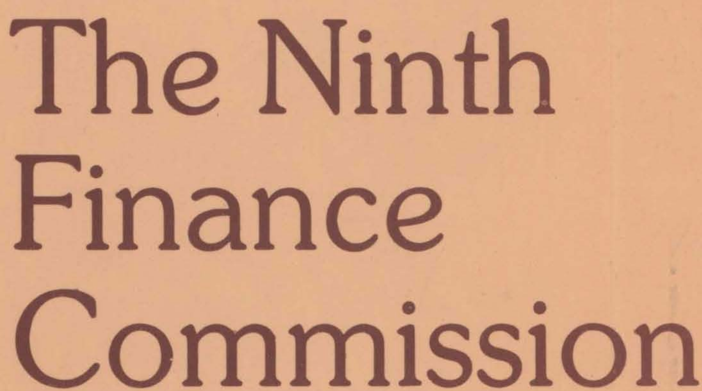

NATIONAL INSTITUTE OF PUBLIC FINANCE AND POLICY

The Ninth Finance Commission

Issues and Recommendations

A Selection of Papers presented at
NIPFP Seminars held in Feb. 1988 & May 1990

National Institute Of Public Finance And Policy

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THE NINTH FINANCE COMMISSION

Issues and Recommendations

Foreword

Appointment of the Finance Commission every five years as mandated by the Indian Constitution has been a matter of great public interest in India. The recommendations of the Finance Commission constitute in many ways the cornerstone of federal fiscal relations in the country. It is thus not surprising that every time a new Finance Commission is appointed, its terms of reference are subjected to close scrutiny as are the recommendations made at the end of their deliberations.

Never before, however, did the terms of reference of a Finance Commission give rise to controversies and protests as followed in the wake of the Presidential Order appointing the Ninth Finance Commission in 1987. Observers of the Indian fiscal scene noticed departures from the past in the tasks set for the Commission in its terms of reference which, depending upon one's viewpoint, appeared to be undesirable and uncalled for, while to others these were timely and essential. The misgivings and controversies centred primarily around two issues. First, whether it was appropriate and legal for the terms of reference to lay down for the Finance Commission its approach to the tasks set for it, as was done in the case of the NFC by requiring it to adopt a normative approach to assess the revenue receipts and expenditures of the States. Could there be objective norms for determining how much resources a State should raise and how much it should spend to discharge its constitutional obligations? Would the reference to "normative" basis lead invariably to imposition of subjective judgements on how much the State

governments should spend and on what and thus erode the already heavily dented autonomy of the States further? Would the norms do adequate justice to the poorer and weaker States? Further, if the States' needs were to be determined normatively why not apply norms in the case of the Centre also uniformly?

The second point stemmed from the mandate given to the NFC to assess revenue needs of the States on the plan side too, a matter which (since the Third Finance Commission's days) was left to the Planning Commission to decide. While some saw in this move an attempt to undermine the Planning Commission's role and authority, others felt that this was perfectly in consonance with the constitutional provisions since the Planning Commission was not a creature of the Constitution and there was no authority in the Constitution for the large transfers which have been taking place from the Centre to the States by way of Plan assistance. Light was sought from the history of the relevant constitutional provisions and as was to be expected, legal experts too joined the fray.

By contrast, the reports of the NFC, however, went almost unnoticed. While there was an extensive debate over the First Report of the Commission which came out in 1988, the Second Report evoked very little public discussion. Of course, one understandable reason is that once a Finance Commission presents its report, it is almost a *fait accompli* and any discussion of its recommendations or the approach underlying them becomes academic. The fact that the report was accepted in its entirety by the Central government (where there was a change in the ruling party when the report was submitted) also served to dispel many of the doubts and apprehensions expressed earlier, although, as is perhaps inevitable, not all the States were happy with the dispensation given to them.

However, there were several significant departures in the approach and methodology followed by the NFC from those of the earlier Commissions which merited closer examination as they reflect an attempt to grapple with some of the basic problems which have surfaced on the fiscal scene in the country and

to use scientific tools in assessing the revenue requirements of the States on a normative basis. It would be fair to say that despite shortcomings, these lay the foundation for the application of principles which would be less subjective in deciding the share of the States in the flow of federal funds.

In order to facilitate dispassionate discussion of the issues involved, the NIPFP had organized two seminars focussed on the approach, methodology and recommendations of the NFC. The first seminar held after the appointment of the NFC and focussed on the terms of reference (February, 1988) and the second held in April 1990 examined the methodology and recommendations after the Commission submitted its second (and final) report. Participants of both the seminars were drawn from leading legal experts and economists, as also policy makers (civil servants) in the Central and State governments. The first seminar was attended by the Chairman, Shri N.K.P. Salve and other Members of the Commission. Both the seminars were inaugurated by Prof. D.T. Lakdawala. Presented below is a selection of papers presented at the seminars along with the inaugural addresses and a record of the discussion on legal issues. Though the first seminar took place four years ago and several of the papers presented therein have since been published, it is felt that it would be useful to put them together so that they are readily available. As many of the issues which came up at the time are still unresolved and might again come up, it might be helpful to have a publication which gives a flavour of the debate that took place not long ago.

A. Bagchi
(Director)

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PART I

Issues Arising from the Terms of Reference

A: INAUGURAL ADDRESS

Issues Before the Ninth Finance Commission*

D.T. Lakdawala

I am very grateful t the National Institute of Public Finance and Policy for giving me the opportunity of discussing with you the main issues that confront the Ninth Finance Commission. Since eight Finance Commissions have preceded this, and each Finance Commission has aroused a great deal of discussion, at least twice, first when it was appointed and later when it submitted its report; many of the main issues before the Commission have been dealt with threadbare in current economic literature. A fresh discussion of these is hardly likely to be rewarding. A more interesting approach may be to concentrate on the two major departures from the past in the terms of reference of the Ninth Finance Commission: the adoption of the normative approach and the taking into account of the entire revenue expenditure, Plan as well as non-Plan.

It must be noted that both these changes have been made in response to criticisms of past reports from responsible quarters that the recommendations were heavily based on the current receipts and expenditure accounts of the States and therefore discouraged tax efforts and resource mobilisation, and promoted extravagance .Tax sharing was used by them to ensure that as few States as possible had to be styled as weak States in need of assistance under Article 275. Given the limitations of the formula of tax-sharing, this invariably meant that the richest four States - Punjab, Haryana, Gujarat and Maharashtra - were left with large surpluses on non-Plan ac-

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* Inaugural Address at the Seminar on Issues before the Ninth Finance Commission.

count which were available to them for planned development, but the poorer States among those not benefitting from Article 275 had much less left for their urgent developmental needs. The States benefitting from Article 275 had to commence the Plan with a clean slate. (Table I). As the enormity of injustice and inequity implicit in the exercise came to be recognized, a number of sophistications were introduced. To mention only a few: Growth rates of income and expenditure of States were standardized; rules were laid down for the permitted salary revisions that should be taken into account; tax arrear reductions were assumed; norms of return on capital lent or invested were determined; need for upgradation of standards of administrative services (understood sometimes even to cover education, medical and health services) was allowed for and tax targets expected to be reached by a particular period were assumed. But, by and large, there was no effort to work out a norm of a tax structure and rate level that should be reached or a standard of State services that should be provided. On the contrary, the States in need of assistance under Article 275 were given grants just enough to cover their developmental revenue expenditure at the existing level of services and expansion thereof was left to be covered by the Planning Commission. This was condemned by many critics as a "gap-filling approach" and introduction of tax and expenditure norms was advocated. Developmental services in poor and rich States widely differ, (Table II) and any worthwhile all-India norm implies a betterment of services at least in some States, provision for which is now included in their plans. Similarly, attempts in less taxed States (Table III) to levy new taxes or increase rates of existing taxes are regarded as Additional Resource Mobilisation for the Plan. The adoption of norms, therefore, raises the question of the overlap of the spheres of jurisdiction between the Finance and the Planning Commissions. The terms of reference of the Ninth Finance Commission seem to hand over the whole question to the Ninth Finance Commission to decide.

The responsiveness of the Government of India to these two criticisms of the academic community and others

interested has brought to the fore many far-reaching issues. How should the norms of tax and expenditure be arrived at? What will be the status of the norms to be laid down by the Finance Commission? If they are to be enforced in the States, what will be the machinery of enforcement? Will norms be laid down for the Centre also, and what will ensure their observance? Will there be a time-table of enforcement? If there are other authorities concerned with norms in these matters, how are their views and actions to be reconciled?

It is apparent on mature consideration that the norms laid down by the Finance Commission can only be for purposes of determining the principles and extent of devolution, and not for prescriptive purposes. There can be no insistence that these norms should be adhered to. Certain limitations follow from the quasi-judicial nature of the Finance Commission, others from its ad hoc nature. The Commission invites the views of different parties on a set of questions, listens to them, especially the Centre and State Governments, and submits its report. It does not discuss its views with concerned parties nor does it seek their acceptance by persuasion. There is no pretension of consultation. It relies for their acceptability on their nature of being an arbitration between the claims of contending parties, which have no other acceptable means of settling the issues. The Finance Commissions in general have not thought it worth their while to recommend specific grants except to a very limited extent, much less conditional ones. The returns on investment in Commercial Departments or State enterprises taken as fair have not materialized. The most important reason for the large gap between the State receipts and expenditures as worked out by the Finance Commissions on the basis of extremely limited application of norms and those assessed by the Planning Commission is that the norms are far from being realised. If there is a more extensive application of norms, the deviations might be greater. Insistence on their observance may be regarded as not only going against the spirit of healthy federalism but may lead to a break-down of the smooth process which has marked the gracious acceptance by the States of the Finance Commission's recommendations.

The Planning Commission proceeds about the business in a different manner and spirit. The Plan giving the broad objectives, the strategies and sectoral allocations is discussed at one or more NDC meetings where all the State governments are represented. The individual Plans of the States are discussed fully at meetings of the Planning Commission with the concerned States. The progress of the State with its Five Year Plan is reviewed every year at the time of the Annual Plan discussions. While there are all-India norms in matters like basic needs, it is realised that the detailed time tables for different States need variations in the light of their individual circumstances; Plan programmes like irrigation and power have different targets. The Planning Commission wields the weapon of Plan assistance which is given to the States on their Plan being accepted, but the role of Plan assistance in the formulation of State plans acceptable to the Planning Commission can be exaggerated. It is the country-wide acceptance of the Plan objectives, strategy and targets and the process of frequent discussions with the States of their plans in pursuance of common objectives that leads to agreed State Plans. Since the Finance Commission cannot by its very nature follow any such procedure, the norms it sets up can be only for the purpose of measurement. If a State raises less by way of taxes than it should according to the tax norm, it must be content with spending less; if it decides to have a higher standard of services, it must accordingly raise more. There is no question of interfering with the choices of the State's residents exercised through their chosen representatives, but the State must take the consequences of its choice. It cannot tax less than the norm, and give its citizens the benefits of services according to norm.

