bihar but, among all major States, Assam is the worst performer in tax and revenue effort. Non-Plan expenditures are relatively high. Plan grants are the highest for any of the 15 States, because Assam qualifies as a 'special category' State for Central Plan assistance, but devolution is below average. Although Plan revenue expenditures are only around the average, Assam has been left with a small final revenue deficit basically because of the disequilibrium between its own revenues and non-Plan expenditures which special treatment in Plan assistance has not been able to redress.

IV. We have so far left out West Bengal because it belongs to a category by itself. Its per capita income is somewhat above the all-India average and the State ranks 5th in the income scale coming just after Gujarat. West Bengal has however been a very poor performer in regard to its tax and revenue effort. Its non-Plan expenditures are relatively low and devolution has been slightly above average but Plan grants have been very low, in fact the lowest for any of the 15 States. In the result, West Bengal has had to face a final revenue deficit.

Following from this typology of States in 1979-84, we might be permitted *en passant* to draw attention to the heterogeneity in fiscal terms of the 7 non-Congress(I) States - Andhra Pradesh, Assam, Haryana, Karnataka, Kerala, Tripura and West Bengal - who have jointly challanged the terms of reference of the Ninth Commission. There is clearly not much in common between Haryana (category I), Andhra Pradesh, Karnataka and Kerala (category II), Assam (the problem State in category III), and West Bengal (all by itself in category IV). If the rest of India were to vanish leaving only these 7 States to constitute the Union, it would be very difficult indeed to arrive at transfer criteria that would be acceptable to all of them. It is one of the ironies of current Centre-State relations that the Centre - like Adversity - should have brought together such strange bed-fellows.

Projections Vs. Actuals

Before we conclude this review of the experience of the major States in the award period of the Seventh Commission, it will be interesting to compare the non-Plan revenue gaps, devolution, and the post-devolution surpluses or deficits in these States as they actually emerged in 1979-84 with the projections in each case in the Seventh Commission's report. Table 14 gives the comparison. The Seventh Commission projected pre-devolution surpluses for 5 States viz., Punjab, Haryana, Maharashtra, Gujarat and Karnataka but a surplus at this stage came about only in Haryana. Post-devolution surpluses were projected in all major States but Assam and Bengal

remained in deficit after devolution as well. Devolution has turned out higher in most States by Rs. 5 or 6 per capita per annum than what was projected; the average increase (unweighted) in devolution flows was Rs. 5.52. However, non-Plan gaps have turned out to be generally much larger than the levels projected by the Seventh Commission on the basis of its 'assessed' gaps. For the 15 major States the Commission projected a net pre-devolution non-Plan gap of Rs. 5365.8 crore compared to which the actual position was an overall net gap of Rs. 12829.23 crore i.e., 239 per cent of the projected one. The Commission's projections of post-devolution surpluses for the major States added up to Rs. 13969.93 crore as against which actual surpluses realised were Rs. 8155.97 crore or only 58 per cent of the projection. The Seventh Commission's projections have thus turned out to be widely, if not wildly, off the mark.

The degree of divergence between projections and actuals of non-Plan gaps has varied from State to State. Tamil Nadu and Madhya Pradesh were two States where the actual gaps turned out to be less than the projected ones. Projections were fairly close to actuals in two other States viz., Kerala and Orissa. In the remaining 11 major States, actuals were substantially higher than projections with the divergence being particularly large in the case of Assam and West Bengal, the two States which ended up with post-devolution deficits. Further analysis will be necessary to identify the factors responsible for the discrepancies. In part they may relate to over (under) estimation of trend revenues (expenditures) by the Commission. For the most part they might have to be explained by unanticipated but inevitable outlays (such as on relief of natural calamities not fully covered by Central assistance), salary increases, the relative impact of inflation on revenues and expenditures, loan write-offs (via grants), fresh non-Plan schemes, new or enlarged subsidies, and so on. These kinds of expenditures proliferated in a number of major States during 1979-84[12].

Overview of 1979-87

The analytical description in earlier sections of the revenue account in the Centre and the States in 1979-84 and 1984-87 has brought out the parameters and could suggest some of the lessons that the Ninth Commission will need to take into account in devising its scheme of transfers under Articles 280(3) (a) and (b) consistently with the objectives laid down in paragraph 4 of the notification constituting it. In the light of this analysis, we shall, in this concluding section, develop a rationale for vertical-cum-horizontal transfers, covering both the Plan and non-Plan segments of the revenue account in the Centre and the States, which is likely to be appropriate for the prospective medium-term period for which the Ninth Commission's award is to apply viz., 1990-95.

To start with, we shall briefly summarise the main facts, trends, and recent-historical experience that the earlier discussion has brought out. We noted that 1979-84 was a period in which combined (Centre and State) revenue surpluses began to be run down and that, by the end of this period, the deficit in the system as a whole had begun to be sizeable. The Seventh Commission's award had transferred revenue surpluses from the Centre to the States at the beginning of the period; in the course of it, deficits in the Centre became larger and the surpluses in the States shrunk. In the subsequent 3 year period, viz., 1984-87, Central deficits escalated, and with the States being just about able to balance their revenue budgets, overall deficits went up *pari passu* with those of the Centre. A compact summary measure of the deterioration over time can be obtained by comparing the ratios of deficits-to- revenues-cum-expenditures in the system between these two periods. This ratio which was only 0.6 per cent in 1979-84 sharply increased to 5 per cent in 1984-87.

In both periods, the burden of the overall deficit came to be unequally shared between the Centre and the States. In 1979-84, Centre-to-State transfers created surpluses with the States while putting the Centre in deficit: in other words, there was

an element of "excess-financing" of the needs of the States. The gradual erosion of surpluses with the States during 1979-84 suggests that such `excess-financing' created disincentives in the States for containing the growth of revenue expenditures and/or for additional resource mobilisation. In 1984-87, transfers were just adequate to keep the States in balance on their revenue account. In this sense, there was no `excess-financing' but the level of transfers required for doing so, among other things, entailed large deficits in the Centre's account.

We had also noted a number of features relating to the horizontal distribution of Central revenue transfers among the 15 major States in 1979-84. These transfers have been effected under multiple sources: shareable taxes, additional excise duties in lieu of sales taxes, Article 275 grants, other statutory grants, grants for State Plan schemes under the modified Gadgil formula, and Plan grants for Central and Centrally-sponsored schemes. The relative proportions of transfers under these various channels have varied from State to State and year-to-year and diverse criteria have operated source-wise. Given this situation, transfers do not reveal any overall explicit rationale. Implicity, it would appear that although transfers *per se* were redistributive, their final impact was not particularly so because the final surpluses the States were left with pretty much reflected initial inequalities in fiscal strength. Specifically, none of the criteria explicitly provided for incentives towards "financial discipline, better resource mobilisation and linking of expenditure and revenue-raising decisions". Nor, in so far as devolution was concerned, did they do so implicitly because the Seventh Commission (and in fact the Eighth as well) devised its scheme so as to fill `assessed' non-Plan revenue gaps, except to the extent that certain normative adjustments were built into the `assessed' estimates of revenues and expenditures. However, these normative adjustments turned out to have little teeth to them because in actual fact non-Plan gaps were significantly in excess of the ones projected by the Commission; and, even so, 13 out of 15 States ended up with final revenue surpluses, basically because of generous devolutions.

Our review has also indicated that in 1979-84 the economically advanced States (in terms of per capita incomes) were not necessarily the ones that displayed the best fiscal effort in terms of the tax-income or revenue-income ratios; nor was the converse true. The richest States (Punjab, Haryana, Maharashtra and Gujarat) recorded a reasonable fiscal effort but their performance was bettered by the middle-income States (Karnataka, Andhra Pradesh, Kerala and Tamil Nadu). West Bengal, although economically advanced, remained fiscally backward. Among the low-income States, Madhya Pradesh showed an outstanding fiscal performance while the others (Rajasthan, Uttar Pradesh, Orissa, Bihar and Assam) were to varying degrees, both economically and fiscally depressed. The lesson that can be drawn from this configuration is that, while Central transfers should respond to the needs in different States in an equitable manner, they should also be so devised as to upgrade the fiscal effort of each State to an appropriate extent. It is also interesting that final revenue surpluses emerged in 1979-84 in many of the poorer States as well. This indicates that their 'absorptive capacity' and/or allocational priorities in respect of Plan revenue expenditures on social and economic services (such as education, health, welfare of scheduled castes and tribes, agriculture) were not in tune with their apparent needs for such purposes.

Definition of the Commission's Tasks

Looking to the Ninth Commission's prospective award period of 1990-95, it is clear that, given present trends, the overall revenue deficit in the system is likely to escalate further both in absolute size and as a proportion of revenue-cum-expenditures because of several factors: increased interest payments; continuing high levels of outlays on defence, subsidies, and other non-Plan non-developmental expenditures; increased non-Plan developmental expenditures in the States arising from the maintenance cost of facilities established in the Seventh Plan (1985-90); and the proven tendency of Plan revenue expenditures for continued growth. The situation we

face is thus one of persistent, large, and growing overall deficits in the Centre-State system as a whole.

In such a situation it is self-evident that transfers can not by themselves reduce the overall deficit: they can only re-shuffle deficits among the constituents of the Union. The task of eliminating revenue deficits - overall and at the levels of individual constituents - is thus beyond the Finance Commission and rests squarely in the realm of Central and State fiscal policy. The ways to reduce revenue deficits are also painfully self-evident: existing revenues will have to be increased through curbing evasion, improving collection efficiency, reducing arrears etc; tax systems will have to be reformed so as to secure greater elasticity; additional resources mobilisation will have to be vigorously consistent with equity, incentives, yield, and other relevant considerations; non-tax revenues will have to be upgraded by securing better returns from departmental and other public enterprises, reducing indirect subsidies, and improving cost-recovery on services provided by the Government; non-Plan expenditures will have to be curbed, especially on defence and on direct subsidies (which are large not only in the Centre but also in the States); and the growth of current outlays in the Plan will have to be contained at sustainable levels.

Having set out the problematic, we shall, for purposes of further analysis, use the term ARMA (Additional Resource Mobilisation for Adjustment) as the measure of the total effort for increasing existing revenues, reducing non-Plan expenditures, and raising additional resources. GR and NPRE indicate respectively Gross Revenues (gross of tax transfers to States in the case of the Centre) and Non-Plan Revenue Expenditures (including (excluding) non-statutory, non-Plan grants in the case of the Centre (the States)). These are assumed to be realistic extrapolations for the award period without taking into account the impact of ARMA on revenues or expenditures but allowing for increased interest payments entailed in the Plan financing pattern on fresh borrowings during the award period. PRE are Plan Revenue Expenditures derived from the Plan.

RT are total Revenue Transfers from the Centre to the States via devolution and Plan grants. RD is the Revenue Deficit. Two other measures that can be derived from these are the Balance from Current Revenues (BCR) which equals GR-NPRE and the Financing Requirement (FR) which is BCR-PRE indicating the deficit or surplus after meeting Plan revenue expenditures. Subscripts within brackets denote the three levels viz., (c) for Centre, (s) for States, and (c+s) for the two together.

The RDs or revenue deficits at each level will then be defined by the following accounting identities:

$$(1)\ GR(c) - NPRE(c) - PRE(c) + ARMA(c) - RT = RD(c)$$

$$(2)\ GR(s) - NPRE(s) - PRE(s) + ARMA(c) + RT = RD(s)$$

and

$$(3)\ GR(c+s) - NPRE(c+s) - PRE(c+s) + ARMA(c+s) = RD(c+s)$$

If a zero overall deficit is to be brought about in the system, RD(c+s) will have to be eliminated and the following will have to hold:

$$ARMA\ (c+s) = - GR\ (c+s) + NPRE\ (c+s) + PRE\ (c+s)$$

i.e. $$ARMA\ (c+s) = - BCR(c+s) + PRE(c+s)$$

i.e. $$ARMA\ (c+s) = - FR\ (c+s)$$

In such a case, RT can also be uniquely solved for in equations (1) and (2) in the preceding paragraph so as to eliminate RD(c) and RD(s) as well i.e. ensure equilibrium at each level. Assuming that GR - NPRE - PRE + ARMA will be negative in each of the States, RT can also be so distributed among the States such that RD is zero in each of them.

The identity in the previous paragraph will make it clear that revenue deficits can be eliminated only by reducing FR(c+s) and/or increasing ARMA (c+s) so that parity is achieved between the two. FR(c+s) is itself BCR(c+s) - PRE(c+s). If BCR(c+s) is negative because GR(c+s) is less than NPRE(c+s), then ARMA(c+s) will have to be adequate to cover the deficit in

BCR (c+s) and the PRE(c+s). The fundamental proposition that comes out is that once equilibrium is achieved, it can be sustained only if in each period the ARMA effort is equal to the revenue account implication of the Plan (including the interest on borrowings) or, vice-versa, only if the Plan revenue outgo is confined to feasible levels of ARMA.

It is clear that given the current and developing imbalance in GR-NPRE, it may not be possible either to sufficiently increase ARMA and/or to sufficiently reduce PRE to achieve equilibrium in the Ninth Commission's award period of 1990-95. Assuming then that a certain level of RD(c+s), or overall deficit in the system, will have to be tolerated in the medium-term, the task of the Commission will be to devise a consistent scheme that will:

i. Set a realistic target for RD in the system consistent with an optimal ceiling on PRE(c+s) and the maximum feasible level to which ARMA(c+s) could be pushed

ii. Set 'equitable' targets for ARMA at each level adding up to ARMA(c+s)

iii. Arrive at a level of RT (i.e. vertical sharing) that is 'equitable' between the Centre and the States

iv. Distribute RT 'equitably' among the States (i.e., horizontal sharing).

The first of these tasks is normative. It involves a balance, in the system as a whole, between toughness in regard to ARMA and realism in regard to PRE, recalling once again that with a given level of imbalance between GR and NPRE (i.e. a given level of BCR) and BCR-PRE + ARMA being equal to RD, the latter can be reduced only if ARMA is improved and/or PRE is reduced. We have seen that the overall deficit in the system amounted to 5 per cent of all revenues and expenditures in 1984-87. The Commission will have to take a normative view, through literative processes of judgement, of the (realistic) ARMA and the (optimal) PRE in the system at which, given its

projection of BCR, the deficit-ratio can be reduced from 5 per cent (or whatever it might turn out to be in 1984-90) to a (realistic and optimal) lower level. Once the overall size of RD(c+s) and ARMA (c+s) are thus arrived at, the remaining tasks are to regulate RT and ARMA 'equitably' among the constituents of the Union in two steps: first, vertically between the Centre and the States (as a whole) and second, horizontally among the States. In other words, a consistent 'rationale' for the 'equitable' sharing of ARMA, RT, and RDs has to be developed.

Proposed Rationale

The rationale that we would propose is that (a) at each level ARMA should bear a uniform proportion to the Transactional Base (TB) comprising GR and NPRE at that level and (b) RTs should be so regulated that RDs, ex-post of transfers, are distributed among the constituents in the same proportion as their TBs. The readily-perceivable and robust logic of this is that TB (i.e. GR plus NPRE) provides the measure of the revenue-cum-expenditure 'base' or 'potential' (that remains after normatively determined ARMA and PRE are taken out) from which the RD will have to be reduced further through resource-improvement-cum-economy measures and that, accordingly, it is the relevant indicator with reference to which individual ARMAs and RDs should be regulated.

Adopting this 'rationale', equations relating to vertical transfers will be;

$$(1)\quad FR(c) + e.TB(c) - RT = \frac{TB(c)}{TB(c+s)} RD(c+s)$$

$$(2)\quad FR(s) + e.TB(s) + RT = \frac{TB(s)}{TB(c+s)} RD(c+s)$$

From these two equations, we can get 'e' and RT to be the following:

$$e = \frac{RD(c+s) - FR(c+s)}{TB(c+s)}$$

$$RT = \frac{FR(c).TB(s) - FR(s).TB(c)}{TB(c+s)}$$

It is to be noted that while 'e' (or the effort factor related to ARMA) varies with the level of RD(c+s), RT is a function of FRs and TBs at the two levels. What the proposed scheme does for a given configuration of FRs and TBs is to arrive at the level of RT at which ARMAs and RDs are 'equitably' shared at the two levels with reference to the TBs at each level. Thereafter any affort to further reduce RDs can be approached as entailing corresponding effort to improve ARMAs keeping RT fixed.

We can now illustrate with the help of numerical simulations how the proposed rationale would have worked if it had been applied to transfers in 1979-84 and 1984-87, what the implications would have been for ARMA at the two levels, and how these compare with actual performance in ARM at the two levels. In 1979-84, actual revenue deficits at the two levels resulted as follows (figures in Rs. crore)

(a) GR(c):90430-NPRE(c):65308-PRE(c):4567+ARM(c):6451 - —RT(actual):4251 = RD(c) (actual): (-7245)

(b) GR(s):54439-NPRE(s):69217-PRE(s):17034+ARM(s):3071 + RT(actual):34251 = RD(s) actual: (+5510)

We can get

e = [-1735 - (20555-31812)] v = .03408
RT = [20555(123656) - (-31812) (155738)]
v 279394 = 26830
ARMA(c) = .03408 (155738) = 5308
ARMA(s) = .03408 (123656) = 4214

Inserting these figures, the transfer scheme would produce:

(1) GR(c):90430 - NPRE(c):65308 - PRE(c):4567 + ARMA(c):5308
-RT:26830 = RD(c) : (-967)
(2) GR(s):54439 - NPRE(s):69217 - PRE(s):17034 + ARMA(s): 4214
+RT:26830 = RD(s): (-768)

It can be seen that the final deficits at the two levels viz., -967 for the Centre and -768 for the States are in the same proportion to each other as the TBs at the two levels viz., 155738 and 123656.

The interpretation of the results in the two preceding paragraphs is as follows:

"System-wise in 1979-84, the BCR (i.e. GR-NPRE) was 10344, the ARM that was possible was 9522, and PRE could not be reduced below 21601. As a result, RD the overall deficit turned out to be -1735. The appropriate level of RT or vertical transfer at which this deficit could have been equitably shared between the Centre and the States would be 26830. Consistent with it, normative ARMAs at the two levels should have been 5308 (Centre) and 4214 (States) entailing at each level a resource-improvement-cum-economy effort equivalent to 0.03408 (i.e. 3.408 per cent) of the respective Transactional Bases (TBs)".

The prescriptive RT of 26830 (covering devolution and Plan grants) is 78.3 per cent of the actual transfer of 34251 made in 1984. It could have been effected by sharing 85 per cent of income-tax revenues (the proportion adopted by the Seventh and Eighth Commissions) and 50.4 per cent of Union excise duties (net of additional excise duties in lieu of sales taxes which will get fully passed on to the States and has been taken into account as part of RT) realised in 1979-84.[13] We can also notice that actual ARM (6451) in the Centre was higher than the normative ARMA (5308) while in the States actual ARM (3071) was less than the normative ARMA (4214). It can also be seen that with an ARMA effort of 4.03 per cent of the transactional tax in each case the revenue deficits could have been wiped out in both the Centre and the States (as a whole) at the same level of transfers.

In 1984-87, the following equations represent the actual experience:

(1) GR(c):105073-NPRE(c):80510-PRE(c):6452+ ARM(c):1875 - RT (actual): 37008 = RD(c) actual: (-17022)

(2) GR(s):55263-NPRE(s):74148-PRE(s):21444-ARM(s):2949 + RT (actual): 37008 = RD(s) actual: (-372)

In this case, at the same overall level of deficit (-17394), the transfer scheme under our formula would produce:

(1) GR(c):105073-NPRE(c):80510-PRE(c):6452+ ARMA(c):2842 - RT:31201 = RD(c) : (-10248)

(2) GR(s):55263-NPRE(s):74148-PRE(s):21444 + ARMA(s):1982 + RT:31201 = RD(s) : (-7146)

At both levels, the ARMAs and RDs will be proportionate to their respective TBs which are 185583 for the Centre and 129411 for the States. The implied ARMA effort at each level is 0.0153 of the relevant TB. It can be seen that actual ARM in the Centre (1875) has been significantly below the equitable ARMA (2842) while in the States actual ARM (2949) has been significantly higher than the equitable ARMA (1982). The prescriptive RT of 31201 is 84.3 per cent of the actual RT of 37008 made in this period. The RT of 31201 would have entailed a 85 per cent sharing of income-taxes and a 62.4 per cent sharing in Union excise, after allowing for additional excise duties to be transferred in full to the States[14].