The logic and limitations of these permissive norms taken for the purpose of calculation in satisfying the cherished aspirations of the people must be recognized. The Constitution has made us long aspire for the countrywide acceptance of time-bound targets for ends like universal literacy, health for all, employment at a living wage, etc. These involve a simultaneous all-India pursuit of certain paths. The pressures, however,

have to be slow and persistent, and have to allow for the varying circumstances and the cultural milieu of different peoples and States.

While it is clear that the normative approach the Finance Commission adopts cannot be prescriptive, one cannot be equally sure as to where exactly the norms should be laid down, and how the gap between the receipts and expenditures arrived at should be treated. Even the insistence on adoption of norms for limited purposes can sometimes compel an immediate setback. It is interesting to note that when the Fifth Finance Commission tried to broaden the adoption of norms, the States had to be rescued out of the consequences by grant of special accommodation loans to cover the non-Plan gap. If with the application of norms to the Centre there is a similar problem there, one does not know how the gap will be made good. This underlines the grave need for choosing realistic norms. If the taxable capacity of a State is determined as proportionate to State Domestic Product, a tax norm can be laid down at the percentage raised by the highest taxed States or near the lowest State, or somewhere midway between. The expenditure norm may be laid down in terms of the per capita or per unit cost of standards of essential services similarly arrived at. Much more sophisticated tax and expenditure norms are possible but may be inadvisable at this stage of our first efforts at normative approach. It may be found more practicable to divide States into groups and prescribe different norms for them.

By common consent we have the "special category States" which we exempt from the general formula of Plan assistance and treat differently. If the Finance Commissions did not follow the same procedure for tax-sharing and Article 275 grants, it was only because even in the case of other States covered under Article 275 they did not follow any general principles. The moment they adopt the normative approach they will have to recognize the distinction and treat them differently because of the nature of their terrain and the stage of their economic development. We can only hope that for all the States falling under this classification, a common treatment will be

prescribed. Even in the case of Plan assistance the tendency to treat each special category State separately as a case in itsel. has led to some unnecessary vexation and resentment.

It has been increasingly realized that the Central budgets should, in principle, be subject to the same degree of scrutiny as the State budgets. Now that the normative approach is advocated for the States, it should also apply to the Centre. In the case of States an examination of the budgets *inter se* can greatly help the process of norm fixation, but the Central budget is a case *sui generis.* Its proper comparison is with national budgets of other countries which are very differently circumstanced, so that the comparison hardly helps. There are a few items like returns on capital lent and borrowed etc., where a treatment analogous to that of similar items in the States can help, but there are items like defence which have no parallel in State budgets. These are inherent difficulties which the Ninth Finance Commission should have been left to tackle. The Central Government has made its task more difficult by laying down that it should keep in view the special problems of each State and the special requirements of the Centre such as defence, security, debt servicing and other committed expenditure of liabilities. Was such a high-powered Commission ever likely to ignore the needs of defence and security? Was debt servicing qualitatively a different liability in the States than at the Centre? Committed expenditures or liabilities are the result of Central and State policies, which should be treated as they fall within or outside the norms. In what way are State liabilities and expenditures different from Central ones? These suspicions which, we are sure, would prove unjustified by the final outcome could have been avoided by a more careful choice of terminology.

While a Finance Commission can be expected to provide for the efficient discharge of the Central functions like defence there are others whose legitimacy will have to be critically examined in laying down norms of Central expenditure. The large sums spent by the Centre on items like agriculture and health, which are essentially State functions, for the

purpose of co-ordination and research will need careful scrutiny. The expenditure on Central and Centrally sponsored schemes which are in the nature of conditional grants by the Centre to the States has assumed a dimension much beyond that sanctioned by the 1969 NDC resolution which laid down a ceiling on them of 1/7 to 1/6th of the total block Plan assistance to the States. In 1986-87, these amounted to 32 per cent of the total Plan assistance and 53 per cent of the total Plan grants to the States. They have also not been in accordance with the general principle of progressive transfers calling for an authoritative statement of the underlying first principles as well as their detailed application. The States also must be put in a position where they have to declare their stand categorically on this issue. As in the case of the States, laying down norms of Central expenditure will be only for purposes of determining devolution; they will not be prescriptive. They will take a lot of time and effort, but without such a procedure the normative approach will be one-sided and defective.

If the Central surplus so estimated equals or exceeds the sum of the States' gaps, a sigh of relief may be heaved. This does not take account of the difficulties involved in so evolving rational tax-sharing formulae that they will just fill in the gap and nothing more. If the gap still remains in the case of some States, Article 275 can be invoked if no self-denying restraints are put on its use. If a State turns out as surplus even before tax-sharing or becomes surplus after getting its share of Central taxes, that cannot be helped, but it will ensure that the States adopting norms laid down by the Finance Commission and getting Article 275 grants will all start more or less on the same equitable basis. In practice, because of various departures from the assumptions made here, the States will have large per capita surpluses and deficits, though their distribution may be very different and more rational than now. Devolution distribution will be more progressive. Hitherto, the successive distributions of Finance Commissions have been more progressive but it is a matter of gratification that they have been accepted even by the richer States. It is hoped that a further step

in this direction will be accepted in the same spirit by the better-off States as the earlier ones. If, however, the Central surplus worked out according to norms is less than State deficits, the norms will have to be reworked so as to make the two equal.

The distinction between Plan and non-Plan revenue expenditure has been regarded by many as an artificial and misleading one. On the side of social services like education and health, a greater concentration on Plan expenditure has led to a wrong impression on the low importance being attached to them and a neglect of the significance of continuing current expenditure which has often escaped evaluation. It has also implied a critical neglect of maintenance, which is of as great importance as the Plan item of expansion. It must be agreed that Plan-non-Plan is only a classificatory device and putting an item in one box does not entitle it to greater consideration than all other items in the other box. At the same time, the difference between Plan and non-Plan is certainly meaningful and very different from revenue - capital. In the recent exercises of economizing, the zero budgeting technique can be applied more profitably to non-Plan expenditure as being of old vintage it is likely to have gathered much chaff. Plan expenditure items having been thought of more recently are likely to be more rational. Immediately, the more important issue is that in a Plan item often the revenue and capital components are intermixed, and one cannot be thought of without the other. Capital expenditure on a new school building and classrooms and revenue expenditure on salaries of teachers are both internal parts of the same Plan. The latter cannot be incurred without the former having been sanctioned nor the former justified before the latter is assured. The Ninth Finance Commission will have to bear in mind this practical need in fully considering the entire revenue budgets. It cannot resort to the easy device of adopting the capital Plan of the Planning Commission and add a revenue complement, as the time tables of the two bodies rule it out. Any attempt to deal with a part of the need for expansion of developmental services will lead to a dual authority and a break in the complex considerations that the Planning Commis-

sion has evolved in agreeing to the sectoral distribution of increased current expenditure. In the current situation of a resource-scarce economy the duplication will be unduly costly.

If the Finance Commission in its wisdom decides to take within its fold all revenue receipts including additional resource mobilization and current expenditure, an interesting possibility will arise. The Planning Commission will be left only with the capital side. The Long Term Fiscal Policy had recognized as a harsh reality that as far as the Centre was concerned, there were hardly likely to be any non-Plan surpluses in the Seventh Plan and therefore Central Plan and Central Plan assistance had to be financed from borrowing, deficit financing and surpluses of public sector. The Finance Commission has been asked to keep in view the objective of not only undertaking balancing receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment. That does not seem to be possible; but can the job of capital balancing be more appropriately left to be dealt with in detail by a National Development Bank with quasi-commercial pretensions? An alternative line of thinking to satisfy critics, who would like to see the poorer States obtain more per capita development funds so that the development gap between them and the richer States is narrowed, would be to give capital assistance on the same line as Finance Commission's assistance on the basis of norms i.e. developmental needs and money that can be raised by themselves for development. The Gadgil formula of Plan assistance in operation now is less progressive than the Finance Commission's devolution, but it has been adopted after a long history of struggle against arbitrary ad-hoc formulae of schematic Plan assistance. The acceptability of a formula follows from its being recognized as fair by all. While an extreme equality is unlikely to be accepted as a goal by richer States which have backward areas of their own, they have already agreed to a revision of the Gadgil formula favouring the poor and may be persuaded to do more. A Finance Commission has more freedom in the matter because having submitted its report it dissolves itself. The dissatisfaction with its

recommendations, the resentment against it disappear in the absence of a target. The next Finance Commission has an entirely different personnel, and grievances cannot be built up. Even then the Finance Commissions have been cautious and have recognized the need of wide acceptability of their recommendations. At the NDC meetings, before and after, there will be a lot of negotiations, bargaining, persuasion, pressures and counter-pressures. This makes the process slower, but the acute problems likely to arise out of the possible rejections of recommendations of the Finance Commission are avoided.

The Fifth Finance Commission which was asked to go into the question of unauthorized overdrafts of States came to the conclusion that an important reason for the States drifting into this position was the absence of a machinery to look into the non-Plan capital gaps of the States, and provide for remedial action. Ever since then, the Finance Commissions have been asked by an additional term of reference to look into this problem. As a result, they have recommended some rescheduling which has helped States avoid overdrafts. The situation calls for a more radical readjustment in the terms of various Central loans to States, but till that is possible, the present process should continue. We hope the absence of an explicit reference to suggestions regarding filling up non-Plan capital gap and a specific requirement to suggest corrective measures keeping in view the financial requirements of the Centre will not prevent the Commission from recommending debt rescheduling, if needed.

The Constitution lays down that a Finance Commission shall be appointed every five years or earlier. This has generally been taken to imply that the recommendations of the Finance Commission will hold sway for a maximum duration of five years. The Ninth Finance Commission appointed in June, 1987 has been asked to make two reports, the first covering a period of one year 1989-90 by 30th June, 1988, and the second for a period of five years commencing 1st April, 1990 by 30th June, 1989. Normally the Tenth Finance Commission

will be appointed by June, 1993. The interval both between the appointments of successive Finance Commissions and the effective date of the implementation of their reports will be six years instead of five. This has been done to synchronize the end of the Ninth Finance Commission's recommendations with the completion of the Eighth Plan. But it has raised a technical anomaly. We hope a mountain will not be made out of a molehill.