We have seen that in 1984-87 the overall deficit of 17394 accounted for 5 per cent of all revenues and expenditures in the system. The illustration in the preceding paragraph assumes the same level of deficit. We can compute what should be the relevant effort-ratios for ARMA if the deficit-ratio were to be reduced to 4 per cent, 3 per cent, 2 per cent, one per cent or altogether eliminated. In each case, the RDs in the Centre and the States will be equitably shared maintaining the RT at the level initially determined by the Financing Requirements and Transactional Bases at the two levels but the ARMA effort will have

to be progressively stepped up. The following table gives the sensitivity analysis.

Target deficit-ratio (per cent)	Equivalent effort ratio (per cent)	RD(c)	RD(s)	RD(c+s)
5	1.53	-10248	-7146	-17394
4	2.64	- 8195	-5714	-13909
3	3.75	- 6146	-4285	-10431
2	4.85	- 4097	-2857	- 6954
1	5.95	- 2049	-1428	- 3477
0	7.05	0	0	0

A comparison of the relevant magnitudes in the system in 1979-84 and 1984-87 will bring out the deterioration that has occurred between the two periods. In 1979-84, PRE was 21601. It was financed to the extent of 10344 from BCR and 9522 from ARM leaving an RD of 1735. ARM amounted to 3.408 per cent of TB and the relatively small deficit could have been eliminated if the effort had been improved to 4.03 per cent. In 1984-87, PRE rose to 27896, BCR was only 5578 and ARM at 4824 was as low as 1.53 per cent of TB leaving a large uncovered deficit of 17394, the elimination of which would have required ARMA to be as high as 7.05 per cent of TB in the period. To put it in another way, the ratio of ARM to FR sharply deteriorated from 0.85 in 1979-84 to 0.22 in 1984-87 while it should have been unity for equilibrium to obtain.

We have so far discussed the vertical aspect of transfers. It is easy to see that horizontal sharing will also fall into place on the same basis if RT, which represents the vertical component of transfers, is allocated among the individual States such that the resultant RD for each State, ex-post of transfers, is in the same proportion to RD(s) in each State as the TB of the State concerned to TB(s). This will automatically entail the ARMA at the level of each State to be in the same proportion (as in the system) to the TB of that State. We had seen that the richer States tend to have larger per capita levels of revenues and

expenditures which means that per capita TBs will tend to vary like-wise with per capita incomes. Accordingly the richer States will have higher per capita ARMA targets. They might also be expected to be allowed lower levels of per capita PRE. As a result they are likely to have smaller per capita RDs ex-ante of transfers. In this situation, transfers so aimed as to keep final (i.e. ex-post of transfer) RDs proportionate to TBs, will turn out to be progressive.

We have envisaged the process in terms of a single unified revenue transfer to each State covering the entire revenue account - Plan and non-Plan - effectuated entirely through tax-sharing so as to give the benefit of buoyancy to the States. In this scheme, Article 275 grants, which have so far been used by Finance Commissions to fill up non-Plan revenue gaps, will not be necessary for the simple reason that the logic of the scheme is premised not on filling gaps but on rationally sharing them. Since the entire revenue account includes PRE on Central and Centrally-sponsored schemes as well, TRs take account of this component also in their impact. However, if it is considered necessary to ensure prescribed levels of expenditures on this category of Plan revenue expenditures, the required 'discipline' can be attempted otherwise than through transfers i.e., through reporting and review; or, Article 275 grants can be suitably carved out of the RT to tie them to performance in specific schemes without altering the level of the RT resulting from the allocational rule. In other words, tied grants (if found necessary) can be accommodated within the all-inclusive RT for each State.

We have worked out the illustrations for periods of time, whether 1979-84 or 1984-87, because the transfer scheme is to operate for an award period as a whole ignoring year-to-year phasing. The simulations are based on current prices while constant prices have been assumed for prospective award periods. Realistically, the Finance Commission's projections will have to be in current prices and subject to annual phasing of Plan revenue expenditures but they can be translated back into base year prices and totalled for the award-cum-Plan period.

The RT to be shared between the Centre and the States, and among the States in 1990-95 will depend on the Financing Requirement in the system (i.e., the levels of GR-NPRE (or BCR) and the levels of PRE) and in each of its constituents. Its proportion to shareable taxes will further depend on expectations of yields on such taxes. The review of the experience in 1979-84 and 1984-87 indicates that it might be possible, if PRE could be adequately contained to locate RT in the zone of a 85 per cent sharing in income-taxes and a 50 to 60 per cent share in Union excise duties after allowing for additional excise duties to be passed on in full to the States. The size of the RDs at the levels of each constituent will however depend on the deficit-ratio that is aimed at in the system and the consequential effort-ratio for ARMA that is accepted as feasible.

Summing up

We can now sum up. The rationale that is being proposed rests essentially on two basic propositions. Firstly, it requires that all efforts be made to reduce the overall revenue deficit in the system by (a) optimally containing PRE consistent with a reasonable view of needs and absorptive capacities in the case of each of the constituents, and (b) maximising ARMA consistent with the ability of individual constituents. Secondly and thereafter, the irreducible overall revenue deficit that remains is sought to be 'rationally' shared among the constituents. The specific 'rationale' of sharing deficits in proportion to the Transactional Base (TB), which we have suggested relate the final gap to the TB which can be construed as constituting the broad potential for covering it. The first part of the exercise which fixes PREs and ARMAs for the individual constituents will have to be 'normative' in relation respectively to 'need' and 'ability'. The second part will relate "fiscally-uncovered need" to a measure of potential "ability". Thus, the final outcome of the scheme will be to arrive at realistic 'target' or 'normative' deficits, thereafter placing the onus squarely on the shoulders of the Central and State governments to adhere to them or to reduce them further. Specifically, the 'target deficits' arrived at in this manner will provide a bench-mark for

monitoring GR, NPRE, PRE, and ARMA, having regard to their inter relationship from year to year and thereby, a basis for adjustments to these several components so as to make actual deficits conform to or to be kept below the targetted ones.

Most importantly, the suggested procedure will provide a unified yardstick for arriving at the quantum of vertical sharing between the Centre and the States and its horizontal distribution between the States. This is precisely what eight Finance Commissions, with their award periods spanning 37 years have failed to do. Vertical sharing has throughout been so arranged as to fill "gaps" and the bases for horizontal sharing have varied according to diverse criteria, from Commission to Commission, representing in the words of the distinguished Chairman of the Fourth Commission (Justice P.V. Rajamannar), a "gamble on the personal views of five persons, or a majority of them". Also, since the Fourth Commission, the "gap" that is getting filled by devolution is the truncated non-Plan gap with the balance being left to Plan grants which have had no pre-designed relationship to Plan revenue expenditures in absolute amounts or in terms of their actual proportion to total Plan outlays[15]. Accordingly, Central revenue transfers in their totality have been essentially *ad hoc* although on each occasion they have been purported to be based on well-intentioned and high-sounding principles. In effect, so long as gaps have been filled, States have not been worried too much in practical terms about the exact mix of tax-sharing and Article 275 grants or the exact criteria applied from time to time to tax-sharing: it is the destination that has mattered with the route actually taken to it being no more than a topic for intermittent discussion by theorists and practitioners of public finance, usually at the commencement and conclusion of Finance Commissions[16].

In fairness it should be pointed out that the objective situation in the Centre-State revenue accounts prior to 1979-84 was also one in which overall revenue surpluses were available in the system as a whole. In such a context it was both understandable and sustainable that the principal thrusts in

the Centre-State debate should have been for increasing vertical shares to the States and for making horizontal shares more progressive. The emergence of non-Congress governments in the Centre and in several States in 1977-80 and the realisation of widening regional disparities were two factors that gave impetus to the demand for larger and more progressive devolution. Successive Finance Commissions were also able to respond positively to these concerns, particularly the Seventh in regard to vertical sharing and the Eighth in the matter of progressivity. The large system-wide deficit that has emerged in 1984-87 and the dimensions and proportions it is likely to assume in 1990-95 have now drastically changed the context into one in which it is an overall deficit that has to be shared, that is, to the extent that it can not be curtailed with the best possible effort. The basic task that the Ninth Commission faces is to evolve normative levels of Plan expenditures and of resource-improvement-cum- economy efforts to reduce the overall deficit and subsequently a method for sharing of deficits that will be both equitable between the Centre and the States, progressive inter-se among States, and 'efficient' in the sense of encouraging 'financial discipline, better resource mobilisation and linking of expenditure and revenue-raising decisions'. On the need to reduce the deficit, there can be no two opinions. For sharing the deficits and for correspondingly sharing the resource- improvement-cum-economy effort, we have suggested one method. It may be possible to think of alternative procedures[17] but whatever method is adopted, the imperative of having to share gaps rather than being in a position to fill them has to be faced in the altered situation.

The first of the guidelines to the Ninth Finance Commission requires that it "adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre and in doing so keep in view the special problems of each State, if any, and the special requirements of the Centre such as defence, security, debt servicing and other committed expenditure or liabilities". If literally interpreted, this guideline might appear to require the Ninth Commission to make a normative assessment of each

and every receipt and expenditure in the Centre and in each of the 25 States ranging from Arunachal Pradesh to Uttar Pradesh[18] In other words, the Commission will have to transform itself into an Expenditure-cum-Taxation Enquiry Commission for all the 26 constituents of the vast and varied Union. This is a path on which angels will fear to tread and one where others should not rush into. All that can be realistically attempted is to make normative assessments of critical and strategic components in the revenue account and on that basis arrive at normative deficits. The scheme suggested consolidates such assessments in ARMA, PRE and in the formula for deficit-sharing.

The Two Commissions

The institutional issue of the inter-face between the Finance Commission and the Planning Commission remains to be discussed. The conflation of Plan and non-Plan in the Ninth Finance Commission's terms of reference does not imply the abolition of the Plan or of the Planning Commission. On the contrary it makes the tasks of the two Commissions even more inter-dependent and casts a heavy responsibility on the Planning Commission as well. The following discussion will explain why. In the earlier era when the Second and Third Commissions were given the mandate to devise their devolution to cover Plan revenue requirements as well, the initial years of their award periods (viz., 1957-62 and 1962-66) were chronologically subsequent to those of the Second (1956-61) and Third (1961-66) Plan periods. The Second and the Third Finance Commissions were therefore in a position to adopt the estimates of expenditures and of additional resource mobilisation arrived at in discussions between the Planning Commission and the States. The Ninth Commission will not however be in a position, given its time-limit of 30 June 1989 to wait for the Planning Commission to finalise the Eighth Plan (1990-95). Nor will the Finance Commission on its own have the competence to bet and integrate the Plan revenue estimates of the Centre and the States. Besides the Plan revenue estimates can be finalised only on the basis of the dimensions and

financing pattern of the Plan as a whole - revenue and capital - in the Centre and the States because the provision for interest payments will depend on the borrowing programme at each level. In these circumstances the wise and proper course for the Finance Commissions will be to jointly work with the Planning Commission. Secondly with the elimination of the Gadgil formula as far as Plan grants are concerned, an appropriate alternative basis for Central assistance to States on their capital account (which will have to include finance to cover revenue deficits) will have to be devised by the Planning Commission. Thirdly, the Planning Commission, in its annual Plan discussions with the States, will have a crucial role in monitoring the implementation of the scheme devised by the Finance Commission. This role has been well-described *in extenso* in the dissenting minute of Shri G.R. Kamat, Member-Secretary of the Third Commission (paras 17 to 21 at pp 55-58 of the Third Commission's report), a minute which resulted in devolution being thereafter confined to the non-Plan revenue account. Now that the wheel has come full cycle, it is important that the role of the Planning Commission should be harmonized with that of the Finance Commission so that the wheel does not wobble again. Thus, logically the two Commissions will have to work in tandem which etymologically means 'like horses in harness one behind the other'. All that has happened is that the horses have been shifted along-side from one-behind-the- other.

Essentially the two Commissions will have to work together with the Centre and the States to formulate a medium-term fiscal policy for the entire Union during 1990-95 pegged on one leg to the Eighth Plan and on the other to the scheme for revenue transfers and resource-improvement-cum-economy efforts. The evolution and implementation of such a policy will need a clear realisation among all members of the Union, of the debt-trap into which the system as a whole is fast sliding and thereafter, firm resolve and resolute effort among all of them consistent with ability and need to pull the system out of the deepening fiscal crisis. Regrettably, the Ninth Commission has been launched in a confrontationist atmosphere provoked by the Centre's failure to take the States into full consultation on

Centre-State fiscal relations as they need to evolve in the context of the fiscal crisis. The hardest but most important challenge that the Ninth Commission will have to overcome is the political one of promoting Centre-State understanding and cooperation in the effort required Union-wide for restoring equilibrium in the revenue account.

Notes

* This paper was prepared for the Seminar on 'Issues Before the Ninth Finance Commission' organised by the National Institute of Public Finance and Policy. The author is indebted to N.K. Jayasri and C.Kalai Selvi for excellent secretarial support.

1. Most recently in B.P.R. Vithal and M.L. Sastry 'Terms of Reference of Ninth Finance Commission: Some Preliminary Comments' in Economic and Political Weekly July 25, 1987.

2. At the Conference of Seven Non-Congress I Chief Ministers held in Calcutta on December 15, 1987.

3. A recent RBI study has pointed out that if current trends in market borrowings continue "a point of no return may be reached by 1992-93 when net market borrowings may not be sufficient to pay even interest on market borrowings". Economic Times December 2, 1987.

4. Since 1981-82, the Centre's tax concessions have entailed losses in the States' share. The figures of such losses are (in Rs.crore): direct taxes: 85.61 (1981-82), 45.22 (1982-83), 34.67 (1983-84), 38.68 (1984-85) and 2.51 (1985-86). Indirect taxes: 50.1 (1984-85). Economic Survey of the Government of India (various issues)

5. Actual total revenue transfers (via devolution and Plan grants) were (Rs. crore) 34251 in 1979-84 and 37008 in 1984-87. Gross income-tax revenue were

7525 (1979-84) and 7201 (1984-87), Union excise duties (net of additional excise duties in lieu of sales taxes) were 35854 (1979-84) and 35558 (1984-87) and additional excise duties (RE figures) were 2359 (1979-84) and 2896 (1984-87).

6. The Long-Term Fiscal Policy document (December 1985) of the Government of India drew attention (para 2.3) to "the massive increase in the size of the Central Plan from about 4 per cent of GDP in the first half of the 1970s to 8 per cent by the end of the Sixth Five-Year Plan. For most of 1979-86, State plans have been around 6 to 7 per cent of GNP while the Central Plan increased from 6.3 per cent of GNP in 1979-80 to 9.4 per cent in 1985-86. In the States' sector it was a case not so much of the increase in Plan size with reference to GNP as an increase in the revenue outlay component of the Plan while the reverse was the case with the Centre.

7. The 15 major States, in usual parlance, are the ones with a population of 10 million or more. The non-major States were 7 in number in 1979-84. Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim, and Tripura. Since then 3 more have been added to the list: Goa, Mizoram and Arunachal Pradesh.

8. We have used the Spearman's Rank Correlation Coefficient which is defined as 1-6di2/n(n2-1) where di is the difference between the ranks of ith observation in the two vectors under consideration and n is the total number of observations. The measure can vary between +1 (perfect association) and -1 (total disassociation). We have used the co-efficient to compare pair-wise situations and not as a measure *per se* of the degree of association.

9. The Seventh Commission used a 90 per cent weight for population and 10 per cent for collections in sharing income-tax. For excise, the weights were 25 per cent population and 25 per cent each for criteia based on (a) the inverse of the per capita State Domestic Product (b) the percentage of the "poor" and (c) a revenue equalisation formula which turned out in effect to a per capita SDP-related distance criterion. We have not analysed the State-wise picture in 1984-87 for want of actuals in the last two years of this period but it should be pointed out that the devolution scheme adopted by the Eighth Commission (1984-89) was much more redistributive than that of the Seventh, primarily because (a) after allowing for a 10 per cent weight for collections in income-tax, the balance of income-tax and the whole of excise was shared according to the same formula. In this formula, weightage to population was only 25 per cent with the balance being subject to per capita income-related redistributive criteria and (b) the reliance on Article 275 grants was effectively increased to 16 per cent.

10. The modified Gadgil formula which was applied in the Sixth Plan (1980-85) to the major States (other than Assam) gave 60 per cent weightage to population, 10 per cent to tax effort, 20 per cent to per capita income restricted to States with a per capita income below the national average, and 10 per cent to 'special problems' of the States.

11. Tamil Nadu's performance in this period had much to do with the lifting of prohibition in 1982; as a result, increased liquor-revenues counted as ARM.

12. 1979-84 was a period of high spending in many of the States on account of several factors: droughts (1979-80, 1982-83), general elections (1980), loan

write-offs in several major States (e.g. Maharashtra, Tamil Nadu) expensive food subsidy schemes (e.g. Tamil Nadu, Andhra Pradesh, Karnataka), Pay Commissions etc.

13. See figures in foot note 5 above.

14. See figures in foot note 5 above.

15. Central assistance to State plans is distributed as 30 per cent grants and 70 per cent as loan. The grant proportion has been well below the average (all-States) ratio of Plan revenue expenditures to Plan outlays which was around 50 per cent in 1979-84 and 1984-87. The proportion in different States will be found in Table 12.

16. For a rich (and expensive:) debate of devolution-related issues see I.S. Gulati (ed) Centre-State Budgetary Transfers Oxford University Press 1987.

17. One alternative might be to relate ARMA to the income-base instead of TBs for purposes of horizontal-sharing. The same procedure, if applied, to vertical-sharing will result in Centre-State parity because the GDP of the Centre (which is not a geographical entity in itself) is the same as that of the States put together. It is, of course, conceivable to have different formulae for transfers at the vertical and horizontal levels.

18. Something like this has been suggested in G.Thimmaiah 'Terms of Reference of Ninth Finance Commission' in Economic and Political Weekly September 26, 1987.

Table 1

Budgetary Surpluses and Deficits in Centre and States 1974-87

(Rs crores)

Year	Centre			States			Centre and States		
	Revenue Account	Capital Account	Overall Surplus or Deficit	Revenue Account	Capital Account	Overall Surplus or Deficit	Revenue Account	Capital Account	Overall Surplus or Deficit
1974-75	-764	-1485	-721	+395	-426	-311	+1179	-1011	-752
1975-76	+887	-1254	-367	+971	-896	-75	+1658	-2150	-292
1976-77	+298	-429	-131	+1111	-1061	+50	+1409	-1490	-81
1977-78	+430	-1362	-933	+1029	-1249	-220	+1450	-2612	-1162
1978-79	-292	-1798	-1506	+1135	-125	+1010	+1427	-1923	-496
Ann.Av.1974-79	-534	-1266	-732	+926	-758	+125	+1460	-2017	-557
1979-80	-976	-1401	-2377	+1548	-1735	-187	+572	-3136	-2564
1980-81	-2037	-440	-2477	+1485	-2382	-897	-552	-2822	-3374
1981-82	-384	-1007	-1391	+1379	-2399	-1020	+995	-3406	-2411
1982-83	-1308	-347	-10551	+588	-1708	-8201	-420	-2055	-2475
1983-84	-2540	+124	-16162	+210	-771	-2612	-2330	+351	-1977
Ann.Av.1979-84	-1449	-414	-1863	+1102	-1799	-697	-347	-2213	-2560
1984-85	-4224	+479	-3745	-924	-514	-1438	-5148	-35	-5183
1985-86[4]	-5565	+628	-49373	+358	-466	+8243	-5207	+1094	-4113
1986-87[5]	-7233	-1052	-8285	+194	-790	-596	-7009	-1842	-8881
Ann.Av.1984-87	-5674	+18	-5656	-124	-272	-403	-5798	-261	-6059

1. Excludes Rs. 1743 crore of loans to clear overdrafts in States.
2. Excludes Rs. 400 crore of loans to clear overdrafts in States.
3. Excludes Rs. 1628 crore of loans to clear overdrafts in States.
4. Actuals for Centre, RE for States.
5. RE for Centre, BE for States.

Source: RBI Surveys of Central and State Finance and GOI Budgetary Documents.

Table 2
Revenue Account of the Centre 1979-84 and 84-87

	Item	1979-84 Rs.crore	1984-87 Rs.crore	Growth[1] Per cent
I	Gross Revenue[2]	96881 (19376)	106948 (35649)	84.0
	of which:			
	Tax Revenue	79321 (15864)	84769 (28256)	78.1
	Non-tax Revenue	17560 (3512)	22179 (7393)	110.5
II	Total Revenue Expenditures	104126 (20825)	123970 (41323)	98.4
	of which:			
	1. Non-Plan Revenue Expenditures[3]	65308 (13062)	80510 (26837)	105.5
	2. Plan Revenue Expenditures	4567 (913)	6452 (2150)	135.5
	3. Revenue Transfers to States	34251 (6850)	37008 (12336)	80.1
	of which:			
	(i) FC Transfers[4]	22365 (4473)	22532 (7511)	67.9
	(ii) Plan grants[5]	11886 (2377)	14476 (4825)	103.0
III	Revenue Deficit (I-II)	-7245 (-1449)	-17022 (-5674)	291.6

Notes: Figures within brackets are annual averages in each period

Source: GOI Budget documents.

1. With reference to annual average.
2. Including additional resource mobilisation and gross of tax transfers to States.
3. Including non-Plan, non-statutory grants to States.
4. Tax transfers and statutory grants.
5. Central Plan grants for State Plan schemes and for Central and Centrally-sponsored schemes.

Table 3
Revenue Account of the States 1979-84 and 1984-87

	Item	1979-84 Rs.crore	1984-87 Rs.crore	Growth[1] Per cent
I	Total Revenues	91761 (18352)	95220 (31740)	73.0
	of which:			
	1. States' own revenues[2]	57510 (11502)	58212 (19404)	68.7
	of which:			
	(i) States' own tax revenues	40755 (8151)	42621 (14207)	74.3
	(ii) States' own non-tax revenues	16755 (3351)	15591 (5197)	55.1
	2. Central Revenue Transfers[3]	34251 (6850)	37008 (12336)	80.1
II	Total Revenue Expenditures	86251 (17250)	95592 (31864)	84.7
	of which:			
	1. Non-Plan revenue Expenditures[4]	69217 (13843)	74148 (24716)	78.5
	2. Plan revenue expenditures[5]	17034 (3407)	21444 (7148)	109.8
III	Revenue Surplus or Deficit	5510 (1102)	-372 (-124)	

Notes: Figures within brackets are annual averages in each period.

Source: RBI Surveys of State Finances.

1. With reference to annual averages.
2. Including additional resource mobilisation.
3. For break-up between FC transfers and Plan grants see Table 2 item II.3.
4. Net of non-Plan expenditures met from non-Plan non-statutory grants from Centre.
5. On State Plan schemes and Central and Centrally sponsored schemes implemented by States.

Table 4
Revenue Account of the Centre and States 1979-84 and 84-87

	Item	1979-84 Rs.crore	1984-87 Rs.crore	Growth[1] Percent
I	Total Revenue[2]	154391 (30878)	165160 (55053)	78.3
	of which:			
1.	Tax Revenue	120075 (24015)	127389 (42463)	76.8
2.	Non-tax Revenue	34316 (6863)	37771 (12590)	83.4
II	Total Revenue Expenditures	156126 (31225)	182554 (60851)	94.9
	of which:			
1.	Non-Plan revenue expenditures[3]	134525 (26905)	154658 (51553)	91.6
2.	Plan revenue expenditures	21601 (4320)	27896 (9299)	115.3
III	Revenue Deficit	-1735 (-347)	-17394 (-5798)	1570.9

Notes : Figures within brackets are annual average in each period

Source : Tables 1 and 2.

1. With reference to annual averages
2. Includes additional resource mobilisation
3. Includes all non-Plan expenditures

Table 5
Additional Resource Mobilisation, Centre and States, 1979-84 and 1984-87

		1979-84			1984-87		
		Centre	States	Total	Centre	States	Total
1.	Cumulative ARM in the period1 (Rs.crore)	6451 (430)	3071 (205)	9522 (635)	1875 (268)	2949 (421)	4824 (689)
2.	Percentage of 1 above to gross own revenues without ARM in the period	7.13 (0.68)	5.64 (0.38)	6.57 (0.44)	1.78 (0.25)	5.34 (0.76)	3.01 (0.43)
3.	Percentage of 1 above to total GNP in the period	1.02 (0.07)	0.49 (0.03)	1.51 (0.10)	0.202 (0.07)	0.372 (0.12)	0.572 (0.19)

1. Cumulative ARM is the realisation during the period from budgetary ARM measures undertaken in each year in that period. Accordingly, annual averages for 1979-84 (5 years) are arrived at by dividing cumulative ARM in the period by 15 and annual averages for 1984-87 (3 years) by 7.

2. These ratios are for 1984-86

Note: Figures within brackets are annual averages in each period.

Sources: RBI Surveys of State Finances (for State ARM figures) and GOI : Economic Survey (for Centre's ARM figures).

Table 6
Structure of Non-tax Revenues Centre and States 1979-84 and 1984-87

(Rs.crore)

	Item	1979-84 Annual Averages			1984-87 Annual Averages		
		Centre	State	Total	Centre	State	Total
1.	Interest Receipts	2180 (62.1)	900 (26.9)	3080 (44.9)	4685 (63.4)	1458 (28.1)	6143 (48.8)
2.	Profits and Dividends from enterprises	355 (10.1)	21 (0.6)	376 (5.5)	461 (6.2)	51 (1.0)	512 (4.1)
3.	Other non-tax receipts	977 (27.8)	2430 (72.5)	3407 (49.6)	2247 (30.4)	3688 (70.9)	5935 (47.1)
4.	Total non-tax revenue	3512 (100.0)	3351 (100.0)	6863 (100.0)	7393 (100.0)	5197 (10.0)	12590 (100.0)

Note: Figures within brackets are percentages to column totals

Source: RBI Surveys of State Finances and GOI Budget documents.

Table 7

Role of Central Revenues Transfers, 1979-84 and 1984-87

(Rs.crore)

Item		1979-84 Annual Averages			1984-87 Annual Averages		
		Centre	States	Total	Centre	States	Total
I	**Pre-Transfers**						
	1. Own Revenues	19376 (62.8)	11502 (37.2)	30878 (100.0)	35649 (64.8)	19404 (35.2)	55053 (100.0)
	2. Revenue Expenditures	13975 (44.8)	17250 (55.2)	31225 (100.0)	28987 (47.6)	31864 (52.4)	60851 (100.0)
	3. Revenue Surplus or	+5401	-5748	-347	+6662	-12460	-5798
II	**Post-Transfers**						
	1. Revenue (net/gross of transfers)	12526 (40.6)	18352 (59.4)	30878 (100.0)	23313 (42.3)	31740 (57.7)	55053 (100.0)
	2. Revenue Expenditures	13975 (44.8)	17250 (55.2)	31225 (100.0)	28987 (47.6)	31864 (52.4)	60851 (100.0)
	3. Revenue Surplus or Deficit	-1449	+1102	-347	-5674	-124	-5798

Note: Figures within brackets are percentages to row totals in each period.

Source: Tables 2 and 3.

Table 8
Contribution of Post-Devolution Surpluses to Plan Financing and Revenue Surpluses in States, 1979-84 and 1984-87

(Rs.crore)

		1979-84 Annual Average	1984-87 Annual Average
1.	Own Revenue	11502	19404
2.	Non-Plan revenue expenditure	-13843	-24716
3.	Pre-Devolution deficit (1+2)	- 2341	- 5312
4.	Devolution	+ 4473	+ 7511
5.	Post-Devolution surplus (3+4)	2132	2199
6.	Plan grants	2377	4825
7.	Resource available (5+6)	4509	7024
	Absorbed by:		
8.	Plan revenue expenditures	3407	7148
9.	Revenue surplus or deficit	1102	- 124
		4509	7024

Source: Table 3.

Table 9
Structure of Non-Plan Revenue Expenditures, Centre and States 1979-84 and 1984-87

(Rs crore)

	Item	1979-84 Annual Average			1984-87 Annual Average		
		Centre	States	Total	Centre	States	Total
1.	Interest Payment	3349 (25.6)	1662 (12.0)	5011 (18.6)	7676 (28.6)	3625 (14.7)	11301 (21.9)
2.	Defence revenue expenditure	3941 (30.2)	-	3941 (14.6)	7304 (27.2)	-	7304 (14.2)
3.	Central Subsidies	2135 (16.3)	-	2135 (7.9)	4905 (18.3)	-	4905 (9.5)
4.	Other non-Plan, non-development expenditures1	2464 (18.9)	3028 (21.9)	5492 (20.4)	4765 (17.8)	5633 (22.8)	10398 (20.2)
5.	Non-Plan development expenditures	1173 (9.0)	9153 (66.1)	10326 (38.5)	2187 (8.1)	15458 (62.5)	17645 (34.2)
6.	Total non-Plan expenditure	13062 (100.0)	13843 (100.0)	26905 (100.0)	26837 (100.0)	24716 (100.0)	51553 (100.0)

Notes: Figures within brackets are percentages to column totals.

1. Includes non-Plan, non-statutory grants in the case of the Centre and excludes expenditures met by them in the States.

Source: RBI Surveys of State Finances and GOI Budget documents.

Table 10

Plan Financing on Revenue Account, Centre and States, 1979-84 and 1984-87

(Rs. crore)

	Item	1979-84 Annual Average			1984-87 Annual Avera...		
		Centre	States	Total	Centre	States	Total
1.	Plan revenue expenditure Financed by:	913	3407	4320	2150	7148	9298
2.	Balance from current revenues	+5884	-2546	+3338	+8544	-5733	+2811
3.	Central revenue transfers	-6850	+6850	-	-12336	+12336	-
4.	Additional revenue mobilisation	430	205	635	268	421	689
		- 536	+4509	3973	-3524	+7024	+3500
5.	Revenue Deficit(+) or Surplus (-)	+1449	-1102	+ 347	+5674	+ 124	+5798

Source: Tables 2, 3 and 5.

Table 11

Revenue Receipts of Major States 1979-84

(Annual Average in Rs. per capita)

	State	Tax Revenue[1]	Non-Tax Revenue[1]	Total Revenue[1]	Additional Resource Mobilisation (ARM)	Tax-Income Ratio	Revenue Income Ratio	ARM-Income Ratio	Memo: Per capita income 1979-84 Average
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1.	Punjab	254.45	73.69	324.14	12.60	8.28	10.68	0.41	3073
2.	Haryana	220.83	109.84	330.67	7.83	8.61	12.93	0.31	2558
3.	Maharashtra	222.18	83.82	306.00	9.54	9.01	12.41	0.39	2465
4.	Gujarat	193.09	62.58	255.67	7.32	8.61	1.40	0.33	2243
5.	West Bengal	110.25	27.76	138.01	17.12	6.20	7.76	0.96	1778
6.	Karnataka	157.85	65.14	222.99	15.95	9.77	13.80	0.99	1616
7.	Andhra Pradesh	133.01	46.83	179.84	1.27	8.45	11.42	0.08	1575
8.	Kerala	151.70	54.26	205.96	9.25	9.81	13.31	0.60	1547
9.	Tamil Nadu	170.79	35.44	206.23	18.70	11.16	13.48	1.22	1530
10.	Rajasthan	93.23	59.86	153.09	8.26	6.46	10.61	0.57	1443
11.	Assam	47.45	51.92	99.37	2.18	3.42	7.15	0.16	1389
12.	Uttar Pradesh	71.27	28.43	99.70	4.84	5.33	7.45	0.36	1338
13.	Madhya Pradesh	91.49	66.66	158.15	4.92	7.05	12.18	0.38	1298
14.	Orissa	59.20	39.94	99.14	18.42	4.75	7.96	1.48	1246
15.	Bihar	47.89	21.98	69.87	7.13	4.64	6.76	0.69	1033
16.	All 22 States	120.95	49.72	170.67	9.13	6.96	9.81	0.53	1739

1. Including additional resource mobilisation.

Source: RBI Surveys of State Finances

Table 12

Revenue Expenditures in Major States, 1979-84

(Annual Average in Rs. per capita)

	State	Non-plan1 Non-devt. expre. net of interest	Non-plan1 Non-devt. expendi-ture	Non-Plan develop-ment expendi-ture	Non-Plan revenue expendi-ture	Plan revenue expendi-ture	Plan Outlay	Ratio of Plan revenue expenditure to Plan out-lay
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8) = (6) v(7)
1.	Punjab	63.81	107.87	216.53	324.40	47.46	206.59	22.96
2.	Haryana	50.27	86.66	211.55	298.21	70.29	218.60	32.13
3.	Maharashtra	86.30	122.20	193.44	315.64	49.89	181.24	27.53
4.	Gujarat	46.10	70.34	180.57	250.91	58.41	197.06	29.64
5.	West Bengal	45.42	71.41	127.54	198.95	46.63	84.78	55.02
6.	Karnataka	58.28	88.62	139.96	228.58	56.05	125.24	44.76
7.	Andhra Pradesh	44.61	63.06	147.06	210.12	50.89	103.5	49.15
8.	Kerala	52.39	77.09	164.40	241.49	50.46	112.52	44.86
9.	Tamil Nadu	46.13	70.25	144.77	215.02	64.03	121.33	53.10
10.	Rajasthan	38.96	68.65	129.10	197.75	42.94	104.75	40.99
11.	Assam	41.36	63.51	107.62	171.13	51.88	108.34	47.87
12.	Uttar Pradesh	27.87	48.53	89.04	137.57	40.68	98.25	41.39
13.	Madhya Pradesh	39.53	57.08	111.23	168.31	54.44	127.68	42.63
14.	Orissa	13.80	39.92	118.05	157.97	59.52	102.28	58.22
15.	Bihar	27.21	41.96	85.33	127.29	28.34	72.89	38.88
16.	All 22 States	44.94	69.59	135.81	205.39	50.56	124.06	40.74

1. Excluding expenditure financed from non-Plan non-statutory grants from the Centre.

Source: RBI Surveys of State Finances.

Table 13

Financing Pattern on Revenue Account in Major States 1979-84

(Annual Average in Rs. per capita)

	State	Non-Plan revenue gap	Devolution	Post-devolution Surplus	Plan grants	ARM	Plan Revenue Expenditure	Revenue Surplus or Deficit	Ratio of Revenue Surplus to Plan Capital expenditure (per cent)
	(1)	(2)	(3)	(2)+(3) =(4)	(5)	(6)	(7)	(8)= (4)+(5) (6) - (7)	(9)
1.	Punjab	-8.86	54.93	46.07	27.11	12.60	47.46	38.32	24.07
2.	Haryana	24.63	53.60	78.23	33.02	7.83	70.29	48.79	32.90
3.	Maharashtra	-19.18	59.92	40.74	23.37	9.54	49.89	23.76	18.09
4.	Gujarat	-2.56	59.35	56.79	26.03	7.32	58.41	31.73	22.88
5.	West Bengal	-78.06	64.49	-13.57	22.03	17.12	46.63	-21.05	
6.	Karnataka	-21.54	59.96	38.42	24.29	15.95	56.05	22.61	32.68
7.	Andhra Pradesh	-31.55	62.79	31.24	31.43	1.27	50.89	13.05	24.78
8.	Kerala	-44.78	67.52	22.74	25.97	9.25	50.46	7.50	12.09
9.	Tamil Nadu	-27.49	68.21	40.71	24.00	18.70	64.43	18.98	33.36
10.	Rajasthan	-52.92	58.82	5.90	41.49	8.26	42.94	12.72	20.58
11.	Assam	-73.94	57.85	-16.09	56.37	2.18	51.88	-9.42	
12.	Uttar Pradesh	-42.71	62.41	19.70	31.80	4.84	40.68	15.66	27.20
13.	Madhya Pradesh	-15.08	66.88	51.80	31.43	4.92	54.44	33.71	46.03
14.	Orissa	-77.25	79.24	1.99	47.08	18.42	59.52	7.97	18.64
15.	Bihar	-64.55	69.39	4.84	25.45	7.13	28.34	9.08	20.38
16.	All 22 States	-43.85	66.36	22.51	35.27	9.13	50.56	16.35	22.24

Source: RBI Surveys of State Finance.

Table 14

Actuals Vs. Seventh Commission's Projections for Major States 1979-84

	State	Non-Plan gap[1]		Devolution		Post Devolution Surplus or Deficit	
		Actual	Projected	Actual	Projected	Actual	Projected
1	Punjab	-73.92	+389.97	458.68	419.53	384.76	809.50
2.	Haryana	+158.85	370.06	345.73	307.67	504.58	678.73
3.	Maharashtra	-601.27	+1290.70	1876.41	1714.05	1277.14	3004.75
4.	Gujarat	-43.41	+164.12	1008.98	963.87	965.57	1127.99
5.	West Bengal	-2127 17	-857.33	1757.48	1597.12	-369.69	739.79
6.	Karnataka	-398.42	+1.15	1109.25	1005.00	710.83	1006.15
7.	Andhra Pradesh	-842.48	-579.79	1676.71	1522.57	834.23	942.78
8.	Kerala	-568.65	-531.11	857.46	770.34	288.81	239 23
9.	Tamil Nadu	-664.00	-849.00	1647.20	1503.60	983.20	654.60
10.	Rajasthan	-902.26	-663.24	1002.85	902.81	100.59	239.57
11.	Assam	-735.78	-410.12	575.62	518.65	-160.16	108.53
12.	Uttar Pradesh	-2368.97	-1258.86	3460.30	3314.74	1091.33	2055.88
13.	Madhya Pradesh	-392.86	-422.63	1742.17	1597.46	1349.31	1174.83
14.	Orissa	-1015.80	-952.19	1042.02	984.45	26.22	32.26
15.	Bihar	-2252.09	-1057.53	2422.342	212.87	169.25	1155.34
16.	Major States	12829.23	-5365.80	20985.20	19335.73	8155.97	13969.93

Notes: 1. Excludes effect of ARM.
2. Includes upgradation grants' also.

Source: RBI Surveys of State Finance (for actuals) and Report of the Seventh Finance Commission (for projections).

Back to Basics : Terms of Reference of the Ninth Finance Commission

Renuka Viswanathan

I. Introduction

1988 is likely to become a landmark year in the history of Indian federalism. The report of the Sarkaria Commission on Centre-State relations will very soon be thrown open to debate. And the announcement of the terms of reference of the Ninth Finance Commission has been greeted with a storm of comment and criticism in political and academic circles. The wording of the terms of reference has come in for close scrutiny. In addition, the competence of the Government of India to define the ambit of the Finance Commission has also been questioned.

A welcome development is the resurgence of interest in fundamental issues relating to the very foundations of federal fiscal theory. Critics and commentators are falling back on the constitutional text to find arguments to bolster up their points of view. All this sound and light are bound to result in fresh insights into intergovernmental relations in India.

II. The Centre's competence to lay down terms of reference for Finance Commissions

For the first time, debate has centred on the question of the Centre's competence to lay down terms of reference for Finance Commissions. Basically, three issues have been raised:

(a) Does the Centre (acting through the President) have the right to prescribe guidelines for the Finance Commissions?