The States have been sore on the question of operation of additional excise duties levied in lieu of sales tax on sugar, textiles and tobacco. They feel that if they had kept this right with themselves, they would have obtained more revenues. The Centre has agreed to this demand but not abided by the agreement and is not willing to go back to *status quo ante.* This matter has been debated again and again. The Central Government feels that the charge against it of increasing basic excises without increasing additional ones can be automatically met if the two were merged and the States got a fixed proportion of the total. The Finance Commission has been asked to examine its feasibility. The States have taken this proposal as the thin end of the wedge as a precursor of the adoption of the Kamalapati Tripathi Committee's recommendations in some form and an infringement of their Constitutional right to levy a sales tax. This misunderstanding could have been avoided by prior consultation and even now by a declaration that no action would be taken on this issue without a discussion at the NDC. It is hoped that the Ninth Finance Commission will take a cue on this from the Fifth Finance Commission's recommendation on a parallel issue.

There are various issues of Centre - State financial relationships where the Centre has necessarily the final voice but which vitally affect the States. Where the power to levy a tax lies with the Centre, whether to levy the tax and its structure are decided by the Centre, but these have a vital impact on the States. The Centre decides whether and at what rate to levy any of the taxes under Article 268 or 269, the proceeds of which go entirely to the States. In case of commodities where the Centre is the sole producer, it has wide discretion in whether to get more Plan-

resources through a price rise or through an increase in Central excise rate. If it decides on the former, the States get no share in increased profits and corporation tax revenues; if the latter, the States will get 45 per cent. A convention could be established that where a public enterprise is already making a profit there will be no price increase in its product; there will only be a greater excise tax, if need be. A tax free public sector bond has an unfair advantage over a State enterprise bond, though a large part of the cost of concession in direct personal taxation is borne by the States. Decisions regarding investment of many funds which lie with the Centre can substantially affect small savings. There are many such instances where the State interests and attitudes differ widely from those of the Centre and there should be some forum for harmonization. The intermediation of the Finance Commission has been suggested for this purpose, but an inter-State Council may be much better. The Finance Commission should not be used for this purpose as its recommendations in these matters may not carry the weight they should. It is of utmost importance that only where consensus of opinion is likely to emerge, the mechanism of the Finance Commissions should be used. At the minimum, we hope that in future the Central government will take care to refer to the Finance Commission only those additional matters on which the States have agreed for a reference.

I have tried to lay before you the main issues, as I see them, which will have to be decided by the Ninth Finance Commission. With your scholarship and experience you will not only raise some more but also help in suggesting the detailed lines on which they can be tackled in the interests of the National economy.

Table 1
Per Capita Non-Plan Surpluses of States
(As Estimated by the Eighth Finance Commission)

	State	Per capita income at current prices (Rs) 1985-86	Eighth Finance Commission (1984-89) Surplus: Before Devolution: Amount (Rs. crores)	Before Devolution: Per Capita (Rs.)	After Devolution: Amount (Rs. crores)	After Devolution: Per Capita (Rs.)
I.	**Major States**					
	Punjab	4,416	1,147.55	610	1,758.70	935
	Haryana	3,669	965.95	635	1,393.92	917
	Maharashtra	3,430	3,790.48	535	6,407.78	904
	West Bengal	2,813	-3,034.33	-494	-213.71	-35
	Gujarat	2,772	1,034.13	269	2,451.31	638
	Tamil Nadu	2,353	774.12	145	3,217.19	602
	Kerala	2,287	-635.43	-225	623.51	220
	Andhra Pradesh	2,184	-845.98	-141	1,908.80	319
	Karnataka	2,136	351.71	83	2,064.68	489
	Rajasthan	2,043	-1,240.63	-308	307.25(a)	76
					-9.70(b)	-2
	Assam	2,017	-1,444.46	-634	-192.79	-85
	Madhya Pradesh	1,988	-801.77	-135	1,986.34	334
	Uttar Pradesh	1,988	-2,113.59	-168	3,802.01	303
	Bihar	1,548	-3,152.50	-397	853.32	107
	Orissa	1,534(c)	-1,663.80	-566	-102.20	-35
	TOTAL for I		**-6,868.55**	**-96**	**26,256.41**	**367**
II.	**Other States**					
	Nagaland	2,931(e)	-484.04	-5,378	-158.57	-1,762
	Himachal Pradesh	2,542	-713.77	-1,487	-183.08	-381
	Manipur	2,200(c)	-422.73	-2,642	-123.55	-772
	Jammu and Kashmir	2,173	-995.39	-1,464	-257.18	-378
	Meghalaya	1,391(d)	-341.30	-2,133	-98.42	-615
	Sikkim	1,300(e)	- 92.65	-2,316	-29.13	-728
	Tripura	1,206(f)	-502.46	-2,094	-144.79	-603
	TOTAL for II		**-3,552.34**	**-1,996**	**-994.72**	**-559**
All India (I+II)		2,596	-10,420.89	-136	25,261.69	331

Ranked by per capita State Income:

(a) For 1984-85
(b) For 1985-89
(c) Relates to 1984-85
(d) Relates to 1982-83
(e) Relates to 1983-84
(f) Relates to 1980-81

Sources: 1. Central Statistical Organisation, **Estimates of State Domestic Product:** 1970-71 - 1985-86, New Delhi, June, 1984.

2. Report of the Eighth Finance Commission: 1984.

Table 2
Per Capita Development Expenditure : 1985-86 (RE)
(Revenue and Capital Accounts Combined)

	States	Development Expenditure Rs. crores	Per capita (Rs.)
I.	**Major States**		
	Punjab	1,054	579
	Haryana	802	553
	Gujarat	1,965	531
	Maharashtra	3,333	487
	Andhra Pradesh	2,596	449
	Kerala	1,225	447
	Karnataka	1,690	417
	Assam	883	405
	Madhya Pradesh	2,121	373
	Tamil Nadu	1,916	371
	Orissa	1,025	361
	Rajasthan	1,345	352
	West Bengal	1,821	308
	Bihar	1,965	258
	Uttar Pradesh	3,108	258
	TOTAL for I	**26,849**	**375**
II.	**Other States**		
	Sikkim	86	2,150
	Nagaland	175	1,944
	Manipur	164	1,025
	Meghalaya	146	973
	Jammu & Kashmir	620	954
	Tripura	210	913
	Himachal Pradesh	388	843
	TOTAL for II	**1,789**	**1,005**
	TOTAL for (I+II)	28,366	386

Ranked by last column.
Source: Reserve Bank of India Bulletin, Bombay, November 1986.

Table 3
Tax Revenues as Percentage of State Income: 1985-86 (RE)

		Per capita State income at current prices (Rs.) 1985-86	State's own tax revenue 1985-86 (RE)		Per capita revenue
			(Rs.) crores	as % of per capita State income	
I	**Major States**				
	Karnataka	2,136	1,101.22	12.7	272
	Tamil Nadu	2,353	1,520.11	12.5	294
	Andhra Pradesh	2,184	1,451.60	11.5	251
	Kerala	2,287	695.60	11.1	254
	Gujarat	2,772	1,051.99	10.3	284
	Maharashtra	3,430	2,292.23	9.8	335
	Haryana	3,669	499.22	9.4	344
	Punjab	4,416	646.50	7.6	335
	Madhya Pradesh	1,988	837.87	7.4	147
	Rajasthan	2,043	564.64	7.2	148
	Orissa	1,534(a)	296.04	6.8	104
	West Bengal	2,813	1,085.38	6.5	184
	Uttar Pradesh	1,988	1,269.84	5.3	105
	Bihar	1,548	573.82	4.8	75
	Assam	2,017	194.99	4.4	89
	TOTAL for I		**14,081.05**	**196**	
II.	**Other States**				
	Sikkim	1,300(c)	4.64	116	8.9
	Jammu and Kashmir	2,173	103.45	159	7.3
	Meghalaya	1,391(b)	12.05	88	6.3
	Himachal Pradesh	2,542	70.53	153	6.0
	Nagaland	2,931(c)	9.48	105	3.6
	Tripura	1,206(d)	8.45	37	3.1
	Manipur	2,200(a)	7.33	46	2.1
	TOTAL for II		**215.93**		**121**
All-India (I =II)		2,596	14,296.98	7.5	195

Ranked by last column:

(a) Relates to 1984-85 (c) Relates to 1983-84

(b) Relates to 1982-83 (d) Relates to 1980-81

Sources: 1. Central Statistical Organisation, **Estimates of State Domestic Product:** 1970-71 - 1985-86, New Delhi, June, 1987.

2. **Reserve Bank of India Bulletin,** Bombay, November 1987.

B: OVERVIEW

1

Issues Before the Ninth Finance Commission: A Background Note

Amaresh Bagchi, Tapas Sen and V.B. Tulasidhar

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 Comm-ission Devolution	Shared Taxes	Statu-tory 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 Devo-lution	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 reshuffle 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

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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	1159	[illegible]	-752
1975-76	+887	-1254	[illegible]	-971	896	75	+1858	-2150	-292
1976-77	+298	-429	-131	+1111	-1061	+50	+1409	-1490	-81
1977-78	+430	-1362	-933	+1020	-1249	-229	+1450	-2612	-1162
1978-79	-292	1798	-1506	+1135	-125	-1010	+1427	-1923	-496
Ann.Av. 1974-79	+534	-1266	-732	+926	-751	+175	+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	+353	-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	-279	-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 Average		
		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	+28[illegible]
3.	Central revenue transfers	-6850	+6850	-	-12336	+123[illegible]	-
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) ÷ (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	1878.41	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 revênue 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.

C : LEGAL ISSUES

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The Task of the Ninth Finance Commission -

The Planning Commission Tangle

H.K. Paranjape

When thinking of the relationship between the Finance Commission and the Planning Commission in the Indian context, certain historical and constitutional facts need to be emphasised. The Indian Constitution does not use the word 'federal', and the relationship under the present provisions has been dubbed as quasi-federal and sometimes even as almost unitary. But the nature of the Indian polity itself compels the Indian union to be a federation of States, however powerful the Centre has been made under the Constitution. One of the essential requirements of a federal relationship must be assumed to be that the federal government as well as the constituent units should have a status of a certain basic quality. This implies that the constitutional scheme must be so understood and operated that, for their normal functioning, neither the federal government nor a State government should have to depend on the other's goodwill.

In the scheme of federal finance this implies that the financial resources must be so distributed between the federal and the State governments that each will have the potential of enjoying adequate resources for the expenditures involved in carrying out the functions allotted to them. Because it is impracticable to make a clearcut allotment of financial resources the device of the Finance Commission has been used in the Indian Constitution for periodically deciding how the finances

raised by the Union government are to be distributed among the States. For obvious reasons, the most flexible and potentially the most important sources of finance have been put in the Union list. Thus the revenues collected by the Union government are normally expected to exceed the amount which the Union government would require to carry out its own functions and the State governments should be assured of their share in such revenues on the basis of the recommendations of the Finance Commission. This is expected to ensure that the States are certain about the amounts that they may expect as their share from the revenues raised by the Union government; they do not have to depend upon the convenience and the goodwill of the latter.