Article 280 of the Constitution speaks only of the Commission's duty to make recommendations regarding the distribution between the Union and the States of the net proceeds of divisible taxes and the allocation of these proceeds among States as well as the principles which govern grants-in-aid to States out of the Consolidated Fund of India. A point is being raised that the President is only competent to indicate the items on which the Finance Commission's advice is sought; he cannot suggest or lay down principles which should govern the Commission's deliberations. This is, however, a rather narrow and legalistic interpretation of the constitutional clause. It is also a wrong reading to say that no guideline can be given to the Commission because the Constitution provides for the Commission itself to determine its 'procedure'. Evidently, the term 'procedure' refers only to administrative devices to be adopted by the Commission like public hearings, hearings of State representatives and other similar matters and not to the methodology followed to arrive at its recommendation. A Constitution is not a stratified rigid structure. It is a living concept that provides room for taking in future development and growth. The tenor of inter-governmental financial relations in India cannot be expected to remain unchanged over the years. In keeping with what he perceives to be the requirements of the period, the President (on the advice of his Prime Minister presumably) can indicate to the Commission the lines on which it is to proceed.

It cannot be denied that there has been a qualitative change in the financial situations of the Central and State governments. We have entered a phase in which the Government of India's revenue budget is not self-sufficient; we are drawing on capital receipts to finance revenue expenditure. It is in this context that the Ninth Finance Commission has been appointed and it is only natural that the government's concern to explore methods which encourage resource-raising and conserve available revenues for optimal uses should be expressed in the Commission's terms of reference. The President who is empowered to refer any matter to the Commission in the interests of sound finance must also be competent to indicate the

principles which should be kept in view while examining these issues. The Constitution does not bar such an interpretation; on the other hand, it appears both logically acceptable and legally valid.

One could also adopt a slightly different stance and indulge in some legal hair-splitting and say that the President is competent to lay down guidelines only in respect of 'any other matter' covered under Article 280(3)(c) and not in respect of Articles 280(3)(a) or (b) for which the Constitution provides that the Finance Commission shall make recommendations. On the whole, however, I would incline to the view that the President and his government are competent to lay down guidelines for Finance Commissions.

It is also noteworthy that such guidelines to Finance Commissions are not a fresh development. Indications have been given to Commissions in some form or other about how to proceed right from the days of the Second Commission. On previous occasions, no objections were raised to the wording of the terms of reference; in fact, this is the first time that attention has been focussed on the matter at all. Evidently, the radical shift from what was expected as terms of reference and what has actually emerged seems to have provided a rude jolt to the States and aroused all kinds of apprehensions about the intentions of the Central government. One can safely presume that if the Central government had not strayed from the beaten path while drafting the terms of reference of the Ninth Finance Commission, the question of its competence to determine the terms of reference would not have arisen and things would have continued as before. It is, therefore, a welcome development that deviation from the expected course has sparked off a debate that was perhaps overdue on the competence of the Centre to lay down guidelines for the Finance Commission's deliberations.

(b) The second issue that raises concern is the kind of parameters that could be laid down for Finance Commissions by the Central government.

Even if the Centre is considered competent to determine the Commission's terms of reference, ideally, it should restrict itself to specifying only broad policy guidelines. The terms of reference could draw the Commission's attention to the immediate pressing financial concerns of the nation and the grey areas on which the Commission's judgement is required. It would not be appropriate for the Presidential order setting up the Commission to descend to minor and petty details since such matters are best left to the Commission's own discretion. This is not a matter of the Centre's legal competence; basically, it is a question of judgement of the most appropriate policy for a federation like India where an independent Commission is expected to arbitrate on inter-governmental finances.

Yet, a study of the terms of reference of successive Commissions reveals that they have very often strayed from this ideal. The terms of reference of the Eighth Finance Commission went to the extent of determining in advance the date on which the emoluments of State government employees are to be taken into account while forecasting expenditures of States (as if this could not have been left to the judgement of that august body). And, ironically enough, no protests have been voiced against the Centre's encroaching into the Commission's legitimate preserves. Evidently, the present debate on the Centre's competence to frame the Finance Commission's terms of reference has its genesis in the anxiety aroused by the revolutionary terms themselves rather than in any fundamental doubt about the Centre's competence in the matter.

Measured by the above yardstick also, the present terms of reference could hardly give much cause for complaint. The parameters put down for the Ninth Finance Commission are general enough-they speak of a normative approach, of incentives for resource mobilisation, financial discipline, speed, efficiency, effectivenness, etc.

(c) The third and perhaps the most crucial issue for the Commission as well as for the States is the extent to which the Commission can be considered bound by its terms of reference.

The Finance Commission is, undoubtedly, a creature of the Central government acting through the President. But unlike the Commonwealth Grants Commission of Australia, it did not post-date the Constitution, nor has it been established by mere statute. The fact that it is enshrined in the Constitution itself gives it a certain sanctity and independence of functioning. It is, no doubt, bound to scrupulously abide by the parameters fixed for it, but it can and should reject them where, in its best judgement, they run counter to what it perceives to be its constiutional role.

What this means, of course, depends upon the Commission itself. Successive Commissions have in their reports mulled over the problem of the Commission's place in the constitutional scheme. It is not surprising that the First Commission spent considerable time on discussing basic issues of fiscal federalism and its role in the scheme of transfers from the Centre to the States. The Second Commission continued the same practice and though the Third Commission opined that there was hardly any scope for it to add to the deliberations of the earlier Commissions regarding the constitutional aspects of its functions, it appended a chapter to its report entitled 'General Observations' embodying its views on issues germane to a correct determination of Union-State financial relations in terms of the Constitution. This covered important basic issues relating especially to the role of the Finance Commission vis-a-vis, the Planning Commission. Such a discussion was all the more necessary, in view of the minute of dissent of the Member-Secretary, whose views ultimately prevailed upon Union government.

The Fourth Finance Commission again went into the constitutional position and averred that the Constitution does not distinguish between Plan and non-Plan expenditure. However, it took a conscious decision to confine itself to non-Plan revenue expenditure and revenue receipts, since it felt that given the Constitution and role of the Planning Commission, it would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' Plan expenditure.

What is important is that Finance Commissions have themselves defined and re-defined their roles against constitutional provisions and the terms of reference and the same privilege accrues to the present Commission. This is why the debate that has raged on the use of the word 'shall' in the terms of reference of the Ninth Finance Commission, has only an academic interest. Past experience and precedents suggest that Finance Commissions have always been free to determine their role within the ambit of constitutional and other provisions and the present Commission is also heir to the same trra`dition.

III. The Content of the Terms of Reference

The broad contours of a Finance Commission's approach are then laid down in the notification setting up the Commission. Certain aspects of the terms of reference undergo hardly any change from Commission to Commission; others differ only in detail. On the whole, what is issued is the known and the expected. The terms of reference of the Ninth Finance Commission, however, mark a radical departure from the normal routine, especially in the parameters that have been laid down for the Commission. The approach is revolutionary enough to indicate a significant change in what is sought from the Commission by the government and what will ultimately emerge as the Commission's own conception of the role it is to play in Centre-State finances.

The terms of reference refer as usual to the double task of the Commission as laid down in the Constitution: determination of the principles governing tax devolution and grants-in-aid to States. However, the terms also go on to define the approach to be adopted by the Commission-a "normative" approach, with incentives for resource mobilisation and financial discipline, by linking up expenditure and revenue-raising decisions, by providing for speed, efficiency and effectiveness and by not only balancing receipts and expenditure but generating surpluses for capital investment.

The major issues which must be considered by the Commission while performing its dual task are four-fold: the adoption of the normative approach; respecting the distinction between Plan and non-Plan on revenue account; estimation of the special problems of States; and the building in of incentives for resource mobilisation and financial discipline.

(a) The normative approach with its attendant criteria has been subject to severe attack on several counts. There is evidently much apprehension on the part of States that the adoption of this methodology will deprive them of the resources needed to maintain present levels of expenditure and continue schemes undertaken at their initiative. They fear that the dropping of the reference regarding provisions for the upkeep of already created assets (which had been repeated in the terms of reference from the days of the Fourth Commission), implies that the need for substantial maintenance expenditures on the non-Plan side will be ignored. They suspect that unrealistic and unrealisable targets of resource-raising would be laid down and expenditure commitments limited to such levels. They have reacted with predictable hostility and questioned the Commission's right to ignore their liabilities while being bound to respect the Centre's commitments. The atmosphere has been vitiated by suspicion and mistrust and this has affected the dispassionate appreciation of the implications of the normative approach.

This is, in fact, the most delicate of the tasks that the Commission would have to address itself to. For the first time, a deliberate opportunity has been given to it to break out of the shackles of the Niemeyer "gap-filling" approach, which has been part of our legacy since 1936. It is surprising that many of those who railed against the gap-filling approach of the previous Commissions have themselves been the first to attack the normative approach laid down for the Ninth Finance Commision, ignoring the exciting task that lies ahead.

The Ninth Finance Commission would have to make up its mind on several fundamental matters before it comes to the

nuts and bolts of the calculation of the devolutions themselves. It is important to note that para four of the terms of reference, which lays down guidelines for the Commission, applies equally to tax devolutions as well as to grants-in-aid (the whole of para 3 in fact). Hitherto, the criteria adopted for determining grants-in-aid have been different from those applied to tax shares and a distinction has been also drawn between the distribution of Central excise and personal income tax receipts. A State that is deemed surplus in resources after tax devolutions are made, is not considered eligible for general purpose grants under Article 275(1), but its right to tax shares remains unaffected. There is constitutional distinction between income tax receipts, (of which a fixed percentage must be distributed to the States under Article 270 and which are, therefore, charged on Central government revenues) and Central excise revenues which may be transferred to States, if Parliament so provides by law. In spite of the option exercised by Parliament on Central excises, they have all along formed part of the divisible pool so that the constitutional distinction has become a mere formality. There is, however, another difference between the two taxes-the proceeds of income tax alone shall be assigned to the States within which that tax is leviable (Article 270-2); no such stipulation has been laid down for Central excises. This means that personal income tax receipts should be distributed only among States where the tax is levied; Sikkim, for example, is not eligible for a share in this tax. The factor of collection or source of such receipts has of course continued to remain important in their distribution. Over the years, however, this has gradually been supplanted by the population factor. In the case of Central excises, the emphasis has shifted from population to other 'need criteria' - the Eighth Commission established for the first time a link between the distribution of grants-in-aid and Central excise revenues by providing for assigning 5% (out of 45% of the receipts transferred to States) on the basis of budgetary deficits as assessed by it. What is to be noted, however, is that there is no bar to treating all transfers as part of a divisible pool and determining one set of criteria and a single percentage for their distribution among needy States-neither the Constitution nor any other consid-

eration would come in the way. And before we come to the conclusion that such an approach would go against the interests of the better-off States who were normally left with substantial surpluses under tax devolutions, let us remind ourselves that the normative approach of the Ninth Finance Commission is also meant to encourage States which raise resources and manage their finances prudently. The clubbing together of all transfers would provide not only for their rationalisation but it would also afford an opportunity to correct unbalanced regional development. It, therefore, deserves the Commission's serious consideration.

The major substantial issue before the Commission relates to the kinds of norms to be applied to "correct" the revenue and expenditure forecasts of States. In view of the express liberation from the shackles of the past, the Commission's choice is likely to have far-reaching effects on Indian fiscal federalism. In spite of the widespread attack on the terms of reference, economists and academicians have been united in the view that a normative approach is not at all a bad idea, their fears relate only to the kind of norms that are likely to be applied by the Commission. The challenge before the Commission is basically the choice of the "right" set of norms—norms which would be both realistic as well as acceptable.

Earlier Commissions applied norms in a peripheral manner. In the case of receipts, for example, the Eighth Commission went partly by the trend approach. Some sophistication was introduced into the identification of past trends and these were moderated by the application of broad judgments. As regards expendtiure, the same tendency is manifest in the selection of a base year (the most recent year for which reasonably accurate financial data were available) and the fact that projections were made from this level. Norms were, however, clearly laid down in projecting the return on investments in power projects and Road Transport Corporations. And a certain degree of equalisation was introduced in other areas. In the case of expenditure forecasts in the health and medical sectors, for example, a step-up was given to the all-

States' average, in respect of States which were below this level. And, while considering employees' emoluments, projections were made to bring the level of actual emoluments to the all-States' average for certain common categories of posts. On the whole, however, the existing approach implied safeguarding committed expenditures and liabilities with a certain correction for individual schemes of States, basically those which fall under the broad head of social security and welfare. It would not be wrong to state that under this arrangement, a scheme operated by several States would automatically find its place in the Commission's forecast, but a pioneering State ran the risk of its scheme being subject to close scrutiny and possible rejection by the Commission. With the present complete shift to the normative approach, past trends would have no relevance and what would count is the value judgment of the Commission regarding the kind of schemes that ought to be undertaken or the levels of expenditure that should be attained for providing an optimum service level. In fact, the difference between the approach of the Ninth Commission and those of previous Commissions is somewhat similar to that between zero-base budgeting and traditional budgeting.

While applying the normative approach, the Commission would have to further refine the methodology adopted by earlier Commissions. Different norms must be chosen for revenue receipts and expenditure. On the resources side, instead of the trend approach, receipts must be projected on the basis of likely proceeds, given a normative level of exploitation of a State's revenue potential. The norm could be the average of all States or it could be the average of selected States. Or again, it could be determined against a targeted level or an accepted minimum level. A State which raises resources above this level would stand to benefit, since the additional resources would not enter into the calculations of its surpluses or deficits. On the expenditure side, similarly, norms would have to be selected to arrive at expenditure levels in different sectors-the cost per relevant unit at a reasonable rate or efficiency for providing an average, standard, maximum or minimum level of public service. The gap between the two could then be

projected as the requirement of the State in terms of Central transfers.

Coming down to brass tacks, the level of resources to be raised is not to be fixed simply as a ratio of per capita tax and non-tax revenues (as an indicator of tax effort) to per capita SDP (as an indicator of taxable capacity). I would suggest proceeding item by item for each major source of a State tax and non-tax revenue and determining the normative level of receipts against each of them by applying a chosen tax rate to a selected tax base. In the case of motor vehicles tax, for example, the tax base of vehicles in a State is known; the Commission would only have to select the appropriate tax rate to be applied to each vehicle category, after projecting a likely growth in the existing number of vehicles, to arrive at the resources to be raised from this instrument. Such an approach would be closer to reality than going by per capita SDP alone, since it takes into account the areas from which revenues can be raised, given the existing number of fiscal instruments. On the expenditure side, similarly, for every major head, the Commission must select the service level to be reached and the cost per unit. In the education sector, for example, the Commission should determine the number of primary schools required to be provided given the children of school-going age in the State and the cost (both recurring and non-recurring) of running each school. A somewhat similar exercise was done by the Eighth Commission when it fixed unit costs for upgrading standards of administration in selected areas. However, these were then kept out of the sphere of the general purpose grants under Article 275(1) and were treated as specific purpose grants. But they have been given up in the terms of reference of the Ninth Commission. Such requirements will presumably be taken care of in the overall assessment of the expenditure levels of States, now that the normative approach has been brought from the wings to centre-stage.

It must be noted that the above approach can still be considered gap-filling. The resource gap will now, however, reflect more faithfully the needs of the population as well as their capacity to generate resources for their own development

and assistance will flow to areas which lack the capacity to finance this development.

The methodology originally adopted by the Commonwealth Grants Commission in Australia was slightly different from the one indicated. The CGC felt that budget deficits of States mirrored their financial needs; thus, it went by per capita budget deficits and aimed at converting such deficits either to balanced budgets or raising them to the level of the deficits of non-claimant States (the approach which required the lower level of grants was selected). This figure was multiplied by the population of the State and adjusted to take care of lower resource potential or higher service costs. Subsequently, however, it moved towards a modified approach, mainly because the new Grants Commission Act of 1973 required it to also consider applications for financial assistance made by regional organizations of local governing bodies. The forty first report of the Commission thus provides for the direct assessment of the financial needs of a claimant State by adding its revenue needs (that is the difference between what it would have raised on a standard revenue base as against its actual revenue base at standard revenue effort) and expenditure needs (the additional cost of providing services at the same level as in standard States). This methodology comes quite close to the one suggested earlier for the Ninth Commission.

The major issues for the Commission would then boil down to the selection of norms, the selection of the level to which equalisation of expenditure is to be done and the enforcement of the norms. A frequent criticism made of the Eighth Commission's recommendations is that the norms regarding rates of return from public undertakings adopted by it were far removed from the reality. No one, therefore, expects that these projections would be achieved. In the interests of its own credibility with the States, the Ninth Commission would have to select the right set of norms. The acid test for it lies here - the application of norms for each sector which would be both realistic and realisable, without at the same time perpetuating the trend approach of previous Commissions. And where the

norms are far above the present levels in any State, the Commission would perhaps have to moderate them downwards so as to fix levels that a State could reasonably be expected to achieve within the time-frame of its recommendations. Such moderation would be necessary both while estimating resources as well as while providing for the required levels of expenditure. It would be unreasonable to expect a State to reform overnight and put up its actual levels of resource- raising and expenditure to a very high degree. On the expenditure side, in fact, excess provisions would only encourage extravagance and waste.

The next vital step for the Commission is the selection of the normative level of expenditure and resource raising. While the simplest option would be the all-States' average, this may not be appropriate in view of the large number of States whose resource-raising and expenditure levels are low. On the expenditure side, perhaps, a minimum level could be determined for each sector, since resource constraints at the national level may not permit the raising of all States to the maximum or the average levels. On the resources side, however, the norm could be determined on the basis of the average of selected States whose performance in that area has been satisfactory.

A major dilemma for the Commission, however, is to ensure that Article 275(1) grants recommended for the less fortunate States are actually utilised by them in the sectors which require attention. But close monitoring of the releases is not the solution. We have already had the unsatisfactory experience of the Seventh and Eighth Commissions with regard to the specific purpose grants determined by them for upgrading the standards of administration in selected areas. In respect of the Eighth Commission's award, a serious attempt was made to monitor the release of the grants by synchronising it with the achievement of the required physical targets. It was seen, however, that the unit costs adopted by the Commission were greatly inadequate for achieving the levels anticipated by them due to rises in the costs of inputs. Hence, tailoring fund releases to physical targets would mean drawing on an equal or

higher amount from State budgets to reach the required levels or surrendering a part of the grants themselves. The most deplorable consequence, however, is the loss of initiative by State governments and the conversion of statutory transfers into discretionary ones dependent on the normal monitoring procedures of the Centre. And yet, the entire basis for the recommendation of normative grants would be affected if no arrangement is made for ensuring that State governments channel these funds into the designated sectors. This is all the more necessary to prevent States from attaching a premium to under- development so as to benefit from Central transfers. The solution might lie in applying a system of incentives and penalties so that recipient State governments are encouraged to raise their developmental levels by utilising grants recommended by Finance Commissions. The terms of reference themselves provide for this contingency.

(b) Incentives for Resource Mobilisation and financial discipline:

The provision of incentives for resource mobilisation and financial discipline has been built into the guidelines of the Ninth Finance Commission in paras 4(ii), (iii) and (iv). Although some apprehensions are being entertained by States on this score, no one will deny that the existing scheme of things was hardly conducive to encouraging prudent financial management. In fact, a study of Tamil Nadu's finances made by Shri S. Guhan concluded rather wryly with the remark that, "in the case of Tamil Nadu, virtue has had to be its own reward".

For the record, it must be noted that this is not a new feature. Earlier Commissions had also been expected to keep in mind similar factors while making recommendations. The Fourth Commission was to consider the scope for economy, consistent with efficiency to be effected by States in their administrative expenditures. The scope for better fiscal management was also tagged on in the terms of reference of the Fifth Commission and the same platitudes were repeated in the case of the Sixth and Seventh Finance Commissions. Although

economy and efficiency were dropped, fiscal management was retained as a guideline for the Eighth Commission. But the methodology adopted by all of them provided no incentive for sensible fiscal policies and the inevitable consequence has been the manipulation of internal financial decisions, so that maximum advantage could be obtained from the Finance Commission's scheme of transfers. A blatant example of this can be seen in the indecent haste shown by all States to take on pay revisions and additional commitments well before the expected date from which the Finance Commission was likely to determine its base year. Such strategies were self- defeating in nature since they did not often produce the expected results and the State continued to be saddled indefinitely with the burden of the announced decision. A scheme of transfers which would discourage such profligacy is to be welcomed, especially in the present context when we can ill afford to squander scarce revenues.

The methodologies that could be adopted by the Commission range from the very simple to the complex. At its simplest, the Finance Commission could satisfy itself with naming States, which, according to its analysis, indulge in irresponsible financial behaviour, without visiting them with specific penalties. While this will have a deterrent effect, it may not be sufficient to correct such behaviour. The Commission could go a step further and specifically deduct a fixed percentage or amount of transfers determined by it as a punishment for imprudent financial management. Conversely, it could reward States whose revenue- raising effort, measured by whatever criterion, is commendable, by giving them a percentage or pro rata step-up, either while estimating revenues or while determining grants. In the earlier years of the Commonwealth Grants Commission's functioning in Australia, penalties of this nature were imposed on claimant States, by reducing per capita expenditures by a percentage as an indication of their responsibility to make a relatively greater effort to control expenditures and by marking up tax efforts by a fixed percentage above standard levels.

The Commission might also distinguish between normal buoyancy rates of important revenue sources (after deflating them with reference to the price and income factors) and conscious efforts made to raise additional revenues. However, similar attempts by the Planning Commission to identify additional resources mobilisation done by States during a Plan period have not proved satisfactory, since arbitrary figures are projected as resources raised by fresh mobilisation efforts by depressing the figures under normal revenues.

The time period is also relevant for this exercise, since effectively one would be rewarding a State's past performance. While this again raises the problem referred to earlier of encouraging or penalising a State at the time of the next Commission's award on the basis of its behaviour during the current Commission's time-span, it would mean commitment to continuity in methodology by successive Commissions. It must be noted that the normative approach, as suggested above, itself provides for incentives and disincentives; what we are speaking of here are additional incentives or penalties to be given to States for good fiscal comportment.

(c) The special problems

The special problems of each area are to be kept in mind by the Commission while determining their right to Central aid. State governments appear to have become suspicious of the motives behind the Centre's inclusion of this condition within the terms of reference. They fear that the provision might be misused to favour some States at the expense of others. However, without this necessary corrective, the normative approach cannot be applied by the Commission. It is no one's case that the same norms can be blindly adopted for all States since there is considerable variation in resource raising capacities and developmental levels over the country. The previous Commissions which went by the trend approach, projected growth rates for taxes and expenditures which were different for different States. Hill States and border States are also getting a special dispensation even under the NDC's

formula and the Gadgil formula for the distribution of Plan assistance is not being applied to them. The per capita cost of a public service is bound to be higher in hilly terrain, which is why the Eighth Commission provided for a 30% step-up in unit costs in respect of upgradation grants for these areas. Historical levels of development cannot also be ignored while estimating growth in tax revenues. In addition to the privileged treatment for such special category States, allowance would have to be made for thinly populated areas like Rajasthan, where the cost of providing services would necessarily be higher than the average. On the whole, however, the Commission's endeavour should be to apply uniform norms to all States with such variations as might be demonstrably justified in the interests of retaining their confidence.

(d) Elimination of the distinction between Plan and non-Plan:

Another basic issue of inter-governmental relations that has been brought to the fore by the terms of reference is the Plan- non-Plan divide. The dichotomy between Plan and non-Plan on the revenue side has been discarded while framing guidelines for the Ninth Finance Commission. This has generated several questions about the possible implications as regards the role and functioning of the Planning Commission:-

- Will the Planning Commission's importance be diminished?
- Will the Finance Commission take over the distribution of Central assistance for State Plans and if so, what will happen to the NDC and the Gadgil formula?
- What then are the prospects for Centrally sponsored Schemes?

There appears to be a complete and surprising reversal in the attitudes of economists and of some States in their approach to the Plan-non-Plan controversy. It is important to

underline the fact that the issue has a long and rather chequered history which cannot be ignored. This is especially relevant for understanding current issues in the proper perspective. We have long been familiar with the argument that the elevation of the Planning Commission (which is a creature of the executive with no constitutional role) to the agency responsible for major discretionary grants to States proves the perfidy of the Centre in inter-governmental relations. The present move, even if it means the emasculation of the Planning Commission ought then to have been welcomed instead of being condemned. On the other hand, it has provoked a storm of criticism which is somewhat baffling.

Although the first Five Year Plan was in operation when the First Finance Commission considered the problem of State finances, no specific recommendation regarding Plan implementation was made. The Second Commission was, however, required by its terms of reference to consider the requirements of States for the Second Five Year Plan while recommending grants-in-aid on the revenue side, and it went ahead with this task. Although the terms of reference of the Third Commission also enjoined on it to have regard to the requirements of the third Five Year Plan while formulating its recommendations, when the Commission took a view of Plan and non-Plan expenditures, the Government of India rejected this part of its report and sided with the Member-Secretary and his minute of dissent. Shri G.R. Kamat opposed the conversion of Article 282 (discretionary) grants to Article 275 (statutory) ones, since the Third Commission recommended grants to meet 75% of the revenue component of State Plans. As a direct consequence of the disagreement on the matter, the Fourth Commission excluded the consideration of the revenue expenditures on the Plan side not on grounds of constitutional limitation on its powers, but on practical considerations, in view of the institutional arrangements relating to Five Year Plans. (The Central government did not restrict the ambit of the Commission to non-Plan expenditure, but it dropped all references to the Plan). The Fifth Commission was specifically debarred by the terms of reference from considering Plan expenditure and the

same practice has continued up to the Eighth Commission. A marginal inroad that has, however, been made into the Plan side is regarding upgradation grants recommended by the Eighth Finance Commission- the capital component of these is now accounted for as a part of State Plans. When the Central government rejected the Third Commission's recommendations and subsequently confined the Finance Commissions to the non-Plan account, it was reviled by academicians and representatives of States as desiring to retain the initiative for Plan financing in its own hands. Over the years, however, the Planning Commission has considerably objectivised its role as grantor by evolving the Gadgil formula which was endorsed by States through the NDC. The institutionalising of this formal mechanism for Plan transfers, which found wide acceptance among the States, has quietened their fears. So much so, that they are now resisting any return to the earlier method by moving what are in effect 282 grants back again to the 275 fold. Evidently, the Planning Commission enjoys their confidence more than the Finance Commission today, a rather ironic and unforeseen situation.

No one will deny that the distinction between Plan and non- Plan is wearing thin. Expenditures are shown under either head with equal panache and schemes like police housing and the mid-day meal programme which were once considered non-developmental and outside the Plan are now being comfortably accommodated within it. Adjustments are even manipulated to inflate Plan size while developmental expenditures which for some legalistic reasons cannot be brought within the Plan, languish on the non-Plan side. One fairly rigid distinction between these two pertains to schemes which have been started under the Plan but are transferred to non-Plan heads at the close of the Plan period. This has created anomalous situations where, for example, the staff of a school building taken up under a previous Plan is shown on the non-Plan side, while that on a new school building has to be accounted for on the Plan side. In respect of Centrally Sponsored Schemes also, termination of Central funding would mean increases in State liabilities, a matter on which protests have been heard.

Another problem pointed out by the Second Commission has also become more acute. This is the great contrast between forecasts presented by States to the Planning Commission and Finance Commission. Both are unrealistic on different counts; for the Finance Commission, the deflation is on the resources and the inflation on expenditure, for the Planning Commission, the process is reversed and much whitewashing is done to show resources sufficient to maintain a respectable Plan size. What is worse is the gulf that separates the Finance Commission's assessment of the resource gap and the Planning Commission's, which is not wholly explained by the different methodologies followed by them. Clubbing Plan and non-Plan together is also advisable in view of the complaints voiced by States regarding taking over staff created under Centrally Sponsored Schemes, when Central funding ceases. The Commission's task is thus to rationalise the system without losing the confidence of States in the impartiality and basic rationality of the Gadgil formula.

Some of the implications of the integration of Plan and non-Plan as well as solutions can be found in past history itself. The Second Commission, for example, adopted the Planning Commission's assessment regarding new expenditure and resources that would be raised on the Plan side. On the non-Plan side, it arrived at its conclusions after confronting State forecasts with Planning Commission projections. In fact, the Commission corrected the Planning Commission's assessments by taking a realistic view of State resources and expenditure. However, the Ninth Finance Commission cannot follow in the footsteps of the Second, because of two vital differences between the circumstances in which both were placed. The Second Commission entered the picture after the Second Plan size had been fixed. Its problem was, thus, different from that confronting the Ninth Commission which will have to make recommendations before final decisions are available on basic issues from the Planning Commission and the NDC. Also, as pointed out by the Member-Secretary of the Third Commission in his minute of dissent, the Second Plan left uncovered a gap in resources and the Finance Commission, therefore, recom-

mended grants to cover this partial gap. That is to say, the Second Plan was financed partly by 275(1) grants and partly by 282 grants, from which we might derive a clue for the Ninth Commission's benefit.

The experience of the Third Commission is, however, directly relevant for the functioning of the Ninth Commission. It recommended 275(1) grants to enable the States to cover 75% of the revenue component of their Plans. The scope for 282 grants was, therefore, reduced and limited. If the Ninth Commission is to proceed on the same lines, would the Gadgil formula and the NDC intervention in Plan financing become redundant? That would not appear to be the case. The coexistence of 275(1) and 282 grants for financing the Plan does not imply a radical departure from present day procedure. The Planning and Finance Commissions need not supplant each other, they can both continue to function as before with marginal adjustments. And we have no reason to bemoan the wide divergence in projections made by States to each of these bodies. After all, the Finance Commission is now clearly expected to project a normative resource surplus/deficit; the Planning Commission could continue to follow up by estimates which are closer to the real picture.

Essentially, the intervention of the Planning Commission in making discretionary grants today is significant only for determining the size and composition of State Plans. The Central assistance flowing to them on the Plan side is an automatic formulation based on the Gadgil formula, at least for the better- off so-called non-special category States, whose gaps in resources would have to be self-financed. In this respect, the situation is not similar to that obtaining at the time of the Second Commission. The allocation of Central assistance for State Plans is not determined either by Plan size or by additional resource mobilisation for the Plan, the exogeneous Gadgil formula takes care of inter-State distribution of funds. The Planning Commission s estimate of the overall requirements of States for Central assistance during a Five Year Plan does not depend on its assessment of their total resource gap. Increasingly,

however, it is likely to get tied more to the availability of Central funds (at least for some more time). Therefore, transferring the function of recommending 275 (1) grants on revenue account to the Finance Commission from the Planning Commission is, in the long run, not detrimental either from the point of view of total transfers to States, or from the point of view of inter-State distribution. On the contrary, the total kitty for assignment to the States will be increased, since Finance Commission grants would cover a part of the Plan revenue requirements of States and these would be in addition to Central assistance given under the Gadgil formula under Article 282. The final implication might be the reduction in market borrowings allocated to States, assuming that the level of Central transfers remains constant over time. Substitution of market borrowings by general purpose grants could only benefit States, since debt-servicing requirements would come down.

Another likely fall-out of the above methodology would be the greater flow of funds into needy areas. Almost all studies have revealed that Central transfers to States have not moved in the direction of compensating poorer States with higher developmental requirements. When 275(1) grants are determined on revenue account on the basis of need, adjusted for tax effort, States which are resource-poor and have been left behind in the process of development will get a greater slice of the cake. The better-off States may not also be affected by this change. And the Planning Commission's assessments would have, necessarily, to take far more note of deviations from Finance Commission projections than it has done so far.

Only a crude methodology can be adopted for assessing the revenue component of the Plan, when actual estimates of the Plan size and even formulations of objectives are not ready. Some arbitrary relationship will have to be established between the Plan and non-Plan components of State expenditures with a provision for stepping up from year to year. The projection of revenue gaps on a normative basis will itself mean the assessment of the overall developmental needs of States by the Finance Commission and a spillover into Plan

financing. This will be of advantage to the States while confronting Central Ministries when Centrally sponsored schemes are formulated, so that their revenue component is kept within the boundaries assumed by the Finance Commission. This will naturally imply optimal use of existing staff by redeploying them and curtailing undue increase of recurring administrative expenditure. On purely State schemes also, the Finance Commission's assessment of revenue requirements can act as a brake on indiscriminate expansion of administrative commitments and this can only contribute to greater efficiency and economy.

Before moving on to the Finance Commission's responsibilities regarding the capital budgeting of States, their reaction to one condition in the terms of reference on the revenue side needs to be examined. State governments seem to have been provoked by the reference to the need for the Commission to keep in mind the defence, security, debt servicing and committed expenditure liabilities of the Central government while recommending grants to States. This has been contrasted by them with the dropping of the usual reference to providing for maintenance expenditures of States. State governments have been demanding that the Finance Commission ought to pronounce judgement on the manner in which the Central government is managing its finances. Unfortunately, this reflects a somewhat distorted appreciation of the role of the Finance Commission. The appropriate mechanism for judging efficiency in expenditure after it is incurred would be the audit mechanism which itself reports to elected legislatures. The Finance Commission is not a fault - finding organisation but an agency for suggesting the quantum of Central resources which should be transferred to States and the manner in which this should be distributed among them. Up to the present, the availability of Central finances has entered the picture only peripherally, when a Finance Commission performed its given functions. In the main, memoranda of State governments are given greater importance than submissions made by Central Ministries while making assessments of requirements of transfers. From the

days of the Fifth Commission, the terms of reference required Commissions to keep in mind the resources available with the Central government, its committed liabilities as well as its demands on account of expenditure on civil administration, defence, border security, debt servicing, etc. Attention has veered around to this term of reference on the present occasion only because the provisions relating to maintenance expenditures of State governments have been dropped. In fact, the terms of reference of the Ninth Finance Commission have also dropped one of the earlier demands on the Central government enumerated in the previous terms, that is the requirements of civil administration, and this is not an insignificant omission. The intention is that the Commission, while determining the global level of Central transfers to States, should not lose sight of the requirements of the Centre. Although, the Eighth Finance Commission cursorily examined the Centre's forecast, it did not expressly link up the available surpluses with the amounts recommended for transfer to States, nor did it make the latter contingent upon the former. The Centre's forecast is important only for the limited purpose of deciding how much can be made available to the States. The Ninth Finance Commission might have to reverse the earlier methodology by looking at things the other way round since for the first time the resource crunch in the country both for the Centre and States will operate as a constraint on Central transfers. The intention is that a global demarcation of funds would have to be done with the full appreciation of the developmental and maintenance requirements of both levels. The normative approach is likely to identify the needs of States for full development in a better manner than previously done and States as a group will not suffer if only the demands of the Centre on defence, border security, debt servicing and other committed liabilities are kept in mind by the Commission.

The last point that must not be lost sight of while determining normative grants is the need for indexing them from year to year to take care of price rises so that the anomalous situation that has arisen, for example, in respect of unit costs for upgradation grants under the Eighth Commission's award is avoided.

Assessment of the Debt Situation

With the modification of the terms of reference relating to resource problems of State governments on the capital budget, which have survived with hardly any change from the Fifth Commission onwards, the Ninth Commission has been again encouraged to break the mould of received dogma. It is to be hoped that neither timidity nor undue respect for tradition will restrain it from fully exploiting the scope for innovation now available. The previous three Commissions evolved a scheme of relief to tackle the debt problems of States which was based on two planks-the rescheduling of certain loans as well as some write-off and grants to bridge the gap on the capital side. But States which have proceeded on their expectations of a repetition of the same terms of reference have been thrown off balance by this development. What has further soured the atmosphere is the specific indication that the Commission should keep in view the Centre's requirements. This is only in line with what has been stated on the revenue side but it also takes note of the fact that earlier Commissions did not specifically assess the ability of the Centre to bear the revenue loss on account of interest and principal repayments from the States. The need for such precision was less urgent then in the context of surplus Central budgets on the revenue account. The recent emergence of the phenomenon of financing revenue expenditure also through capital receipts has underlined the need for a certain prudence in framing the terms of reference.

The Finance Commission should not content itself with merely meeting the gap between capital receipts and expenditure. The net interest liability grants computed very generously by the Eighth Commission have resulted in States like West Bengal finding themselves in the surprising company of usually deficit States and drawing substantially on this resource. A deeper analysis would be required of the lending and borrowing structures of States, of the productive and non-productive uses to which loans are put, of interest subsidies and rates of return. The terms of reference have repeated the emphasis on efficient utilisation of capital resources. The rec-

ommendations should, therefore, deter States from going in for indiscriminate loan and interest waivers to influential sectors in the belief that debt management need not be a major financial objective.

Along with the normal reference of the distribution of the grant in lieu of railway passenger fares and the net proceeds of the additional duties of excise, the Presidential order appointing the Ninth Finance Commission has again aroused much ire by seeking the Commission's views regarding the merger of additional and basic excise duties. Under Article 286(3) of the Constitution, Parliament has been authorised to declare certain goods to be of special importance in inter-State trade and any good so declared can be subject to State sales tax only within the limits prescribed by the Centre. This legal provision has been made use of to enforce the agreement entered into between the States and the Centre to replace the power of levying sales tax on textiles, tobacco and sugar with additional excise on the part of the Central government. The transfer of this power has been regretted by State governments who have opposed any further extension of the scope of additional excises and have even sought return of their original power in view of the tardy manner in which the rates of additional excise are being raised, vis-a-vis, corresponding State sales tax rates. Under the circumstances, the Ninth Commission would be well advised not to recommend any merger but return the tax powers of the States under the earlier agreement and restore the original constitutional position.

The financing of relief expenditure has again been referred to the Commission with only one caveat, viz., that wasteful expenditure should be avoided. Although the possibility of establishing a National Insurance Fund has also been brought in, the Sixth Commission's admirable analysis of a similar suggestion and its rejection of the proposal, can hardly be bettered. A simple alternative, which is administratively least cumbersome and reduces waste, is the Sixth Commission formula. Another possibility would be to provide for funds during the periods when calamities temporarily stretch State

resources so that immediate cash requirements are met. It is to be hoped that the Commission does not continue in the same old groove which has only resulted in phenomenal increase in relief expenditure.

The Commission's mandate applies to the last year of the Seventh Plan and for the full five years of the next Plan. This is part of an exercise aimed at making the Commission's term co-terminus with that of the Planning Commission. To avoid major disruption, the Finance Commission's recommendations for the last year of the Seventh Plan would have to provide for a transition between the existing system of devolutions and the new methodology.

The terms of reference of the Ninth Commission, therefore, pose major issues which go to the very roots of Centre-State relations. They have also revived the debate on fundamental issues and permitted the Commission to raise itself from the merely accounting agency to which it had almost degenerated, to a body of experts capable of novel ideas. Although some of the terms have aroused the passions of State governments, it is to be hoped that a major re-thinking on fiscal federalism would be achieved by the new terms of reference.

Issues Relating to The Ninth Finance Commission

G. Thimmaiah

Introduction

For the first time in the history of independent India, the terms of reference of the Finance Commission have come in for severe criticism not only by the State governments but also by economists and other independent commentators.

The issues raised on the terms of reference of the Ninth Finance Commission can be grouped under six heads:

i. language of the terms of reference;

ii. intentions of the language as well as some terms of reference;

iii. normative approach of the Commission;

iv. specific points included under the terms of reference;

v. relative roles of Finance and Planning Commissions; and

vi. some broader constitutional issues.

Language of the Terms of Reference

The language of the terms of reference has given rise to controversy on two grounds. First, it has been argued that the use of the word "shall" is contrary to the spirit of the

constitutional status given to the Finance Commission under Article 280 and therefore is unconstitutional. Second, that the use of the word "shall" while making reference to various relevant considerations to be kept in view by Ninth Finance Commission while formulating its recommendations, amounts to giving directives to the Finance Commission which is again unconstitutional.