When the Constitution made provision under Article 282 for both the Union and the States to have the authority to make "any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be may make laws", this was put among "Miscellaneous Financial Provisions", and was not thought of as the main or even a principal provision to ensure the appropriate financial relationship between the Union and the States. As is well-known, provisions of that kind were out in Sections 268 to 281, and were included in the sub-chapter with the title "Distribution of revenues between the Union and the States".

The possibility that economic planning will be taken up as an important activity under the new Constitution was not ignored by the Constitution-makers. A specific provision in the concurrent list was made for "economic and social planning". Mr. M.R. Masani has written[1] that at one stage of the constitutional discussions Jawaharlal Nehru had thought of putting this item in the Union list but after further thought and when a number of members stressed the importance of this item being under the jurisdiction of both the Union and the States, it was decided to put it in the concurrent list. Even though the Planning Commission was constituted a few months after the Constitution was promulgated it is not as if the

idea of organising such a body came up only then. The Advisory Planning Board had already reported in 1946 the importance of organising development planning in the country and alternative ways in which this should be done were already under consideration. The importance of taking up integrated schemes of development was already being thought of in the interregnum. It would not thus be proper to say that when the provisions governing the financial relationship between the Union and the States under the Constitution were finalised, the possibility that the relationship would be vitally affected by plans of development was overlooked. Such an assumption would make out the Constitution-makers as well as the leaders of government, especially those like Nehru who were keen on organising India's development efforts through economic planning as persons without much understanding or foresight about what development planning would involve.

It is also well-known that Article 282 closely follows Section 150 of the Government of India Act (1953), which section was also placed under "Miscellaneous Financial Provisions". The main use which was made of this Section, it is also well-known, was for granting special assistance by the Central government to Bengal in connection with the famine of 1943. Ad hoc grants were also later on given under this Section for purposes like growing more food, post-war development, and relief and rehabilitation. It is thus obvious that this provision, which is virtually repeated in Article 282, was always meant to serve the purpose of ad hoc grants which had to be made for contingencies and unforeseen requirements. If there was any idea that grants on a regular footing were to be made by the Union government to the State governments which would lie outside the scope of the Finance Commission, such a provision should have logically been made in that part of the Constitution which deals with the "Distribution of Revenue between the Union and the States", and surely not under "Miscellaneous Financial Provisions". It is thus not only that the arrangement under which Article 282 is extensively used on a regular basis for making Plan grants to States (which grants have usually outweighed the grants made under the award of

the Finance Commission) is not 'neat', as the ARC Study Team had put it[2]; many legal experts have also opined that such use of that Article is probably unconstitutional and illegal.

The Advisory Planning Board had not specifically stated whether it would like the proposed Planning Commission to be one created under a special provision of the Constitution, under a status, or by executive order. One of the members, Prof. K.T. Shah, had raised this question and opined that the best procedure would be to establish it through legislation.[3] No information is available about why it was decided that the Planning Commission should be constituted merely through an executive order of the Government of India instead of giving it a statutory basis. Perhaps it was thought that as it was a new experiment it would be better if its constitution and organisation were not confined by the straitjacket of a law. But what is remarkable is that even though the Planning Commission has played a very important role in the economy of the country as a whole and its activities have encompassed both the Union and the States, it has continued for almost forty years now on the same basis, a body created by an executive order of the Union government. It is a creature of that government, fully subordinate to it, and therefore subject to the wishes of that government, both in its composition and therefore in the last resort, in the working.[4]

It could not have been anyone's idea that such a body should have a greater say in the transfer of resources from the Union to the States than the Finance Commission, a body specifically charged with this responsibility in the scheme of the Constitution. In practice what happened was that in the early years of planning, not only were all States governed by the same party as was in power at the Centre but the party itself was very much dominated by Jawaharlal Nehru who was both the Prime Minister and also the unrivalled leader of the Congress Party, especially after the death of Sardar Patel. With Nehru as the Chairman of the Planning Commission and taking keen interest in all the important decisions relating to planning, there was little prospect that the States would object to an

arrangement under which an extra-constitutional body like the Planning Commission should decide on the devolution of finances from the Union to the States even though, as these grants were conditional, this arrangement forced the States to adopt policies and projects relating to State subjects as directed by the Union authorities. It should also be said that a genuine attempt was made both by Nehru himself and by the Planning Commission to have a dialogue with the State governments at various levels so that a consensus could be evolved about such matters. Institutions like the National Development Council - and its sub-committees - and Programme Advisors (later called State Plan Advisers) were developed and carefully used for this purpose. Of course if persuasion did not work, the fact that a large part of the plan resources of the State came by way of conditional assistance from the Union government always did.

The fact that the Planning Commission was established even before the First Finance Commission was constituted, and the First Five Year Plan was promulgated with its own scheme of plan grants to the States even before the first award of a Finance Commission, surely had some impact upon the relationship between the two Commissions as it came to evolve.[5] The political reality of all the States being for long under the same party as ruled at the Centre also surely influenced the approach that the successive Finance Commissions took regarding this relationship.

Even then, dissatisfaction about this arrangement gradually became pronounced. Many State planners felt that there was very little scope for planning at the State level in view of the manner in which the twin instruments of Central assistance and the Planning Commission functioned. "Apart from the imposition of decisions on Plan targets, the States are also many times given the methodology of achieving the objective", it was pointed out,"and departure even from the patterns of staffing etc., are not permitted. In such cases the only option to the States is either to accept Central programmes or reject them. Since each programme carries a subsidy (some

times as much as 100 per cent) from the Centre, the States almost invariably accept such offers, even when these have limited utility and applicability for them. The net result is a growing tendency towards inter-State similarity in the sectoral distribution of plan outlays. There is thus consciously or unconsciously a tendency on the part of the States to follow the national pattern of priorities and Central directions with consequential neglect of their own specific growth capacity and requirements. This may not always be in the best interests either of the country as a whole or of the particular State or States". This was the finding of a Study Team of the Administrative Reforms Commission[6] which looked into questions relating to the machinery for planning. The Study team pointed out that there had been a growing tendency on the part of the States to adopt a standard pattern of priorities which was the inevitable result of the manner in which Central assistance was administered. "The Planning Commission has very rarely imposed its decisions on the States in a direct way," it was stated, "and yet the Planning Commission's approach to priorities gets generally accepted by the States". The remedies for this state of affairs suggested were: (i) improving the planning capability in the States, and (ii) ensuring that the instrument of Central assistance was so used as to provide a sense of direction to State authorities but not unjustifiably to influence State planning priorities.

The ARC's study team on Centre-State relationship[7] had suggested that the States should receive block amounts as Central grants and the States should be free to use these amounts at their discretion, except in the case of a few programmes of crucial importance. The study team on Financial Administration[8] had also recommended that the proportion of discretionary element in Central assistance should be considerably reduced and the untied element increased. This team however went further and recommended a shift from discretionary grants to semi-judicial allocations. To achieve this it suggested that one and the same body should deal with both plan and non-plan assistance. It recommended for this purpose the creation of a permanent Finance Commission with a Vice-chairman who would also be a member of the Planning

Commission, the Chairman and other members being appointed for a period of six months or so when the award was to be given. Another institutional innovation suggested by this study team was the creation of a National Development Bank for channelizing long term finance for large and identifiable projects.

The period between 1964, when Jawaharlal Nehru died and 1969 when the Fourth Five Year Plan was finalised was a kind of period of transition in the planning process as well as Centre-State relations. The Planning Commission itself initiated an examination of the whole matter in consultation with the States. This resulted in a number of changes. The number of Centrally sponsored schemes was drastically reduced and the procedures for assistance simplified. But a feeling continued among many States that these changes had not gone far enough. The fact that parties other than the one in power at the Centre were in power in a number of States for some time after 1967 also led to a further assertion by the States that this matter needed more drastic changes. As a result, the Planning Commission decided that the number of Centrally sponsored schemes was to be further reduced so that the outlay on such schemes was not to exceed 1/6th of the Central Plan assistance to States. The bulk of the assistance would be through block grants subject only to the condition that outlays under certain specific programmes and schemes were not to be diverted and further, that the States fully meet the target relating to total Plan outlay as approved by the Planning Commission. It was also decided, in what came to be known as the Gadgil Formula, that 60 per cent of Central plan assistance to States was to be allocated on the basis of population and 30 per cent keeping in view particular aspects of individual States; 10 per cent was to be distributed among six States having per capita incomes below the national average. These modifications certainly helped to remove some of the glaring anomalies which had arisen in the period since the beginning of the Plan era. But there was no real change in the basis of the relationship between the Centre and the States. The two State governments governed by leftist United Fronts in 1969-70 had suggested a drastic reduction in the size of the

activities, if not abolition, of Central Ministries such as Agriculture which dealt with subjects in the State list. They had also taken the view that the Central share of overall Plan outlay should be decreased and the States' share increased. This proposal was not accepted either by the Planning Commission or by the Central government. The proposal to create a National Development Bank was also not accepted. The idea of a permanent Finance Commission was apparently also ruled out. But what was accepted was the creation of a link between the Finance Commission and the Planning Commission through the appointment of one member of the Planning Commission also as a member of the Finance Commission whenever it was constituted. These changes helped reduce the dissatisfaction felt in the States. It was also helped that these changes would set up a trend in Centre-State relations towards greater decentralisation.[9]

But with the ruling Congress securing a majority not only in Parliament but also in a number of States in 1970-71, this trend was reversed and the earlier tendency towards centralisation again began to assert itself. In the interregnum of the Janata rule between 1977 and 1980, the Planning Commission again made efforts for decentralisation. But the centralising tendency reasserted itself in 1980 and has continued since then. There has also been a more pronounced tendency to appoint party political personalities as the effective heads of the Planning Commission, thus taking away whatever the impact of keeping non-political expert personalities in that position was. The Planning Commission is now seen to be quite openly an organ of the Union government, subordinate to its will and with no pretensions to having a federal and non-partisan character. Though the Gadgil Formula (albeit with some modifications) continues to hold sway regarding Plan assistance, there has been a persistent reassertion of the trend[10] towards Centrally sponsored schemes and discretionary assistance is becoming important, in the distribution of which political favouritism as well as the use of finance to influence policies becomes possible.

An important effect of the financial arrangement made in the Indian Constitution and as it has evolved in practice has been that the Union government appears to have available to it more resources than are strictly necessary for carrying out the functions assigned to it under the Constitution. Instead of this surplus revenue being devolved to the States through the award of the Finance Commission, a practice which would create a kind of right among the States for their share of the common revenue, the devolution taking place through Plan grants created the illusion that the Union government was being specially helpful if not generous to the States.[11] The Finance Commissions have also fallen in line with this approach, the result being that the Union government has developed a tendency to undertake excessive expenditures and also to take up functions which are really within the State list. Two or three illustrations will indicate how this has been happening.

The emoluments of government employees constitute a very substantial part of public expenditure. The rates of emoluments fixed by the Union government for its own employees unavoidably have repercussions not only on the rates which the State governments and local authorities have to pay but also upon the rates which organised employees everywhere expect and demand. It is true that there is no Constitutional or legal reason why employees of the State governments should receive emoluments equivalent to their counterparts serving the Union government; but with the increasing unionisation of employees, any upward increases in the emoluments of any major category of employees cannot but induce a similar demand from all the others. Because of various historical reasons, payscales in the Union government have set the pattern for the emoluments of almost all categories of organised employment. In pre-Indendence days, government employees, especially those at the middle and higher levels, enjoyed emoluments which were conspicuously higher than those of their counterparts in non-government employment. The public service emoluments also had no clear and logical relationship with the normal income in other walks of national life or with the national per capita

income. The top-heavy character of these emoluments had been criticised by the critics of foreign rule,[12] and especially by the leaders of the Indian National Congress throughout the pre-Independence period. Under Mahatma Gandhi's leadership, it had been decided that one of the major changes after Independence would be to bring the emoluments of government employees into a more logical and reasonable relationship with incomes in other walks of life, efforts being specially concentrated on reducing the gap between the highest and the lowest as well as bringing the lowest into a reasonable relationship with the per capita income in the country. We have had four Pay Commissions since Independence which have examined this matter on behalf of the Union government; and the emoluments of the Union government employees have been continuously revised upwards as a result of their recommendations. Analysis of available data shows that the emoluments policy of the Union government, far from fulfilling the expectation raised in the pre-Independence period, has belied them. While the gap between the highest and lowest in government service has been gradually reduced, the relationship between the remuneration of government employees and per capita income continues to be loaded in favour of government employees.[13] The emoluments policy of the Union government has increasingly come to form the basis for determining the emoluments policy of the State governments, local authorities, public sector enterprises, educational institutions and many other avenues of employment in the country. The result is that a very substantial part of the revenues raised by public authorities, whether at the Union or any other government level,[14] are eaten up in paying an increasing number of employees, thus leaving a much smaller than appropriate part for other necessary expenditure, whether for developmental, social service or other essential government functions. The Union government has been able to be generous to its employees only because it has not seriously felt the constraint of inadequate financial resources. In turn, this has also made the position of State governments and local authorities difficult. The latter have willy-nilly to bring the

emoluments of their employees on par with those of the Union government employees and this makes their financial position very precarious.

It should also be noted that the increases in the emoluments are effected without any previous full-scale examination of the effects of such a change on the personal income structure in the organised sector of the economy, its expenditure and savings implications, and the resulting impact on the rate and pattern of economic growth. The Planning Commission has hardly any say in the matter while the Finance Commissions have merely to accept the financial implications of the change as a fait accompli.

The Union government spends large amounts on areas of activity which are either put in the State list under the Constitution or, even when they are in the concurrent list, the main part of the work has to be carried out in the States' sphere. In subjects like agriculture it is obvious that most of the development activity has to be undertaken by the State governments, Union government activities being functionally useful mainly in aspects like research and coordination. The same can be said even about an activity like education. In this case, if priorities are rightly observed, the State governments will have to undertake the main responsibility not only in primary and secondary but even in university education; and in effect, this is what happens. The Union government should really confine itself to research and coordination and perhaps to a few special activities of all India importance such as institutions for the comparative study of different Indian languages, or anthropological and archaeological studies of a country-wide character.

What one finds, however, is that not only does the Union government maintain full fledged Ministries with all their paraphernalia for these and similar other subjects, but it also attempts to compete with the State governments by setting up certain institutions of its own which enjoy facilities - thanks

to the munificence of the Union government - which are far better than any that the State governments can provide. The so called Central universities thus have per capita government grants which are far larger than those enjoyed by the State universities which form the large majority in the country. It is not even as if the institutions supported by the Union government necessarily attract the best candidates from all over the country. While such a claim can perhaps be made about the Indian Institute of Technology, it can hardly be made about the Central universities such as those at Delhi, Varanasi, Aligarh or Hyderabad. Experiments of a doubtful character like the Navodaya Schools can be undertaken - and practically forced on the State governments - only because the Union authorities have little constraint about funds for pursuing their hobby horses. The Union territories appear to be able to incur per capita much higher expenditure for developmental as well as social welfare services as compared to even the more prosperous States; and it cannot be said that there is any special reason for such higher expenditure because of the backwardness of the population there or any other such special characteristics.

The very fact that for subjects which cannot but be for the most part, and in fact are, the responsibility of the State governments, special departments and Ministries are created at the Union level, makes it possible both for the political and bureaucratic persons incharge to take up fancy activities which should have low priority in a poor country. The manner in which massive expenditure was undertaken in connection with the organisation of the Asian Games some years back is a good example of this. Probably more expenditure was undertaken in connection with this activity, most of it in and around Delhi, than the total expenditure undertaken for the encouragement of sports throughout the country over a long period, maybe since Independence. Such extravagant expenditure becomes possible only because of the wrong turn which the whole question of distribution of revenues under the constitution has received right from the time of the First Finance Commission.

With the Ninth Finance Commission being specifically given the task of applying 'normative standards', it can, in spite of the limitations of time, go into such matters and indicate what expenditures can be done away with in the light of the illustrative examples mentioned here. There is no reason why it cannot make an assessment of what can be saved if some of these uncalled for activities are curtailed to the minimum and assume that these amounts will in fact not be a necessary part of the Union government's expenditure in the coming years.[16]

The expenditures incurred by the Union government on its special subjects and especially on security and defence, pose a different problem. These expenditures have been rapidly increasing year by year and little detailed scrutiny is exercised over it either through Parliamentary debates or committees. The government is usually able to get away with one-line explanations like not compromising with national security. It will obviously be difficult for a body like the Finance Commission to adopt any but a broad normative standard like proportion of security expenditure to national income as compared to other countries; and even then it will be quite a difficult task. But if the Commission makes some effort in this direction and exposes the problems as well as the implications of the present trend for the public to see, it will have served an important public purpose.

In addition to the question of the propriety of certain expenditures incurred by the Union government, many other difficult issues like the price policy of important public enterprises - mostly under the Union government - have an important bearing on the question of Union-State financial relations. There are conflicting considerations like the importance of generating surpluses on the one side, and the impact of higher prices on the expenditures as well as potential tax resources of the State governments on the other. It may be difficult for the Finance Commission to sort these out fully.

Another aspect of the Centre-State financial relation-

ship which would be difficult for the Finance Commission to do anything much about is the essentially inadequate financial resources allotted under the Constitution to the States. The possible criticism that a potentially flexible source like agricultural income tax is hardly fully exploited by the States can be answered by the counter-criticism that surely the Government of India does not ignore the political implications of whatever financial measures it adopts or does not adopt. The fact that under the Constitutional scheme the States are loaded with very capital intensive responsibilities such as looking after most of the economic as well as social infrastructure, and also bear the full impact of natural calamities, is well known. Would the Finance Commission be entitled, under the new terms to go into matters like the inclusion of upto now not shared revenue sources like corporation tax being shared or - like in the USA - certain commodities being exempted from Central Excise so that they can become good sources for States to tap. On the other hand, the Commission being asked to examine the feasibility of the merger of additional excise duties - in lieu of sales tax - with basic duties can create a difficult precedent.

Another important issue is about the proportion of Central assistance to be given in the form of loans and grants. With the States being responsible for meeting all difficult burdens including natural calamities like floods and famines, the indebtedness of the States to the Centre goes on mounting. What we now find happening is that the resulting interest payments to the Centre have escalated to an extent where these more than wipe out the non-plan grants which have mainly resulted from the awards of the previous Finance Commissions. In fact, it can be seen that the repayment of loans and advances plus interest payments to the Centre take away around one third of the total grants and loans - and over two third of the new loans - which the States obtain every year from the Centre. One does not know whether the Finance Commission can suggest a scaling down of some of these large repayment obligations or a kind of moratorium on interest and whether the Government of India will accept any such recommendation. Otherwise in the case of quite a few States, unless the Finance Commission can show

very special favour in their case, their net gain by way of loans and grants from the Centre would make only a little net addition to their financial resources.

An important limitation arising out of the Constitutional Scheme is the control over the Reserve Bank of India being exclusively in the jurisdiction of the Government of India and no convention having been established to ensure that the RBI genuinely operates as an autonomous agency. The result is that the Central government can go on indulging in deficit financing on a large scale without any check being exercised by the RBI while it can exercise such control in the case of States. There is now a persistent tendency for the Central government to indulge in deficit financing even for balancing its revenue account, and thus its indebtedness has gone on rapidly mounting. How much a State government is to be permitted to borrow is a matter decided entirely by the RBI which is an agency subordinate to the Central government. The Central government also is able to obtain far more accommodation from the banking system which is also directly under its control. The investments by various semi-government organisations are also loaded in favour of the Central government, and now Central government enterprises. The Government of India itself obtains revenue from special sources which are not available to the State governments. The loans which are obtained from foreign aiding organisations usually carry very concessional rates of interest but a large part of the benefit of this accrues to the Government of India even if the loans are meant for development schemes in the State sphere. Moreover, only 70% of the amounts obtained are passed on to the State governments. In all these matters, the State governments are handicapped. The Finance Commission will have to deal with such matters or at least keep their implications in view when making its recommendations. It may perhaps recommend the creation of an Inter-State Loans Council which will guide the RBI in its policy regarding market borrowing by the Union and the State governments.

This is related to the big question about the Planning

Commission itself being a body which continues to be entirely subordinate to the Central government. With Plan grants and loans forming such a large chunk of the resources transferred from the Central to the State governments, the fact that the Planning Commission is not genuinely a federal body has been increasingly seen to be a handicap in the smooth functioning of Centre-State relations in the matter of development planning and financing. There is no doubt that until that position can be thoroughly re-examined and revised there is little that even a well meaning Finance Commission will be able to do in the matter of ensuring better financial justice to States. Moreover, the Union government has upto now not only failed to create a body like the inter-State council envisaged by the Constitution, but not even developed a convention that the State governments - or a body like the National Development Council on which they are represented - will be consulted before the Terms of Reference of the Finance Commission and its composition are decided. After all, the States increasingly look to a statutory body like the Finance Commission to do them justice rather than to the Planning Commission. That is why this is so important.

One hopes that the Finance Commission will at least raise these issues; and, in the light of its own experience and studies as well as the representations made to it, once again point out how important a basic change in the nature of the Finance Commission would be. The question about a part of the Finance Commission being made a permanent one will have to be brought up; and so also that about the anomaly of a substantial part of the Centre-State financial relations being dealt with by a non- statutory Planning Commission.