Let us examine the two criticisms levelled against the language of the terms of reference. First, use of the word "shall" is not peculiar to the Ninth Finance Commission alone. It was used earlier in the terms of reference of all the earlier Commissions. It was used even while giving guidelines to some Finance Commissions. Further, it has been used in the terms of reference of the Australian Commonwealth Grants Commission whose model was studied by the framers of the Constitution who gave a constitutional status to the Indian Finance Commission. This would suggest that the word "shall" has been the product of British imperial administration and therefore, there is no need to read too much and give unintended meaning to this word. One may question the relevance of the Australian experience. That will be considered as a matter of opinion. So, mere use of the word "shall" will not make the terms of reference unconstitutional.

In regard to the second point whether the Government of India can give guidelines to the Ninth Finance Commission, we have to examine the language of Article 280. Proviso 3 (a) of Article 280 specifies the task of the Commission in regard to the formulation of principles and their application for distributing the net yield from Union taxes which are to be and may be shared between the Union and the States and also the criteria for distributing the States' share among the States. Proviso 3(b) of the same Article 280 requires the Commission to suggest principles which should govern the grants-in-aid to State revenues.

In the terms of reference of the Ninth Finance Commission, the contents of proviso 3 (a) of Article 280 have been kept

intact. But, the term of reference related to proviso 3 (b) is sought to be restricted by the Union government by asking the Ninth Finance Commission to recommend grants-in-aid only under Article 275. This is not consistent with the financial provision of the Constitution. Under proviso 3 (b) of Article 280, there is only a broad reference requiring the Commission to suggest the principles which should govern the grants-in-aid of States' revenues. This would imply that the Finance Commission may recommend grants-in-aid either under Article 275 or under Article 282 or under both. Further, the Commission may recommend both revenue and capital grants under both these Articles. The point is that the purview of the Finance Commission to recommend grants-in-aid have been unauthorisedly restricted to Article 275 by the Union government. This kind of restriction has been made in the terms of reference of earlier Finance Commissions also. This has not been noticed either by the critics of the language of the terms of reference of Ninth Finance Commission or by the interested State governments. Therefore, we urge the Ninth Finance Commission to interpret this constitutionally specified term of reference (that is proviso 3 (b) of Article 280) to recommend grants for meeting both Articles 275 and 282 if desirable in the interest of the nation.

However, under proviso 3 (c) of Article 280, the President may refer any other matter in the interest of sound finance. It is under this "any other" provision that the Union government has been giving guidelines to the Finance Commission. One far reaching guideline which became a directive and was also slavishly followed by the previous Finance Commissions relates to narrowing down the scope of recommendations of the Finance Commission to non-Plan revenue account of the State governments' budgets. This was unconstitutional. But nobody questioned it because it served until recently a useful purpose of formulating and implementing public sector planning through the mechanism of the Planning Commission. Now this distinction is removed for good which has restored the Constitutional domain of the Finance Commission. But what has led some critics to interpret the guideline as a directive is the combined use of the word "shall" along with the suggestion to

adopt a normative approach for assessing the revenue receipts and revenue expenditures of the Union and the State governments. There is no doubt that this appears like a directive though the Chairman of the Ninth Finance Commission has not interpreted it this way. There is a long history behind this guideline.

In the past, most of the Finance Commissions by and large followed what has come to be known as the 'gap filling' approach. This approach was first adopted by Otto Neimeyer in 1936 to recommend financial transfers from the then Government of British India to the then Provincial governments as part of the implementation of the Government of India Act 1935. This approach was simple and therefore came to be used by the successive Finance Commissions of Independent India to recommend financial transfers from the Union government to the State governments. Probably, they had one justification for such continuation of the 'gap filling' approach. The Constitution of India, in so far as the financial provisions are concerned, continued the financial provisions contained in the Government of India Act of 1935 with very few modifications. Therefore, the First Finance Commission thought that it would be better to follow the approach used by the Otto Neimeyer. The approach does not require any special efforts to estimate the financial needs of the State governments. It is more an arithmetic exercise and therefore became quite handy even for the lowest rung of bureaucracy to follow without much effort. This 'gap filling' approach did not create any special problems until the commencement of the Five-Year Plans. However, with the emergence of the regime of plans and also of the practice of channelising the Union government's funds through a parallel mechanism, i.e. the Planning Commission, the gap filling approach created some confusion. This became obvious from the recommendations of the Third Finance Commission when it asserted the constitutional status of the Finance Commission, vis-a-vis, the Planning Commission. This approach got a snub from the Union government as the majority report which included financial assistance for a major portion of the Plan component of revenue expenditure was rejected and the minor-

ity report which was appended in the form of a dissenting note was accepted. After receiving this bruise, the Finance Commissions could not continue to fight the politically dominant Planning Commission lobby in the Union government. The Fourth Finance Commission voluntarily surrendered its powers and narrowed down its scope of recommendations to non-Plan revenue expenditure. From then onwards, the 'gap filling' approach started playing havoc as will be shown later.

Since the past Finance Commissions used the 'gap filling' approach for recommending grants-in-aid, there was no need to estimate the expenditure needs and revenue efforts of the State governments with reference to any normative standard. Even in two stray cases in which the Finance Commissions recommended special grants for promoting primary education and road communication facilities, no attempt was made to estimate the unit cost and to determine the normative standard level and then to estimate the financial needs of the State governments for upgrading the physical levels of these services. The First Finance Commission identified some States for special assistance for expanding primary education facilities on the basis of its best judgement. Even the amount of grants recommended had no relation to the financial needs of the States for that purpose. Similarly, the Third Finance Commission identified 10 States for special assistance for developing road communications without reference to any objective criteria. The amount of grant recommended was fixed at Rs.36 crore which was about 20 per cent of the then yield from the duty on motor spirit. There was no explanation for the basis of fixing this amount and the distribution of this special grant among the States was equally arbitrary. However, when the 'gap filling' approach of the Finance Commission started receiving severe criticism at the hands of economists, the Union government realised that it should ask the Finance Commission through the terms of reference to use certain criteria for assessing the financial needs of the State governments. Accordingly, the Sixth, Seventh and Eighth Finance Commissions were asked to determine the financial requirements of the State governments for the purpose of upgrading certain essential public services. The

Sixth Finance Commission used the relevant terms of reference to increase the absolute amount of financial assistance to the States by interpreting the coverage of public services broadly to include general administration, land revenue administration and administration of justice, jails, police, education, medical facilities, public health and welfare of Scheduled castes and Scheduled tribes and other backward communities. The Commission tried to bring the per capita expenditure of the backward States on these public services to all States' (excluding special category States) average per capita expenditure. In other words, the Commission tried to equalise the per capita expenditure on these services instead of estimating the revenue needs of the States for these purposes in terms of normative physical levels. Consequently, those States which had already reached the higher levels of per capita expenditure were not entitled to increase provision in expenditure even though many State governments were in need of financial assistance for upgrading the physical levels of these public services in terms of a necessary package of complementary parts. Further, the Commission only made a provision for such financial needs while estimating the growth of expenditure of the State governments for the purpose of determining the net revenue gap. Thus, no additional grant specifically for upgrading this provision was recommended. But the Commission recommended monitoring of the utilisation of this financial provision by the States, by the concerned Central Ministries and the Planning Commission. This was an exercise in futility. Thus, the Sixth Finance Commission failed to equalise the public services in physical terms and only satisfied the letter rather than the spirit behind that additional term of reference.

The Seventh Finance Commission was asked to recommend upgradation of only essential public services by narrowing down the scope of this term of reference to cover the revenue, district and tribal administration, fiscal services, treasury and accounts, judicial administration, police and jail administration. The Commission collected extensive data and information on the levels of provision of these services in the States to find out inter-State disparities. Then the Commission

recommended both revenue and capital grants of varying amounts to some States for expanding personnel as well as building facilities. Here again the Commission only made expenditure provision while projecting the growth of States' expenditure and did not recommend earmarked grants for the purpose. The two drawbacks of the Commission's recommendations in this regard were narrowing down of the scope of terms of reference as a result of which the impact of normative standard on the 'gap filling' approach was reduced to the minimum and second, the physical units as well as unit costs of these services and their variations between the States were not estimated for determining the levels of expenditure of these services.

The Eighth Finance Commission tried to rectify these deficiencies by expanding the list of public services by including police housing, police station buildings, number of police stations, women police wing, armed police under police service; school buildings and additional teachers under education; new sub-jails, basic amenities in jails, jails for women, jails for juveniles, jails for lunatics, staff and staff quarters under jail administration; compensatory allowances, construction of staff quarters, provision of infrastructural facilities in tribal areas under tribal administration; staff quarters for primary health centre (PHC) doctors, rural allowance for them, and equipment for PHCs under health sector; creation of new courts, construction of buildings for the courts and staff quarters for the judicial administration; buildings for revenue officers under district and revenue administration, training facilities for the State administration personnel, and establishment of new special treasuries, buildings for the special treasuries and treasury staff training facilities under treasury and accounts administration. Thus it may be noticed that the Eighth Finance Commission reduced the influence of 'gap filling' approach to a considerable extent by expanding the normative method while estimating the expenditure requirements of the State governments for upgradation purpose. The Commission also tried to improve the methodology of estimating the special financial needs of the State governments for the purpose of upgradation of the services

in several ways. First, the Commission used certain physical norms as standard levels upto which the States' actual levels should be raised. Second, the Commission also took into account in some cases variation in unit costs between States for estimating the additional financial requirements of certain backward States for purpose of bringing up the physical standards of these services. Third, the Commission recommended additional earmarked grants for upgradation of these services to many States. These three exercises clearly indicate that the Eighth Finance Commission had already started using the normative approach for estimating the financial needs of the State governments in crucial sectors of the non-Plan component of revenue expenditure. The only failure was that the Commission did not estimate the revenue potential of the states and compare the revenue efforts of the State governments with the revenue potential existing in various sources allocated to the State governments in the Constitution. The Commission simply took into account the additional resource mobilisation targets promised during the various Plan periods. Though an attempt was made to take into account the revenue efforts of the State governments, the method used was not objectively consistent with the normative approach which was used for estimating the levels of expenditure required for upgradation of public services.

Thus the Finance Commissions, until the Eighth, failed to evolve objective criteria for assessing the financial needs of the State governments. Even though the Eighth Finance Commission extended the scope of its normative approach so as to reduce correspondingly the scope of the 'gap filling' approach, it did not go far enough to make the impact of the normative approach outweigh the adverse impact of 'gap filling' approach on the financial stability of the entire country. In a way the Eighth Finance Commission was restricted from doing that as it was asked to look into only the non-Plan component of revenue expenditure of the States. These repeated failures on the part of the Sixth, Seventh and Eighth Finance Commissions presumably impelled the Union government to ask the Ninth Finance Commission to use a normative ap-

proach for assessing the revenue receipts and expenditure levels of the Union and the State governments. This is obvious from the fact that the earlier term of reference relating to the special grants for upgrading public services has been dropped. Evidently the Union government has realised that explicit reference to a normative approach which the Ninth Finance Commission has been asked to adopt, would secure the minimum normative standard of essential public services in all States funded from the revenue account. Further, the Ninth Finance Commission has also been asked to consider the total revenue expenditure of the State governments by removing the distinction between Plan and non-Plan expenditures. This is a logical step in using the normative approach and a right step for discarding the 'gap filling' approach. If the normative standards are used for assessing the non-Plan expenditure provision and if similar norms are not used by the Planning Commission for Plan expenditure, there will be problems in their integration. Therefore, once the Finance Commission decides about the norms for Government expenditure in its totality taking into account both Plan and non-Plan expenditure, it will be left to the Planning Commission to follow those norms and determine the size of the Plan and monitor the Plan implementation so as to reach the prescribed normative levels.

The historical background is narrated here only to show as to how the explicit mention of normative approach came to be added in the Presidential Order of June 17, 1987. In the light of the foregoing background, it becomes clear that there is nothing wrong in asking the Ninth Finance Commission to use a normative approach while assessing the financial needs of the State governments. This is required in the interest of sound finance which is clearly indicated under proviso 3(c) of Article 280 of the Constitution. The normative approach is explicitly mentioned and also justified as otherwise the Ninth Finance Commission might continue to retain the 'gap filling' approach for a major portion of its recommendations and would use the normative approach for a few selected items of expenditure and revenue receipts. Perhaps in the absence of this explicit mention, the Commission would not attempt to

estimate the revenue potential from each source of revenue assigned to the States and the Union in the Constitution and compare the potential revenue with the actual revenue raised to determine the revenue efforts of both the Union and the States. Now, since the normative approach is explicitly mentioned, the Ninth Finance Commission has got to do this exercise. Since the Ninth Finance Commission has been asked to use the normative approach which was already practiced by the previous three Commissions there is no need for a reference to assessment of the financial needs of the State governments separately for the purpose of upgradation of certain public services. This is because half of the normative approach is meant for upgradation of most of the important items of expenditure in physical terms. As a further logical corollary, the Finance Commission cannot use a normative approach meaningfully without taking into account both non-Plan and Plan expenditure and therefore rightly, the terms of reference do not make a mention of the distinction. This is not going to create any problem for the Planning Commission as will be shown below. Finally, the Ninth Finance Commission will have to take into account both the revenue and capital needs of the State governments even under revenue account for the purpose of raising the physical levels of public services to the normative level.

Therefore, we have to interpret this guideline against the relevant historical background and if it sounds like a directive, it is only intended to emphasise the need for throwing away the 'gap filling' approach and using a more objective normative approach. This is again not unconstitutional as it is in the interest of sound finance, since the truth is that the 'gap filling' approach has been partly responsible for the financial instability facing both the Union and the State governments.

There is another angle from which we may look at the guidelines as a whole. Guidelines indicate the contours of the scope and the context of other related and/or relevant factors which should be kept in view while formulating the recommendations. Even the most able Chairman and members would

look to the terms of reference and their accompanying qualifications for guidance. Guidelines also help to minimise differences of opinion within the Commission and avoid misinterpretations of the relevant constitutional provisions and terms of reference. They would also help improve or modify the approach and principles. Some of the guidelines may be submitted through memoranda[1]. Such guidelines will not have the force of "minimum necessary task". They become opinions, views and/or suggestions. Therefore, explicit guidelines are necessary and desirable.Since they are only guidelines, they cannot be forced on the Commission in the form of directives. Only one guideline given to the Ninth Finance Commission, which appears as a directive, is an exception and has got its historical background. Therefore, to say that will only serve to perpetuate the gap filling approach. What is, however, unconstitutional is the use of the word "Centre" instead of "Union". The Indian Constitution does not mention or use the term Central government.

There are also some other guidelines given to the Ninth Finance Commission. Some of them are equally vague and some of them cannot be quantified. Therefore, only qualitative judgements will have to be formed by the Commission based on relevant circumstantial evidence.

Intention of the Language of the Terms of Reference

Quite apart from the undesirability of giving binding guidelines, the language of some of the terms of reference gives rise to suspicion about the true motives of the Union government. First, the explicit mention of specific expenditure responsibilities of the Union government and absence of such enumeration of the requirements of the State governments under the term of reference 4(i), and explicit mention of the need to keep in view the Union government's financial requirements while examining the financial needs under terms of reference 7 and 8 give rise to the suspicion that the Union government is interested in only safeguarding its own

financial interests and not so much concerned about the financial needs of the State governments. This part of the language clearly indicates that the Ninth Finance Commission should pay more attention (and not equal attention) to the financial responsibilities of the Union government than the financial needs of the State governments. This is patently clear from the term of reference relating to the feasibility of establishing a National Insurance Fund with contributions from only the State governments. Why should the Ninth Finance Commission make recommendation for such a fund? It is gratifying to learn that the Chairman of the Ninth Finance Commission has decided to interpret this term of reference in such a way that it does not exclude the contribution from the Union government.

Second, certain terms of reference like the feasibility of merger of additional union excise duties in lieu of sales tax with the basic excise duties have clearly given the hint that the Union government is bent upon further centralising its taxing powers and reducing the States to magnified municipalities. It is here that the Ninth Finance Commission will have to interpret the terms of reference in the background of the relevant constitutional provisions and their history. Thus it is necessary to analyse the implications of the language of the terms of reference with reference to their relevant constitutional provisions and urge the Ninth Finance Commission to interpret them in the best interests of the financial stability of both the Union and State governments.

Approach of the Ninth Finance Commission

The terms of reference of the Ninth Finance Commission include a guideline under item no. 4(i) which requires the Ninth Finance Commission to adopt a normative approach while assessing the revenue receipts and expenditure levels of the Union and State governments. This particular guideline has created a good deal of apprehension in the minds of the State governments. Economists and other critics have hardly added anything to help clear the doubts or to

suggest an objective method of operationalising such a normative approach. They have gone on criticising the reference to the normative approach on the ground that it has been made binding on the Commission. The intellectuals have played, by and large, a negative role in regard to the Ninth Finance Commission. In the past, economists and even the State governments criticised the 'gap filling' approach and urged for the use of a more objective approach. A suggested approach was the fiscal needs approach. The normative approach is probably much broader than the fiscal needs approach. The fiscal needs approach takes into account the essential financial needs of the State governments for performing the functions assigned to them under the 'police state' and at the most under the 'welfare state'. But the functions which have emerged under the planning regime have also to be taken into account. Perhaps the normative approach would serve the purpose of a comprehensive review of both non-development and development needs of the State governments.

There is some cynicism among the State governments regarding the practicality of operationalising the normative approach. Efforts in this direction are branded as 'academic' in nature. The word 'academic' has come to be interpreted in many ways. People use this to indicate an act of suggesting imaginary ideas or politically and administratively impracticable solutions to complex problems. So any suggestion which is not consistent with the conventional ways of thinking and doing and tries to disturb the status quo is considered academic. Hitherto, we used to hear criticisms about "bureaucracy" and in fact this term came to acquire an even derogatory meaning such as being insensitive to the needs of the people, maintaining status quo resisting any change and deliberately attempting to throttle efforts intended to seek lasting solutions to fundamental problems. Both academic and bureaucratic efforts are required to translate the normative approach into an operational methodology. New ideas are required from the academics and the bureaucrats who should have an open mind to try new ideas. Otherwise the hopes of the Constitution framers enshrined in the Preamble and Directive Principles

will remain unfulfilled. It was in this context that we suggested some methods of operationalising the normative approach. We would like to repeat them and elaborate them here even at the risk of repetition.

The normative approach has got to be applied uniformly to Union and State governments. This has already been conceded by the Chairman of the Ninth Finance Commission in his letter addressed to the Chief Ministers. There is no dispute about this. Next, the normative approach will have to develop some objective norms for assessing the expenditure needs of the State governments for the purpose of upgrading certain public services across the States and also raising the physical levels to the expected normative levels in future. It is possible to use the average national standard as a norm for determining the physical levels of public services and the resultant expenditure on such services and also for assessing revenue efforts. But the average national standard would be lower than the levels which some of the States have already reached in which case they will not benefit if the average national standard is adopted for estimating the physical as well as the financial levels of expenditure of the State governments. Even if all-States' average standard which was used by Sixth Finance Commission is adopted, some of the States whose financial as well as physical levels of public services are already above such all-States' average may not get any additional financial assistance. This happened when the Sixth Finance Commission used all-States' average per capita expenditure as the norm for upgradation of certain essential public services. This may be justified from the point of view of achieving horizontal federal financial equity. But it would amount to keeping even equity level at a low level. Therefore, we suggest that it would be better to use the highest State's standard for the purpose of assessing the financial needs of the State governments. This has been done in Australia. In that case, many States will benefit not necessarily at the cost of the highest State.