At the present crucial juncture in the Union-State relations situation, the proper approach to the work of the Finance Commission can be to expect it to use the best norms and judgements it can devise to work out what the Union and the States can raise and what they genuinely need to spend in relation to their own appropriate functions as laid down in the Constitution. It will be only proper that it should suggest

expenditure norms which the Union government should adhere to - accepting a period over which such a change can be brought about - and recommend the distribution of a large part of the amount that is to devolve on the States to be distributed under Section 280,17 reserving Section 282 grants for disasters and other such unexpected events.

An important and very useful fallout of such an arrangement will be that the Planning Commission will then have to become a genuinely expert advisory body. It will have no clout of 'Plan-grants' to enforce the pattern of development schemes and approaches which it and the various Union Ministries think appropriate for all the States to follow. Only on the basis of its genuine expertise will it be able to influence State governments and not through the financial clout. To the extent that enforcing some degree of uniformity is necessary in respect of certain areas of development, a decision will have to be taken to provide authority through a statute under the heading "social and economic planning" in the Concurrent list. The Planning Commission's authority and responsibility would also then come to be more clearly defined.

Notes

1. The Times of India, July 17, 1983.

2. The Administrative Reforms Commission - Study Team on Centre-State Relations, Report, New Delhi, para 4.8. The opinion expressed was that "the legality of the present use of Article 282 can not be questioned. The arrangement, however, though not unconstitutional, is not neat".

3. The Advisory Planning Board, Report, Delhi, 1947, pp. 55-57.

4. A number of recent statements of the Prime Minister, Mr. Rajiv Gandhi about his having 'directed' the Planning Commission to work on the Eighth Plan in a certain manner e.g., on the basis of decentralised district planning - indicate how the Union government assumes that the Planning Commission is entirely a body subordinate to it. No reference to the National Development Council is considered necessary before such directives are given.

5. It is interesting to note that the Report of the First Finance Commission (signed on December 31, 1952) does not make any mention of the Planning Commission or the First Five Year Plan, even though the Planning Commission was established in March 1950, and the Draft Outline of the First Five Year Plan also being finalised and submitted on December 7, 1952. The Plan document however, mentions that "a reappraisal of State finances will be necessary in the near future, particularly in the light of the recommendations of the Finance Commission". It further states, "the whole scheme of Central assistance, as now worked out, may have also to be readjusted in the light of the recommendations of the Finance Commission". The First Five Year Plan, pp. 54-59.

6. The Administrative Reforms Commission - Study Team on the Machinery for Planning: Final Report (Delhi) 1968, p. 87.

7. Op. cit., paras 2.10, 2.32 and 2.33.

8. The Administrative Reforms Commission - Study Team on Financial Administration - Report (Delhi), pp. 79-85.

9. For a resume of the developments in this field upto 1969, see this author's "Centre-State Relations in Planning", Indian Journal of Public Administration, Vol. XVI No. 1, January-March 1970 (also published as a IJPA Reprint).

10. See - "in 1979, on N.D.C.'s recommendation, it was decided to transfer 72 schemes to the State Sector and retain only 75 schemes. But during the Sixth Plan period, these schemes have again multiplied from 75 in 1980-81 to 201 in 1984-85. In the Seventh Five Year Plan, a total of 262 Centrally sponsored schemes have been included..." Government of India - Commission on Centre-State Relations, Report, Part I, (1988), p. 375.

11. It has thus sometimes been claimed by spokesmen of the Union government (including Prime Ministers) when commenting on schemes taken up by State governments - especially with reference to those controlled by other political parties - that whatever was being done was only possible because of Central funds.

12. See D.R. Gadgil: "On Salary Levels - The Salaries of Public Officials in India; Memorandum on Scales of Salaries; Ex-colonial and New Income Differentials in India," in writings and speeches of Professor D.R. Gadgil in <u>Economic and Political Weekly (Pune) 1981, pp. 106-166.</u>

13. Date given by the Second Central Pay Commission indicates changes in disparity ratios as follows: (lowest paid against highest paid cadres):

	1939-40	1947-48	1951-52	1957-58
Starting salary	43.4	6.9	5.4	5.1
Maximum salary (after income-tax)	257	38	31	28.5

(Report, pp. 78-79)

To look at the matter another way, the minimum payment in Central government services in 1950-51 (including D.A.) was Rs 780/- and the maximum Rs 36,000 p.a. (excluding ICS and other pre-independence services); i.e. the maximum was 46 times the minimum. Now (1987-88) it is Rs 10,860 and Rs 96,000 p.a. (excluding a few special posts where it is Rs 1,08,000); thus the maximum is 8.8 times the minimum.

As compared to per capita NNP at current prices, the minimum in Central government service was 3.17 times in 1950-51 and 3.28 times in 1987-88; the maximum was 36.6 times and 32.2 times in respective years. (per capita NNP pertains to 1986-87, and is based on the new series).

14. Data about wages and salaries as proportion of total expenditure for the Central government is as follows:

	1985-86 Accounts	1986-87 R.E.	1987-88 B.E.
Administration	9.6	10.0	10.5
Departmental undertakings	26.9	29.6	28.6

(Data from An Economic and Functional Classification of the Central government Budget, 1987-88, pp. 9-10).

According to another source the proportion of expenditure on wages and salaries to total was 19% for the Central government, 30% for the State governments and 29% for the Union territories in 1975-76. (Anand P. Gupta: "Who Benefits from Government Expenditure in India?" quoted in Basic Statistics relating to the Indian Economy, Vol. 2 / States, Centre for Monitoring Indian Economy, Bombay, 1982, Table 16.7.

15. The following data should be instructive in this regard: Per Capita Central Plan Assistance (Rs.)

	1987-88 R.E.	1988-89 B.E.
States	135.68	132.44
Union territories of which	731.77	784.18
Pondicherry	789.50	891.66
Chandigarh	987.44	1035.55
Delhi	870.32	987.10

(Calculation based on 1981 Census figures).

16. See George K.K. and Gulati I.S. - "Central Inroads into State Subjects: An Analysis of Economic Services:, Economic and Political Weekly, April 6, 1985, pp. 592-603. The Sarkaria Commission has pointed out that the Union government incurs substantial expenditure on the subjects included in the State list; e.g. agriculture, rural development, cooperation, education, health, etc. It points out: data show that the Central Plan Outlay during the Sixth and Seventh Plans on some of such items was very large; e.g., agriculture 43.0% and 38.4%, rural development 43.1% and 54.0%; village and small industries 51.9% and 46.7% social services 31.7% and 35.35, for the 6th and 7th Plans respectively. See - Report, op.cit; pp. 281, 375-76, 399-401.

A rough calculation made by the present author suggests that from the budgets of Union Ministries and departments like Agriculture, Rural Development, Irrigation and Flood Control, Industry and Minerals, General Education, Technical Education, Sports and Youth Services, Women and Children, and Environment and Forests, large proportions can be cut as unnecessary for the purposes of carrying out essential Central functions in respect of these activities. The cut can be of the order of over Rs 1,600 crore (based on R.E. for 1987-88 and B.E. for 1988-89).

Round Table Discussion on Legal Issues

Dr. A Bagchi: Two sets of legal issues have been raised by the terms of reference of the Ninth Finance Commission. The first group of issues focuses on the question whether the Constitution authorises the President to lay down guidelines, mandatory or indicative, for the Finance Commission. If the answer is 'No', can the Finance Commission ignore such guidelines or directives?

The next set of issues revolves round the interpretation of the Constitution arising out of the enlargement of the Finance Commission's jurisdiction and the transfers contemplated under Articles 275 and 282 of the Constitution. The respective roles of the Finance Commission and the Planning Commission call for consideration, because it needs to be determined whether the substantial transfers being made through Article 282 are permissible under the Constitution.

Briefly, the questions that need to be answered are: First, does Article 282 permit transfer of funds by the Centre to the States or by one State to another for specific public purposes only as a residuary head of transfer, as the marginal heading of the Article suggests? Or does it enable the Centre and the States to make transfers freely for

purposes outside their respective jurisdictions, as defined in the Constitution?

Secondly, Artide 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 revenues of the States out of the Consolidated Fund of India. Grants under both Articles 275 and 282 come out of the Consolidated Funds of India. Can it therefore be argued that the Finance Commission can recommend grants-in-aid under both these provisions?

Thirdly, does Article 275 authorise general or untied grants or does it also permit specific or conditional grants?

Lastly, can grants be given under Article 275 for capital purposes also?

Justice A.S Qureshi : (In Chair) Notwithstanding the Constitutional provisions, it seems that certain aspects were either not given due emphasis or certain assumptions were made or some aspects were taken for granted. It is necessary to ascertain the exact scope of the various provisions of the Constitution for the work of the Finance Commission.

The founding fathers of our Constitution were careful to see that so far as the fiscal relations between the Centre and States were concerned, there should be an impartial body like the Finance Commission to consider all relevant aspects, because in a Union of States harmonious relations are essential if it is to remain united. It was for this very important relationship between the federating States and the Union that the institution of the Finance Commission was contemplated. It

is necessary to understand the significance of the Constitutional provisions so that the purpose for which the provision for the Finance Commission was made is achieved.

Mr. K K Venugopal: The controversy regarding the powers of the Union, that is, the Central Government, in regard to the transfer of resources from the Centre to the States without the intervention of the Finance Commission dates back to 1950 and may be attributed to the conflicting opinions regarding the interpretation of both Article 275 and Article 282 of the Constitution.

There were provisions corresponding to both Articles 275 and 282 of the Constitution in the Government of India Act 1935. It was not a live issue then as the transfer of resources had to be effected out of the Consolidated Fund of the Federation under the Government of India Act 1935, and there was no authority like the Finance Commission to recommend and monitor such transfers of resources. The quasi-federal structure of the Constitution which was fashioned from the 1950 Constitution called for control over the transfer of funds to maintain parity among the States, and between the States on the one hand and the Centre on the other. The founding fathers of the Constitution, thinking it essential that the States should not be made to depend upon the munificence or the arbitrary will of the Centre, evolved a scheme consisting of Articles 275, 282 and 280 (3). Article 280 provides for the setting up of the Finance Commission as a constitutional authority which 'shall' make suitable recommendations to the President in regard to (i) the devolution of taxes under

the various Articles, namely, Articles 268 to 272 and (ii) the principles which should govern the grants-in-aid of the revenues of the States. Thus was brought into existence what could be considered a term of art, namely, "grants-in-aid of the revenues" though the same phrase finds a place in the corresponding section of the Government of India Act 1935. Unfortunately, the phrase 'grants-in- aid of the revenues of the States' was defined under Article 366 of the Constitution, which defines various terms of art. Therefore, a wide area of discretion was thrown open to those who were given the duty of interpreting the relevant Articles, that is, 275 and 282.

The effective result of the official interpretation has been that the area of jurisdiction of the Finance Commission which is to recommend grants-in-aid of the revenues of the States, has been progressively reduced while the vast reservoir of discretionary power claimed by the Centre under Article 282 has been progressively enlarged. As a consequence, only a small proportion of the total transfer of resources from the Centre to the States now comes under the purview of the Finance Commission. One is concerned with the legality and constitutionality of this situation.

In my opinion, the practice which has been followed so far is contrary to the Constitutional provisions. This is the result of two processes. One is construing Article 275 of the Constitution in a restrictive or limited fashion so as to cover by the phrase 'grants-in aid of the revenues of the States' only general grants of a revenue character, non-

Plan expenditure and untied grants. Thus, grants on capital account and grants to cover Plan expenditure are outside the ambit of Article 275. Then where would the Plan expenditure be covered? This question has led to the second process that is, of reading more into Article 282 than is warranted. Article 282 is supposed to provide the solution to the problem. It says "The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws". This has been interpreted as a residuary power which would enable the Union at its discretion, without any control from the Finance Commission or any other authority, to transfer resources to States as it desires, for Plan expenditure and for special purposes, which are tied grants in the sense that the Centre would be able to monitor such transfers or the actual incurring of such expenditure.

This approach would cause an imbalance in the quasi-federal structure of the Constitution because the various States which need funds would have to rely on the goodwill of the Central government for financial help. If the States are ruled by opposition parties then further complications may arise in the transfer of such funds for special purposes.

External aids for the interpretation of the Constitution are resorted to only if the wording of a particular Article is ambiguous. Article 275 has two provisos which use the phrase "grants-in-aid of the revenues of the States". It apparently interprets this phrase

by setting out what expenditure or grants would be covered by it. The first phrase states that "there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of a State such capital and recurring sums as may be necessary to enable that State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes...."

What does this mean? A proviso does not add a new area to an existing provision; it only carves out an area from that covered by the main provision and gives it special treatment. It therefore follows that besides covering grants for capital and revenue expenditures for the purpose of promoting the welfare of the Scheduled Tribes, etc., the main provision also includes grants of both capital and revenue nature for special development schemes.

Thus all Plan expenditure special purpose grants, tied grants, etc. would come within the scope of Article 275(1) itself. And if this is so, the practice which has been adopted by the Government of India during the last few years or from the very inception of the Constitution is not in accordance with the Constitution, in fact it is unconstitutional.

Examination of Article 282 of the Constitution also leads to the same conclusion. The study team of the Administrative Reforms Commission and others have ignored the non-obstante clause with which the Article ends - "notwithstanding that the purpose is not one with respect to which Parliament or

the legislature of the State, as the case may be, may make laws". This Article, without the non-obstante clause, simply means that the Union or a State may make grants for any public purpose. The question arises, was it necessary at all to have an independent provision in the Constitution declaring that the Union and the States may make any grants for any public purpose? That power is always there as part of the executive power of the State. The need for this particular Article arose because there is a quasi-federal distribution of legislative powers under our Constitution; between the Centre, which is autonomous in the areas which are allotted to it and the States which are equally autonomous in relation to the areas which are alloted to them. Their respective jurisdictions are spelt out by a detailed division of topics. Thus there are List I and List II, which are exclusive subjects, and the Concurrent List III. Therefore, a constituent State cannot legislate in regard to Posts and Telegraphs, nor can a State by reason of its legislative or executive power make a grant to a welfare institution run for or by say, the Posts and Telegraphs department. It became necessary to lift this bar so that both the States and the Union could mutually make such grants to the State institutions by the Union and vice versa, or by one State to another State. Article 282 serves this purpose.

If Article 282 conferred only a residuary power (residuary to Article 275 of the Constitution) why was it necessary to include "a State" in addition to "the Union"? Article 282 cannot be residuary because it visualises that the grantors could be either

the Union or a State and there was no need to bring in a State if this Article was residuary to Article 275. The whole of that area is left by the Constitution to the Finance Commission. The Finance Commission would not be entitled to abdicate its function under the Articles of the Constitution because what binds them is the Constitution, and where the terms of reference to the Commission involve any repugnance, conflict or inconsistency, the Finance Commission would be bound to follow the Constitution as against the terms of reference. In such a case it is doubtful whether this is practicable or whether the Commission would go back to the Government and ask for reconsideration of the terms of reference. But to the extent that any of the terms of reference seek to deprive the Finance Commission of its powers which are constitutionally vested in it under Article 280, Clause 3, the terms would be invalid and unconstitutional.

Mr. A.G. Noorani: It must be reiterated that where the text is clear one need not resort to any external aid, but two facts are important here. The first is that Article 282 occurs under the heading "Miscellaneous Financial Provisions", and has been bodily lifted from the Government of India Act 1935. It is unthinkable that a provision of the magnitude which is now ascribed to it would have occurred under "Miscellaneous Financial Provisions" at all. Secondly, we have the authority of no less a person than Dr. P V Rajamannar, both as Chairman of the Fourth Finance Commission and as Chairman of the Tamil Nadu Centre-State Relations Inquiry Committee, to give due importance to the very significant

marginal note: "Expenditure defrayable by the Union or a State out of its revenues". The "grants" mentioned here really imply expenditure, not devolution.

In the Government of India Act, 1935, this was denoted as subclause 2. Subclause 1 stated that the expenditure could be incurred only within the territory of India, in spite of the fact that India was then a British dependency. Clearly, the significance of these two clauses is to permit expenditure. The non-obstante clause was provided to remove any fetter on expenditure.

The third point is that precisely because of the wide language of this provision, it is not only permissible but also necessary to construe it in harmony with the other provisions.

To illustrate, if a State or a Union can incur expenditure regardless of the legislative distribution, can one envisage the contingency of a State government making grants of a nature which would undermine the Government of India's foreign policy? That kind of expenditure would be unconstitutional despite the width of the language of Article 282 because of the doctrine of harmonious construction. The Constitution has to be viewed in its entirety. As the United States Supreme Court and our Supreme Court have always emphasised, if the Constitution is being expounded, it has to be read as a whole. The question for consideration is "would it be possible for the Union to make grants under Article 282 in a way which would reduce Article 280 and 275 to insignificance?" The answer can only be in

the negative.

The framers of the Constitution fell back on Section 142 and Section 150 (b) of the Government of India Act 1935 in providing for devolution of taxes and grants-in-aid. On the 4th September 1947, Sir N. Gopalaswamy Ayyangar submitted an elaborate list of points on the various issues then under consideration. A crucial passage in Part 3 reads: "Federal grants to units; history during last ten years; principles to guide such grants in the future." Between 1937 and 1947, that pertinent provision which is the counterpart of Article 282, that is, Section 150 subclause (b), enabled the Centre to make grants to the Government of Bengal during the Bengal famine.

To proceed: "Machinery for the distribution, for the determination of such grants, whether it might be the same Finance Commission or a different one". In other words, Sir Gopalaswamy squarely raised the issue whether there should be two bodies or one, and only one body was eventually adopted. This is a significant point; there was to be a single body under the Constitution. Both the Study Team and the Administrative Reforms Commission have also said that the present use of Article 282 for making grants was not, and could not have been, within the contemplation of the founding fathers of the Constitution.

However, going back to the Constituent Assembly debates one finds that there was no discussion on this point and the proposal was just adopted mindlessly. Much has been heard about the inter- State councils,

but this too was accepted in the Constituent Assembly as something incontrovertible. A true study of the inter-State councils is available only in the House of Commons debate and in the report of the Joint Parliamentary Committee on the Government of India Bill.

A detailed discussion on these points was held, however, in the presence of Dr. Rajendra Prasad, President of the Constituent Assembly and the Finance Minister. A strong Centre was being contemplated but it was felt that the provinces should not be made to depend wholly on the Centre for their finances. The expert Committee constituted in October 1947 submitted in its report that "It is necessary to place at the disposal of the provincial Governments adequate resources of their own without their having to depend on the variable munificence of the Centre".

In Paragraph 67 the report of the expert Committee defines the role of the Finance Commission: "The Finance Commission is to be entrusted with the following functions: to allocate between the provinces the respective shares of the proceeds of taxes, to consider applications for grants-in-aid from provinces and report thereon". (Emphasis added).

Paragraph 69 of the same report is crucial: "The Commission's first function would be of the nature of an arbitrator and therefore the Commission's decisions will be final".

It must be conceded readily that this language was not adopted by the framers of Constitution. However, these points mark

the start of a grey zone. The awards of the Finance Commission were not made explicitly binding, but they were not also of the nature of the reports of Commissions of inquiry that could be ignored or shelved. The practice has been to treat them with the utmost respect and to depart from them very, very sparingly. It must be mentioned that on Article 275 the Assembly debate was fairly extensive and even towards its close in October 1949, both Dr. Ambedkar and Dr. Rajendra Prasad felt that although they had done their best, they had left little to the provinces. However, at the point they might not have been aware that Pandit Jawaharlal Nehru was thinking of a Planning Commission. Before the Constitution came into force, in the President's Address to Parliament in January 1950 he mentioned the Finance Commission, though the formal order was made on the 15th March, 1950. The Finance Commission's existence was also mentioned by the Central Finance Minister in his Budget speech on 28th February 1950. These dates have a significant connotation. With the very best of intentions, it was not conceived that the Finance Commission would have the powers which it has now come to enjoy. Therefore to that extent, the present use of Article 282 for Plan transfers is unconstitutional; a large value of transfers was not to be made under this Article. The intention was to have one body which was to receive applications and entertain them and act as both arbiter and monitor. But it so happened that while the Constitution was being enacted, almost simultaneously, the Finance Commission was also conceived by the Government. The first three Finance

Commissions did not have to go into the question of transfers under Article 282. For the Fourth Finance Commission, both the Administrative Reforms Commission and the Study Team agreed on the proposition that "Had the financial provisions of the Constitution been framed at the time when the Planning Commission was in full operation, it is a matter for conjecture whether the determination of the budgetary needs of the States would have been entrusted to two separate bodies".

Mr. Setalvad, in his Tagore Law Lectures in 1973, had observed that the Planning Commission was a political body and could therefore be subject to pulls and pressures. If this is true, clearly it cannot be the body to which transfers to States can be entrusted, least of all transfers under any discretionary provisions.