But the highest State's standard as also all-States' average standard have no relevance for determining the

normative levels of revenue expenditure and revenue efforts of the Union government. Therefore, it is desirable to eliminate such noncommon items of expenditure like defence, external affairs, civil aviation, railways, post and telegraph and use one common normative standard of expenditure for both Union and State governments wherever the items of expenditure are common. This, however, does not mean that the Ninth Finance Commission should not scrutinise the Union government's expenditure on defence and such other items of expenditure which pertain only to the Centre. That will have to be done as per a separate guideline. The Ninth Finance Commission should examine efficiency in all spheres of financial operation of the Union and State governments from the point of view of ensuring financial discipline. The Ninth Finance Commission can reassess the Union government's expenditure on defence and other items with a view to estimating the revenue surplus which the Union government might have for transferring to the State governments. However, for the purpose of upgradation of the levels of public services to a normative standard, non-common items of expenditure may be excluded.

The Ninth Finance Commission will have to identify the number of public services which should be taken into account for the purpose of assessing the financial requirements of the State governments in terms of normative approach. This would require the Ninth Finance Commission to decide whether it should take into account all items of expenditure listed in the revenue account of the Union and State budgets or take into account only the more essential ones. No doubt, once the Commission decides to use the selection process, value judgements become unavoidable. This would imply that it would be better to cover all items of expenditure under the revenue account leaving out only non-common items. This may appear quite objective but this is also an extreme view. The Ninth Finance Commission cannot afford to raise the levels of all items of expenditure to a normative level in the context of the present resource crunch in the country. It is operationally a difficult task. Besides, it is not desirable as it will not serve any social purpose. This is because many items of expenditure have

emerged and survived in the budgets of the Union and State governments for historical reasons and not necessarily for any socially justifiable reasons. Therefore, the Ninth Finance Commission will have to obtain the opinions of the State governments on the list of public services which should be considered for inclusion in the normative approach and then use a more realistic judgement for identifying the items of expenditure which should be covered by the normative approach.

It would be better to use the earlier incremental-cum- expected-growth rate method to all other sundry items of expenditure for assessing the financial needs of the State governments on account of their expected growth. Even within the identified broad items of expenditure, it would be desirable to confine the normative approach to the most essential as also desirable items of expenditure which have social relevance today. For instance, under the major head "education" there is no need to attempt to raise the standard of university and such other higher education. Extension of universal literacy and raising the standard of primary education are more important. Similarly, extension of ICDS to primary school children, and providing minimum facilities to primary schools can be included as priority schemes under education. Promoting family planning programmes, providing preventive medical and health facilities in rural areas may be considered as priority items under health. Providing drinking water to the rural people, strengthening the public distribution system, welfare of destitute women and children may be considered as top priority items of expenditure under social welfare. Training of grass roots level planning personnel can be considered as an important item of expenditure under agriculture. Increasing the police personnel, number of police stations, and training for the police may be considered as important items under "police". No doubt any such listing of priority items of expenditure under public services involves value judgement. This cannot be avoided in a normative approach. But the value judgement should not adversely affect the State governments. This may be ensured by using some objective criteria and

including those items of expenditure which are initiated for achieving the national goals indicated in the Constitution like universal literacy, promotion of social justice etc. Then the Commission will have to fix a normative physical standard for each of these items of public services and estimate the financial costs of providing a physical unit of such services. It is open to debate, particularly in the light of the present inflationary trend, whether the Ninth Finance Commission should allow for some cost escalation resulting from inflation which might (and definitely will) emerge during the Eighth Plan period.

The most difficult task in this exercise is the fixing of the norms. There are many sources from which we can develop norms in each field of expenditure. For example, a Directive Principle provides for norms for primary education. Operation Blackboard provides norms for improving the quality of primary education. The National Educational Policy provides for long-term norms for other levels of education. The Minimum Needs Programme provides norms for housing for the poor and for rural health. The National Police Commission has suggested norms for police service. The National Policy of Health for all by 2000 A.D. has developed norms for health services. The Transport Policy drawn up by the Union Ministry of Transport has laid down norms for road development. Like this, we have long-terms goals of government activities which have been specified by the national agencies. These norms can be worked back from 2000 A.D. to feasible normative physical targets for 1995. Then they can be phased to give annual financial targets for the period from 1989-90 upto 1994-95 by using realistic (and not at constant prices) unit costs. In this way the normative expenditure levels of both Union and State governments can be estimated. Some of these norms are higher than even the highest norms achieved by some States like Kerala in literacy level. Adoption of such norms will benefit even such States. The 'highest State's norm' need not worry such States as they will be free to aim at still higher norms under the Plan.

Normative approach can also be interpreted as part of the exercise towards a long-term fiscal policy at the State level. This needs some elaboration. In almost all countries of the world there has been a gradual shift from mere annual budgeting to long-term budgetary forecasting. The traditional budget cycle has no doubt become an inevitable part of the financial administration particularly in democracies. But during the post-war years, formulation and implementation of macro-economic policies in these countries required long-range planning in fiscal spheres. Therefore, fiscal policy tools like taxation, public expenditure and public borrowing came to be planned for a long period of time ranging from five to ten years. Consequent on the expansion of public sector and of even the traditional activities of the government, huge capital investment was planned and this investment had to be made annually over a long period of time both for financing it and also for executing the physical targets.

This type of long-range planning did not influence the developing countries for a longtime, mainly because they had public sector economic planning under which long-term and medium- term investment outlays were planned in advance. But sufficient attention was not paid to planning of 'all other items of expenditure and revenue receipts. It was against this background that long-term fiscal policy was formulated by the Union government in December, 1985.

The normative approach only translates the logic underlying long-term projection of revenue receipts and expenditure levels at the State level also. So the normative approach, in a way, is an attempt to persuade the State governments to plan their revenue receipts and expenditures at least for a period of five years. No doubt, they were doing it even under the 'gap filling' approach. But they were only projecting the past into the future by assuming the past growth trend. Under the normative approach, they have to first decide about the future goals they want to achieve in all important areas of public expenditure activities like education, health, police, justice and the like.

Long-term goals which have been set by various national policies indicate the norms in various spheres of government activities. These norms also try to equalise the levels of public services across all the States by treating all the States as one unified nation. Taking these nationally proclaimed norms as reference points, the State governments may work back the physical targets to 1995 and estimate the expenditure required to achieve those physical levels from 1989-90 to 1990-95. Some of these policy documents also broadly indicate the unit costs of the physical targets and therefore it is not very difficult to decide the unit costs which no doubt vary from State to State depending upon the service in question, nature of topography and the relative administrative efficiency to execute them. Allowing for such variations, if the State governments apply unit costs to the physical norms and estimate the expenditure, that will be the projected normative expenditure for the period covered by the Ninth Finance Commission. Thus the normative approach, in a way, has come as a blessing in disguise for State governments to change their mode of thinking about their financial goals.

In the next stage, the Commission may compare the actual physical levels of public services along with the corresponding unit costs of different State governments and Union government separately with the Ninth Finance Commission's normative standard physical levels and normative unit costs. If the actual physical level is below the normative physical level, the Commission will have to multiply the difference by the normative unit cost and count the resulting amount as deficit for the purpose of assessing the financial needs. Similarly, if the actual unit cost is less than the normative unit cost, it should be counted as deficit in need of financial support. This method ensures equalisation of essential public services and promotes cost efficiency.

This method takes into account the unit costs and the existing as well as required physical levels of public services and not some hypothetically projected expenditures of the State governments. The previous Finance Commissions used to

reassess them by using some past growth trend. Under the normative approach the State governments will have to aim at the normative physical standards of public services and by using reasonable unit costs, convert them to expenditure levels. The 'gap filling' approach did not bother to raise the physical levels of the State government's public services to a desired level. It was assumed that once more funds were made available, they would automatically ensure higher levels of physical units of public services. But this has not happened because of diversion of funds for other purposes. There was no attempt to equalise the essential public services across the country under the 'gap filling' approach. There was no incentive for avoiding wasteful expenditure and for mobilising additional resources. What is more, the 'gap filling' approach became a mechanical formula as it did not require either any special skill or judgement of the Chairman and Members of the Finance Commission. The attempt made by the Sixth, Seventh and Eighth Finance Commissions to apply normative standards for upgradation of certain public services did not improve the 'gap filling' approach. It only enabled them to develop an alternative approach step-by-step and as a result the Eight Finance Commission came to use the 'gap filling' approach for all the items of the non-Plan expenditure except those covered under upgradation, and the normative approach for those items of expenditure which came under the upgradation approach. This mixing of approaches became an exercise in patch-work because it did not change the basic methodology but only tried to graft some norms to the 'gap filling' approach. Even under the normative approach, there will be some degree of 'gap filling' but the basic methodology will be normative where objective norms would be used. Wherever such objective norms cannot be applied, the incremental-growth-method will continue to be adopted by the Ninth Finance Commission.

On the revenue receipts side, the Ninth Finance Commission may take into account the revenue raising capacity of the States and the Union government in terms of existing sources of revenue as listed in the Constitution under the State List and Union List respectively and assess their actual tax

efforts in each of these sources. In this sphere, there is no difficulty as there are already developed standard methodologies in the literature on public finance. In India also some studies have been made to assess the revenue potential of the State governments and examine their relevant tax efforts with reference to the revenue potentials. The representative tax system approach which has been developed in the United States of America and used in Canada may be adopted by the Ninth Finance Commission. This requires an assessment of the taxable capacity of State governments in terms of existing tax base potential and then choosing a standard rate of tax to be applied to the tax base to estimate the potential revenue yield from that source of revenue.

By applying the standard rate to the estimated potential tax base, the potential revenue yield may be estimated. Again the standard tax rate may be all-States' average or a national average rate or the highest rate actually in operation in a State. It may not be very difficult to choose the standard rate of tax for all the sources of revenue which are constitutionally available to the State governments. It is also not very difficult to assess the potentials of the tax bases by using appropriate or proxy indicators of tax bases. In any case, it is easier to estimate the revenue potentials and revenue efforts of the State governments as some exercises have already been done with reference to the State governments in India.

But the estimation of revenue potential of the Union government will pose some problems as the exercises comparable to the estimation of revenue potential of the State governments have not been done with reference to the Union government. Even so, it is possible to use the proxy variables and assume the structure of rates and exemptions which existed during a given period of time and apply a standard rate to estimate the potential revenue yield from each of the sources of revenue available to the Union government. It is necessary to assume some normative levels of exemptions, deductions and allowances as the Union government has been resorting to frequent changes in the exemption limits and tax rates in an

attempt to rationalise the tax structure. While this objective is laudable, its impact on the States' finances should be assessed and compensated. The Ninth Finance Commission may take a view that it has no objection to the Union government giving tax concessions, reducing tax rates and enhancing exemption limits of divisible taxes provided the loss of revenue on account of such measures is made good to the States so that the States will not suffer on account of the Union government's tax reform measures. Similarly, there are certain taxes which are enumerated under Article 269 of the Constitution. These taxes have to be levied by the Union government and the net proceeds will have to be transferred to the State governments. But the Union government has not levied these taxes except the Central sales tax. Though there is nothing in the terms of reference of the Ninth Finance Commission requiring it to take into account the revenue potential of these taxes mentioned under Article 269, it is possible to interpret the first term of reference to cover them as it emanates from Chapter I, Part-XII of the Constitution which includes Article 269. The normative approach requires the Ninth Finance Commission to estimate the full potential revenue which can be raised by the Union government from its own exclusive sources, assigned sources and shareable sources. Therefore, while we appreciate that estimation of the revenue potential and revenue efforts of the State governments has to be made with reference to the sources of revenue available to them, it is only fair that a similar exercise be done with reference to the sources of revenue available to the Union government also as otherwise the normative approach will lose its objectivity.

Such an exercise will not interfere with the political decisions of the Union and the State Governments relating to the exploitation of the sources of revenue available to them. It is quite possible that the Union and/or the State Governments may not be able to tap a particular source of revenue given to them under the Constitution for political or administrative reasons. In such a situation, there is no need for the Ninth Finance Commission to compel either the Union or the State Governments to levy such a tax. For instance, the State Govern-

ments are not taxing the agricultural sector to the full potential. Similarly the Union government has not been levying all the taxes mentioned under Article 269 partly for political reasons and partly for administrative reasons. In fact the estate duty which comes under Article 269 and which was in operation until 1985-86 was abolished on the ground that it was not yielding substantial revenue. Whether a particular source of revenue yields adequate revenue or not depends upon the design and structure of the tax in the sense of its coverage, exemption limit, deductions, rate structure, etc.. The Ninth Finance Commission should assume the potential which such a source of revenue would have yielded if it had been levied under a given standard tax structure and adjust that much of revenue to the revenue potential of the Union and/or State governments. Such an adjustment would act as a penalty for not exploiting a particular source of revenue. This kind of adjustment will not amount to interfering with the political decisions of the Union or the State governments as it will not compel them to levy a tax. Therefore, it will not create any political uproar because the principle involved here is simple. If the Union or the State government wants to spend on a particular item of expenditure more than what is warranted by the normative standard level fixed by the Ninth Finance Commission, it has to find its own resources. Similarly, the Ninth Finance Commission should have no objection if the Union or the State government does not tap the Constitutionally given sources of revenue fully for whatever reasons. But the Commission should estimate the potential revenue from that source and add it to the revenue side of the estimated revenue of the Union and/or of the State governments so that they are free to let go a particular source of revenue provided they pay a penalty for foregoing that amount in the federal financial allocation and adjustment mechanisms.

Providing incentives for resource mobilisation bristles with difficulties. If the Ninth Finance Commission provides incentives in the form of additional grants for those States which have achieved tax efforts above the normative standard, it will distort federal fiscal equity because the States which

would show high tax efforts may be the States which are also economically better-off and may be in a better position to raise more financial resources. Such States will benefit from the incentives which is basically a wrong way of encouraging resource mobilisation. Therefore, all adjustments in the form of incentives or disincentives on both revenue and expenditure sides should be made only with reference to the normative standard and not above that.

The terms of reference of the Ninth Finance Commission also require establishing closer linkage between expenditure and revenue raising decisions. This can be interpreted into two ways. The conventional view is that every item of expenditure should be financed by a corresponding earmarked source of revenue. This interpretation has no relevance today as it is not possible to have earmarking of items of revenue for different items of expenditure. Such linking is also considered economically inefficient as it would result in surplus under some heads and deficit under others. Another and perhaps more reasonable interpretation would be that when the Union or the State governments decide to incur expenditure on any new item of expenditure or increase expenditure on any old item beyond the normative standard level, they should be asked to meet such additional expenditure from their own additional resources. The Ninth Finance Commission may leave the Union and the State governments free to raise the expenditure above the normative standard level determined by the Commission. This would meet their demand of non-interference with their expenditure decision making powers. But the Commission should not take into account that additional expenditure above the normative level for the purpose of estimating the revenue needs of the Union and the State governments. This is a more meaningful and operationally effective way of enforcing a closer link between expenditure and revenue raising decisions of both the Union and the State governments.

Relative Roles of the Finance and Planning Commissions

Though the relative roles of the Finance and Planning Commissions have been discussed for a long time, this subject has acquired special significance now because of the absence of the distinction between Plan and non-Plan components of revenue expenditure in the terms of reference of the Ninth Finance Commission. The Ninth Finance Commission has been asked to assess the financial requirements of the State governments on their revenue account by adopting a normative approach and without any distinction between Plan and non-Plan revenue expenditure. This has got two implications. First, removal of the distinction between Plan and non-Plan components of revenue expenditure has only exposed the weakness of the budgetary classification used by the government of India. Second, it has reopened the question of the relative scope of recommendations of the Finance and of Planning Commissions.

It may be mentioned in this context that this term of reference is also not new to the Finance Commissions. When the First Finance Commission was appointed, there was no mention of Plan or non-Plan expenditure in the terms of reference and the First Finance Commission, therefore, dealt with the total revenue expenditure requirements of the State governments. The Second Finance Commission was specifically asked to take into account the requirements of the State governments for the Second Five Year Plan as well as the efforts to raise additional resources from the sources available to them. The recommendations of the Second Finance Commission relating to the grants under Article 275 covered the total revenue components of the Plan as well as non-Plan expenditures of the State governments. In other words, Plan grants and the State governments' additional tax measures were made supplementary sources of funds for meeting the revenue component of Plan expenditure during the Second Five Year Plan. The Third Finance Commission was also

asked to take into account both Plan and non-Plan components of revenue expenditure and in particular the State governments' proposed Plan expenditure during the Third Plan period. The Third Finance Commission in its majority report determined the grants under Article 275 in such a way as to enable the State governments to cover 75 per cent of the revenue expenditure borne on the Plan outlay. While the recommendations of the First and Second Finance Commissions were accepted by the Union government, the recommendations of the Third Finance Commission in this regard were ignored. The Member- Secretary in his minority report expounded the idea that the Plan component of revenue expenditure should be determined by the Planning Commission. This point of view was accepted by the Union government.

Even so, the Fourth Finance Commission was not specifically asked to take into account only the non-Plan component of revenue expenditure. Nor was there any reference nor any guideline debarring the Commission from taking into account the Plan component of revenue expenditure of the State governments. But the Fourth Finance Commission itself narrowed down the scope of its recommendations to only non-Plan revenue expenditure and expressed the view that the Planning Commission should take care of the Plan component of the revenue expenditure. This unexpected narrowing down of the scope of the Finance Commission gave legitimacy to the Union government's guideline to the subsequent Finance Commissions to confine their recommendations only to the non-Plan component of revenue expenditure of the State governments. The Ninth Finance Commission has not been specifically asked either to take into account or not to take into account the Plan component of revenue expenditure of the State governments. But we are given to understand that the Ninth Finance Commission is going to take into account both the Plan and non-Plan components of revenue expenditure of the State governments. This is the correct interpretation and is welcome. It will help the Sate governments to fulfil the normative targets under the revenue account.

Doubts have been expressed by some State governments about the appropriateness of allowing the Ninth Finance Commission to take into account the Plan component of revenue expenditure of the State governments. These doubts are due to the assumption based on past experience that the Finance Commission normally reduces the States' forecasts of revenue expenditure to unreasonably low levels to show non-Plan revenue surplus whereas the Planning Commission is more flexible in its determination of Plan expenditure and hence more generous towards the States. Precisely, it is that flexible generosity of the Planning Commission which has landed the country in the present financial straightjacket. In an attempt to satisfy every State, the Planning Commission has reduced the rigorous planning process to a political bargaining process. Now the Ninth Finance Commission will have to re-establish the financial stability of the State governments and also restore the rigour of the planning process to the Indian planning regime.

There has been a long debate in the country on the appropriateness of dividing public expenditures into Plan and non-Plan expenditure categories. The justification for making this distinction has been that the Plan expenditure would include additional (or continuing) expenditure in the nature of investment or the outlay on the creation of new assets, whereas non-Plan expenditures would include recurring expenditure on operation and maintenance of capital assets created under Plan outlay. This distinction was found useful for the purpose of formulation of Five-Year Plans. But as time passed, this economic basis of the distinction lost its relevance. On the face of it one may interpret that Plan expenditure would be in the nature of development expenditure. But in reality such clear cut classification is not possible as there are items of expenditure under non-Plan category which can be considered development expenditure as for example building for administrative office, courts, police stations etc. Similarly, under Plan expenditure there is a lot of non-developmental expenditure such as salaries to administrative personnel engaged in supporting services. What is more, political considerations have also forced the Planning Commission to change the classifica-

tion of the same item from non-Plan to Plan category. For example, Tamil Nadu's midday meal scheme was declared by the Planning Commission as non-Plan expenditure in the initial years. But subsequently it was transformed into Plan expenditure. Another example is the outlay on irrigation works which is normally Plan expenditure. However, irrigation works involved in inter-State river disputes are allowed to be undertaken by some State governments as non-Plan development projects. The only basis for such categorisation is that such projects are not eligible for Plan assistance. Then what is the actual basis of Plan and non-Plan classification? It is only administrative convenience rather than economic or accounting logic. If this is the actual situation, do we still want the distinction to continue? Should the answer depend upon only the 'self-interest' of the States? Then where do we place the national interest? There has been a long-standing demand for the abolition of the distinction between Plan and non-Plan expenditure and therefore the terms of reference of the Ninth Finance Commission have only conceded this demand.

We have already observed earlier that the previous Finance Commission, particularly the Fifth, Sixth, Seventh and Eighth Finance Commission were asked to confine their recommendations to the financial needs of the State governments on the non-Plan revenue account of their budgets. These Commissions assessed the revenue receipts of the State governments at base year level i.e., the first year of the application of the recommendations of the Finance Commission. Therefore, mobilisation of any additional revenue, (ARM), which the State governments proposed to make in the course of the next five years was considered as part of the Plan resources to be taken into account by the Planning Commission. This was made easy by leaving the determination of the Plan expenditure to the Planning Commission. The Planning Commission determined the States' Plan expenditure on the revenue account after taking into account the balance from current revenue resulting from the revenue surpluses experienced by the States as a result of the recommendations of the Finance Commission and their proposed ARM. By and large, the capital part of the Plan

expenditure was met by loan funds, i.e., net market borrowings, net Union loans, small savings loans and miscellaneous capital receipts.

Now the Ninth Finance Commission is allowed to take into account the Plan component of the States' revenue expenditure. Besides, while determining the Plan expenditure, the Ninth Finance Commission has been asked to take into account the proposed additional revenues which would be mobilised by the State governments during the period of the Eighth Five-Year Plan. This would imply that the Planning Commission will have to determine only the capital outlay to be undertaken during the Eighth Plan period. In other words, the Ninth Finance Commission is going to determine the size of the Plan expenditure on revenue account along with the balance from current revenue, additional resource mobilisation and the revenue surpluses resulting from its recommendations. The Planning Commission will have to take the assessment of the Ninth Finance Commission either as given or as a tentative estimate subject to review and determine the size of the States' plans in the light of the capital funds which will be available during the Eighth Plan period.

The removal of the distinction between Plan and non-Plan components of revenue expenditure in the terms of reference of the Ninth Finance Commission has created some apprehensions. It is feared that the Planning Commission will be reduced to a sort of loan financing agency for capital investment projects and will ultimately assume the role of a magnified loan Council. This will transform the Planning Commission from the present position of a national apex agency which would keep in mind the regional imbalances in social as well as economic development in different parts of the country while determining the size of States' Plans, into a Development Bank. If financial viability is strictly applied by such a transformed Planning Commission for sanctioning loans for the projects and accordingly for determining the size of State governments' capital outlay under the Plan, then the backward States will be at a disadvantage.

Apart from this, it is feared that the present position of the Finance Commission with limited resources and time at its disposal, will be inadequate for making a reliable assessment of the financial requirements of the State governments for financing the Plan component of their revenue expenditure. In contrast, the Planning Commission, with its large secretariat will be in a better position to assess the financial needs of the State governments on Plan account both under revenue and capital heads. All this leads to the conclusion that the Ninth Finance Commission should redefine not only its constitutional role but also the role of the Planning Commission to get over the impasse created by the reference to the normative approach and implicit abolition of the distinction between Plan and non-Plan components of revenue expenditure.

One solution would be that the Ninth Finance Commission may estimate as per the normative approach the financial requirements of the States for the Plan component of their revenue expenditure and recommend to the Planning Commission to take it into account while finalising the size of the States' plans. However, if the Union government accepts such a recommendation, it becomes an award and the Planning Commission cannot modify that award which includes the assessment of the Plan requirements of the State governments. The flexibility which exists today in the determination of the size of the States' plans by the Planning Commission will be lost as the award becomes a rigid figure.

An alternative solution would be for the Planning Commission to take the balance from current revenue of the States, their additional resource mobilisation targets as also the normative level of revenue expenditure on Plan account recommended by the Ninth Finance Commission and then determine the size of the States' plans. Earlier, the Planning Commission used to develop its own norms as for example for the items included under the Minimum Needs Programme (MNP). But now the norms will have to be determined by the Ninth Finance Commission and the Planning Commission will have to accept them if they become part of the Finance Commis-

sion's award. If they are not treated as an award, the Planning Commission may modify the estimates of the balance from current revenue, additional resource mobilisation targets and norms of Plan expenditure while finalising the size of the States' plans.

But there is one snag here. The Ninth Finance Commission would need to know the level of Plan component of revenue expenditure of the State governments for the period from 1989-90 to 1994-95. This requires an outline of the Eighth Five-Year Plan. The State governments have not even started working on the Eighth Plan. Hence, it will be very difficult to expect them to estimate the levels of their Plan expenditure during the Eighth Plan period. However, the Plan component of revenue expenditure for the year 1989-90 is already decided and available with the Planning Commission. This may be taken into account by the Ninth Finance Commission for the purpose of preparing its report for the year 1989-90. For the remaining five years, from 1990-91 to 1994-95, the Planning Commission will have to start immediate dialogue with the State governments on the probable size of the Plan component of revenue expenditure during the Eighth Plan period.

Similarly, it is very difficult for the State governments to indicate in advance contemplated additional resource mobilisation efforts for a period which is too far away from the year 1988. At the most, the State governments may indicate their proposed measures and probable yield during the coming years 1988-89 and 1989-90.

At present, the State governments receive central assistance for State plans, 30 per cent in grants and 70 per cent in loans. This ratio of grants-loan is maintained for all the States except for special category States which receive 90 per cent of the assistance in the form of grants. The idea is that 30 per cent of the Plan expenditure is supposed to be incurred on revenue account and, therefore, has been assisted with grants and the remaining 70 per cent of the Plan expenditure constitutes

capital expenditure which is assisted with loans. If the Ninth Finance Commission determines the Plan component of revenue expenditure of the States, then it will have to recommend corresponding Central assistance to cover that part of the Plan expenditure. This would mean that both Plan component of revenue expenditure and grant component of Plan assistance will be taken out of the purview of the Planning Commission. Even the operation of Gadgil Formula will have to be bifurcated. Because of all these implications the State governments and perhaps the Planning Commission want the Ninth Finance Commission to confine its recommendations to the non-Plan component of revenue expenditure of the States.

Such a point of view is retrogressive and goes to protect *status quo ante.* In a changing society, even the planning process should change. The present change made in the terms of reference of the Ninth Finance Commission appears to be deliberately intended to bring about the required change. The Ninth Finance Commission may determine the total revenue expenditure of the Union and the States by using appropriate objective norms. The Planning Commission may review the total revenue expenditure and determine the size of the State Plans. So far, only the Finance Commission used to review non-Plan revenue expenditure of the State governments, that too once in five years. The non-Plan revenue expenditure of the Union government has never been reviewed either by the Finance Commission or by the Planning Commission. The Planning Commission reviews the Plan expenditure of both the Union and State governments annually. Hereafter, it should subject even the non-Plan expenditures of both the Union and the States for annual scrutiny with reference to the norms used by the Ninth Finance Commission. This means, the Ninth Finance Commission will determine the level of total revenue expenditure of the Union and the States, and the Planning Commission will monitor this expenditure and also their revenue efforts every year when annual Plan exercises are done. Such annual review of both Plan and non-Plan revenue expenditure of the Union and the States will enable the Planning Commission to control the growth of non-Plan expenditure.

This is necessary for maintaining the overall financial stability of the Union and the State governments. Such a review will not conflict with the role of the Finance Commission. It will make the relative roles of the Finance and the Planning Commissions complementary to each other.

Specific Items of Terms of Reference

Quite apart from the language used and the guidelines to adopt a normative approach, some specific terms of reference also have come in for criticism. One such term of reference is the feasibility of merger of additional union excise duty with the basic excise duties. This term of reference gives rise to apprehensions that the Union government intends to gradually eliminate the State governments' power to levy sales tax on three commodities covered under additional excise duty.

It has been clearly stated by the Fifth Finance Commission that the additional union excise duty arrangement is a tax rental arrangement. The State governments have only rented their power to levy sales tax on these commodities to serve some national interest. When this arrangement did not work to the advantage of the States, they complained to the Fifth Finance Commission. The Commission advised the Union government to have dialogue with the State governments to redress their grievances. The matter was discussed in the meeting of the National Development Council in 1970 and the Union government agreed to increase the ratio of basic excise duties to additional excise duty to 2:1 and also the incidence of additional excise duty to 10.8 per cent of value clearance within a period of two years. But the successive Finance Commissions were unhappy to find that the Union government had not fulfilled these conditions. In 1980 the Union government informed the State governments that the incidence of additional excise duty had reached almost 9 per cent of value clearance. However, the Tamil Nadu government is reported to have conducted a test survey to find out the truth and the survey

revealed that the rate of additional excise duty was only about 5 per cent of value clearance. This finding seemed to indicate that the Union government has not fulfilled the terms of the 1970 agreement. Instead, the Union government has asked the Ninth Finance Commission to examine the feasibility of doing away with the separate identity of the additional union excise duty. Since the arrangement relating to additional union excise duty was reached in the meeting of the National Development Council and again certain conditions were stipulated for continuation of this arrangement by the Council, this term of reference should have been referred only after consulting the Council. By unilaterally referring the merger issue to the Ninth Finance Commission, the Union government has given cause for misapprehension.

The Ninth Finance Commission should reject the suggestion implied in the term of reference. The Commission should advise the Union government to first implement the terms agreed to in 1970. Besides, the Commission should also advise the Union government to enact the enabling legislation to levy consignment tax. This promise was also made in the National Development Council. Unless the Union government scrupulously implements the decision of the Council, the State governments will continue to suspect every action of the Union government as an attempt to reduce their financial powers. In Australia the decisions taken in the Premiers Conference (which is held regularly to discuss Commonwealth-State relations) are dutifully implemented by the Commonwealth government. This has created mutual trust and confidence between the Commonwealth government and the State governments.

Another specific item of the terms of reference, which should have been carefully worded, relates to the feasibility of establishing a National Insurance Fund with contribution from only the State governments. It may be recalled in this context that the Sixth Finance Commission was asked to suggest a National Fund for assisting States with contributions from both the Union and State governments. The Sixth Finance Commis-

sion rightly ruled out the desirability as well as feasibility of such a fund. Inspite of such earlier advise, the Ninth Finance Commission has been asked to examine, this time, the feasibility of a National Insurance Fund.

It is unfortunate that the Union government wants the insurance principle to be extended to the sphere of social responsibility of providing relief to the poor in distress. The very idea is repugnant to the consideration of human welfare.

Natural calamities have become regular in some regions like floods in north-eastern States and drought in many others. If the insurance principle is used, then the amount of contribution by some States should be substantially more than by the affected States. In times of wide spread drought, the magnitude of expenditure required for providing relief to the affected people will be too large to be met from a National insurance fund if it is created with contributions from only the States. If the scope of the insurance fund is confined to some specific natural calamities, then the purpose of assisting the State governments will not be served. All these limitations lead us to the conclusion that the Union government cannot shirk its responsibility of assisting the States which face the consequences of natural calamities. We are glad to learn from the statement of the Chairman of the Ninth Finance Commission that the Commission is going to ask the Union government also to contribute to the national fund. If such an arrangement is accepted, then the Ninth Finance Commission should also recommend the procedure of identifying the States really in need of assistance from the national fund and the procedure for releasing the funds so as to provide timely assistance to the States in need of help.

Some Relevant Constitutional Issues

After having discussed some important issues relating to the terms of reference of the Ninth Finance Commission, we would also like to highlight some Constitutional issues relating to the powers and functions of the Finance

Commission which have been neglected and have remained unresolved. These issues have a bearing both on the interpretation of the terms of reference as also on the relative responsibilities of the Finance and Planning Commissions.

The first Constitutional issue relates to Articles 275 and 282 and their relevance for proviso 3(b) of Article 280. We have already pointed out earlier that nobody seems to have noticed or pointed out the unconstitutionality of the term of reference made under item 3(b) of the Presidential Order of June 17, 1987 listing the terms of reference of the Ninth Finance Commission. This was formulated long ago and has been repeatedly referred to the successive Finance Commissions without being questioned by any one. This term of reference reproduces proviso 3(b) of Article 280 and limits its scope to Article 275. This is unconstitutional. If the intention of the framers of the Constitution was to limit it to Article 275 they would have mentioned it under proviso 3(b) of Article 280. Since there are two Articles under which grants could be recommended by the Finance Commission and provided by the Union government, they left it open to the Finance Commission to use either Article 275 or Article 282 or both for recommending grants. Therefore, the Ninth Finance Commission should recommend grants either under Article 275 or under Article 282 or under both depending upon the need to use them under the normative approach. If there are any doubts, the Ninth Finance Commission may obtain the opinion of the Supreme Court.

Further, the Ninth Finance Commission can recommend both revenue purpose and capital purpose grants under Article 275 if such grants are complementary to each other and are intended for upgrading public services to normative standards. Furthermore, the Ninth Finance Commission may recommend even conditional, (earmarked or tied), grants under Article 275. In fact it would be better to recommend earmarked grants for upgradation of public services as otherwise the State governments are likely to divert block grants for fancy populist programmes.

The second Constitutional issue is whether the devolution of tax shares should be distributed first before distributing grants-in-aid under Article 275 and 282, or not. So far, all previous Finance Commissions distributed tax shares first and then recommended grants-in-aid to net deficit States. This was obvious under the 'gap filling' approach. But under the normative approach, the Ninth Finance Commission will have to ensure adequate funds for upgradation of public services. Therefore, it will have to first estimate the financial assistance required for this purpose on revenue account. In other words, the Ninth Finance Commission will first have to estimate the normative level of total revenue expenditure of different States. Then it will have to estimate gross as well as net revenue potential of each State. The gross revenue potential minus revenue efforts gives the net revenue potential. The Ninth Finance Commission will have to add the estimated net revenue potential to the actual revenue projected for the period 1989-90 to 1994-95. Next, the estimated revenue (as suggested above) may be deducted from the estimated normative level of expenditure and the remaining gap will have to be covered by tax shares and grants. At this stage the Ninth Finance Commission may adopt any one of two alternative methods. One is that before distributing the tax shares, conditional grants may be recommended for each of the identified public services for upgrading their physical levels. Then the States' share in the net yield from income tax will have to be determined depending upon the revenue gaps which still remain. The total share of all States should be determined according to the extent of gaps which still remain to be filled after recommending conditional grants. The total States' share will have to be distributed among the States according to some criteria which have got to be made uniformly applicable to all States. If varying amounts of conditional grants are determined first for each State and then the States' share in the net yield from income tax is distributed based on uniform criteria, some States may get more than required and thus experience revenue account surplus and some States may still get less than required and experience revenue account deficit. Finally the States' share in the net yield from additional union excise

duty and the compensatory grants-in-lieu of tax on railway passenger fare will have to be distributed in proportion to the original share of each State. An alternative method would be to determine the conditional grants for upgradation purposes and then distribute the net yield from additional union excise duty and grants-in-lieu of tax on railway passenger fare and proceed to determine the States' share in the net yield from income tax according to States, net revenue needs. In order to fill the remaining revenue gaps of the States, either varying amounts of a share in the net yield from union excise duties may be recommended or in the alternative block grants may be recommended under Article 275.

The foregoing elaboration of the methodology of determining the relative shares of different States in the Federal financial assistance is intended to raise certain constitutional issues. Since the Ninth Finance Commission has to recommend a share in the net yield from income tax to the States as per Article 270, it may do so after recommending compensatory transfers under additional union excise duty and grants-in-lieu of tax on railway fare. The States' constitutional claim for devolution of Central taxes is not absolute and it is valid only for a share in the net yield from income tax as determined by the Finance Commission. The States have no constitutional claim over the net yield from union excise duties. The Parliament may decide not to share this yield in view of the financial stringency faced by the Union government or the Union government may decide to use it for giving Plan grants.

Moreover the Ninth Finance Commission cannot use the distribution of the States' share in the net yield from income tax for achieving horizontal federal fiscal equity since every State has the right to have a share based on uniform application of criteria for *inter se* distribution. If the Ninth Finance Commission uses the States' share in the net yield from income tax for achieving federal fiscal equity, it will amount to violation of Constitutional rights of the States. However, the Ninth Finance Commission can use the net yield from union excise duties for achieving any such equity objectives because it is a discretion-

ary transfer. It is better to obtain the opinion of the Supreme Court on all these issues. This will help the Ninth Finance Commission to use different components of federal fiscal transfers for achieving the objectives of federal financial transfers.

The third Constitutional issue centres around the question what part of the recommendations of the Finance Commission, when accepted by the Union government, becomes award binding on both Union and State Governments? So far, the recommendations of the past Finance Commissions relating to tax shares and grant-in-aid and perhaps debt relief were treated as awards after their acceptance by the Union government. The recommendations relating to the expenditure side of the revenue account had been treated as only indicative. This was obvious under 'gap filling' approach as it was only concerned with covering the projected gaps in the revenue account of the State budgets. However, under the normative approach, it may become necessary to make even the net additional expenditure financed by conditional grants binding on the States. Otherwise, diversion of even earmarked grants may take place which will frustrate the efforts of the Ninth Finance Commission to raise physical levels of public services to normative levels. Therefore, it would be better to make that part of the additional expenditure which is intended for pushing the physical levels of public services upto normative level and financed by conditional grants, binding on both Union and State governments. If such a view requires legal clarification, the Ninth Finance Commission may seek the opinion of the Supreme Court.

Fourth, the Ninth Finance Commission should recommend monitoring of both Plan and non-Plan expenditure as also revenue efforts of the States promised during the Eighth Plan period. Since the distinction between Plan and non-Plan is removed for the purpose of the Ninth Finance Commission's assessment of States' forecast of revenue expenditure, the Planning Commission also should not confine its annual Plan exercise to only Plan expenditure. It should review the progress in raising the physical standards of public

services to the suggested normative levels and keep watch whether the State governments are adhering to the limits of revenue expenditure as determined by the Ninth Finance Commission or not. This will make the role of the Planning Commission truly complementary to the role of the Finance Commission. Such a comprehensive annual or even quarterly review of total revenue expenditure will ensure some degree of financial stability of the State governments. We do not think that such an extension of Planning Commission's review to total revenue expenditure will face any legal or Constitutional hurdle.

Finally, the Ninth Finance Commission has been asked to use 1971 population figures wherever the Commission decides to use population as the basis of distributing tax shares and grants-in-aid. The use of 1971 population was decided upon in 1976 on the ground that it would act as a disincentive to those States which did not achieve family planning targets to reduce population. In other words, it was realised that on one hand the State governments were exhorted to control population by effective implementation of family planning programmes, on the other hand the Finance Commission and the Planning Commission were using population figures of each State as the basis of distributing Central assistance to the State governments. In order to remove this apparent contradiction, it was decided to advise both the Finance and the Planning Commissions to use 1971 population for the purpose of distributing Central assistance to the States till 2001 A.D. This decision was no doubt in keeping with the overall objective of the nation to reduce population. But if the Ninth Finance Commission uses 1971 population for determining the financial needs of the States and for recommending financial assistance to them for providing certain essential public services to all people, it will come in conflict with the Constitutional provision of equality before law and fundamental right to have access to public services by all citizens. The use of 1971 population figures denies implicitly the right of those people born after 1971 to have equal access to public services. This may appear as a hairsplitting argument. But its constitutional impli-

cations need to be examined without brushing them aside as frivolous.

The use of 1971 population also conflicts with the need to provide more resources for highly populated States for controlling their population. What is more, by using 1971 population, wherever the population criterion becomes relevant, the influence of inter-State migration on the population pressure of different States is ignored. The Ninth Finance Commission should at least give adequate weightage to the impact of migration while using 1971 population for recommending assistance to the States which have been experiencing large-scale in-migration. Furthermore, under the normative approach, if 1971 population figures are used for determining physical and financial norms, the financial needs of those States which have experienced higher population growth after 1971 mainly on account of in-migration may get underestimated. Thus, there are some justifiable reasons for cautioning the Ninth Finance Commission not to follow rigidly the guideline relating to the use of 1971 population.

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1. This suggestion has been made by B.P.R. Vithal, see "Terms of Reference of the Ninth Finance Commission", Economic and Political Weekly, November 28, 1987.