Mr. K Santhanam, Chairman of the Second Finance Commission, said in his lecture in March 1959 that "There is no purpose in having two Articles (in the Constitution) enabling the Centre to assist the States, one through the Finance Commission and the other by mere executive discretion". In the light of the construction being discussed here, which seems to be incontrovertible, it is clear that there are no two overlapping Articles. One comes under the Miscellaneous head, the other deals with a particular purpose, and it seems to be a gross abuse of power, in a purely legal sense, to utilise Article 282 as a general instrument for Plan transfers or transfers on a large scale. No doubt the transfers are well intentioned, but in the process the Planning Commis-

sion has grown and acquired dimensions which were absolutely unimaginable.

Though given in a slightly different context i.e. the Customs Act, a judgement of the Supreme Court appears very relevant here: "The resources of the Union Government are not meant exclusively for the benefit of the Union activities. They are also meant for subsidising the activities of the States in accordance with their respective needs, irrespective of the amounts collected by or through them". If this is the legal position and the States have a right, then there is no question of either the Centre's munificence or discretion. To revert to the observations of Shri Setalvad, "It is somewhat anomalous that vast resources should be devolved to the States by the Union at the instance of a purely executive body of this character..." He goes on to point out that "the role of the Finance Commission as provided in the Constitution can no longer be revised fully". In other words, Article 280 has been virtually atrophied, "due to the emergence of the Planning Commission as an apparatus for National planning".

As regards the Constitutional status of the Finance Commission, it is not a Commission of inquiry bound by its terms of reference as a body appointed under statute. The terms of reference of the Finance Commission are laid down in Article 280. Once the President makes an order under Article 280 it is like a grant of property with absurd conditions; the conditions are invalid, the grant is valid. Once a Commission is appointed under Article 280, the invalid conditions can be ignored and the Commission

can act under Article 280.

It is obvious that as a body set up under the Constitution, the Finance Commission would be open to the writ jurisdiction of both the Supreme Court and the High Court.

Also, the Government of India cannot lay down any guidelines. The Finance Commission is a quasi-judicial body, advisedly having a judicial member. Under the scheme of the Constitution it is meant to be an arbiter though its decisions regarding devolution of resources are not made explicity binding on the President. If paragraph 4 of TOR is given its full force, the Finance Commission would become virtually a monitor of the finances of the States.

Justice Qureshi : The Planning Commission does not stop at merely making the Plan grants; it has even made grants for revenue deficits, which squarely falls under Article 275. There is no reason to doubt anybody's bona fides and no reason to think that there is a deliberate grabbing of power by anybody. But at the same time we are all under a duty to find out whether the Constitutional provisions have been properly followed or not, and it is not merely following the letter of the law. The spirit of the law is as much important, because a dead body of law is useless. If we have to survive as a nation, we cannot ignore the spirit of the Constitution. If we do so it will be at our own peril.

Mr. B. Errabbi: Article 280 confers absolute autonomy on the Finance Commission because the Finance Commission is duty-bound under this Article to make recommendations to the

President on the matters mentioned in Clause 3. The first two clauses of the Article relate to the devolution of resources and the principles which should govern the grants-in-aid of revenues. It is only sub-clause (c) of Clause 3 which points to terms of reference by the President to the Finance Commission but it qualifies the scope of the terms as "any other matter". The terms of reference envisaged in this provision are laid down with regard to all matters other than those referred to in the first two clauses. It is thus absolutely clear that the Finance Commission is meant to have absolute autonomy. Thus the terms of reference which have been issued to the Commission are by and large unconstitutional.

The preparatory materials support this view. The sub-clause 3(c) of a provision which was made in the Constitution in its drafting stage is the modified version. That provision read, "any other matter referred to the Commission by the President for the purpose of sub-clause a, b of this clause in the interests of sound finance". The purpose seemed to be to elucidate all matters mentioned in clauses a and b but later the Drafting Committee omitted the expression, "for the purposes of sub-clauses a and b" thereby indicating the intention of the Constitution-makers that `any other matter' only refers to matters which are not mentioned in clauses a and b.

An important aspect concerning Article 275 is its under-use by the Government evidently because it thought that the article provided only for grants-in-aid of a revenue nature, not a capital nature. But, as pointed out earlier, the main provision must be inter-

preted in the light of the provisos. The provisos have already mentioned both capital and revenue grants. Article 275 is the sole repository of the grants-in-aid of revenues and the Constitution contemplated no other provision. Therefore, whatever grants are to be made by the Centre to the States can come within the purview of this particular provision alone and also only on the recommendation of the Finance Commission. Since Article 282 was adopted without any discussion, its intent remains unclear. However, one important aspect of the provision is that both the Union and the States can make grants, because the word "State" is also used in the provision. It does not seem to contemplate the transfer of resources from the Centre to the States or vice-versa, it only implies that grants can be given by the Centre or by States for any public purpose which is of a private nature. Any public purpose sponsored by other public authorities of the Government and the grants for such a purpose are not contemplated in Article 282. Although this is in tune with the grammatical or literal interpretation of the provision, what transpired in the Constituent Assembly is of interest in this context. The report of the Expert Committee said, "It is clear that during the development stages of the country it will be necessary for the Centre to make specific public grants to the provinces from time to time. The provisions of Clause 203 of the Draft Constitution seems to be adequate for that purpose. While we do not recommend the adoption of the Australian system for our country, we have no doubt that the Centre, when distributing specific purpose grants under Article 203 of the Draft

Constitution, will bear in mind the varying circumstances in different provinces".

Article 282 was not just meant to be an innocuous provision; it was also intended to be one of the channels for transfer of resources from the Centre to the States.

Ms. Renuka Viswanathan : Two points are relevant from the point of view of federal fiscal theory and practice. First, the growth of the federation cannot be restricted by the intentions of the Constitution-makers. For instance, the Australian Constitution had a number of clauses relating to finances but most of them were transitional provisions relating only to the first ten or fifteen years of the Constitution. All the transfers that have taken place in that Constitution were under a residuary clause, namely, the Braden clause. There is no reason why the Indian Constitution should not also be interpreted in line with the growth of the federation over the years.

The second point is that there are several channels for inter-Governmental transfers, such as the legislative process as in the West German Constitution where the Upper House really plays a very important role in determining financial transfers; an objective academic body of experts; a political process and so on. Each of these processes has a certain validity and usefulness and each suffers from disadvantages. So it would not be proper to assume that just because the Finance Commission is a body of experts it would be the best or the exclusive agency for transfer of funds.

Lastly, there can be advantages in utilising

the political mechanism of bodies like the National Development Council or the Planning Commission, assuming that the Planning Commission is not so much a body of experts as a political body.

Justice Qureshi: The question is whether any power which is either sought or exercised has to have any Constitutional basis, whether a point as delicate as Centre-State relations can be left to be determined by some political or other body having no foundation in the Constitution. If it has to be in the Constitution, then there must be a provision for it in the Constitution. If it is not there and if a political decision calls for such provisions, the Constitution can always be amended. But a Constitutional provision cannot be misused. Parliament's power to amend the Constitution has been time and again interpreted by the Supreme Court but the Constitution continues to undergo changes and grow.

Mr. N.K.P. Salve: My query is based on an opinion which we have taken from Shri Palkhivala, who is extremely perturbed that transfers under Article 275 are getting abridged day by day and those under Article 282 are increasing. He thinks that in view of the express language of Article 280 3(b), the duty cast on the Finance Commission to recommend principles for grants-in-aid of revenues is confined entirely to Article 275(1) and not to grants under Article 282. The second view which he has taken is that Article 282 is an additional source of authority for the States and the Union to give grants for public purposes.

Therefore the query would be, can the description of Article 282 as "Miscellaneous Financial Provisions" restrict the full operation of the express language of the Article?

Was it not open to the founding fathers to make what was implied explicit? If it is made explicit, why do we restrict the operation of Article 282? Once a power is given under Article 282 the argument that it is not consistent and does not harmonise with the federal spirit of the Constitution, may perhaps not appeal to the legislator.

Mr. Noorani: It is not open to the President to lay down any guidelines whatsoever for the purpose of the work of the Finance Commission. Perhaps for sub-clauses (a) and (b) of Article 280 (3) this is true, but will it also apply to (c) in view of the nature of the provision itself where it says, 'any other matter in the interest of sound finance'?

The language is very obvious: Clause (a) is for distribution of taxes, (b) is for principles regarding grants in aid, (c) refers to "any other matter". The President can refer a `matter' - it could be Plan grants - but `The matter' is not synonymous with guidelines. Once the Finance Commission is seized of the matter it applies its own independent approach and it is not permissible for the President to fetter its discretion under sub-clauses (a), (b) and (c) as well.

Therefore it seems that considerable controversy has arisen on account of the meaning of "terms of reference". The `terms of reference' under the Commission of Inquiries Act are quite different, as the Commissions

constituted under that Act draw their mandate from them. The Finance Commission does not have a mandate outside the Constitution. It is brought into being under the mandate of Article 280.

Mr.Venugopal: My entire approach was both based first on a positive interpretation of Article 275 and, secondly, a negative approach according to which Article 282 has no part to play in the matter. If my interpretation of Article 275 is correct, that Article comprehends within its scope the entirety of grants by the Centre to the States on the capital account as well as revenue account including grants for special purposes, in which even both Plan and non-Plan expenditure would be covered by Article 275. Therefore, I do not know whether Mr. Palkhivala has dealt with the provisos which really are in the nature of Articles of the Constitution which interpret a phrase otherwise not defined in Article 366, the phrase 'grants-in-aid of the revenues of the State'. That phrase is a term of art coined under the Government of India Act for the simple reason that there was no high-powered monitoring constitutional authority like the Finance Commission under the Act to maintain the balance between the Centre, on the one hand, and the States on the other and between the one State and the other States. Therefore, in those circumstances, once we come to this conclusion that grants-in-aid of the revenues of the State would comprehend capital and revenue, Plan and non-Plan, special purposes, tied and untied, then where does the question of one's going about searching for any other Article which covers the same area arise?

Article 280 Clause (3) subclause (b) compels the Finance Commission, whether it likes to or not, to recommend to the President the principles in regard to the "grants-in-aid of the revenues of the State", which means every single grant which would come within the compass of the phrase. Therefore it has no choice in the matter. If it has to deal with it and the President has to act on its advice, then the question of the Centre exercising the same power otherwise under any other provision would not arise. Therefore this is a complete answer by itself.

But I have also dealt with the negative aspect of it to explain as to why Article 282 has nothing whatsoever to do with the making of grants exclusively in derogation of the powers of the Finance Commission under Article 275. Article 282 merely lifts the bar which otherwise would prevent the Centre or the States from making grants outside the topics which have been entrusted to them for the purpose of legislation by the Constitution. That is really the answer.

Dr. M.D. Godbole: Reference has been made to the Finance Commission being the only body and it was said that it was more an arbiter than a monitor. In that situation, what is the functioning of the Finance Commission that was contemplated? Is it to be a permanent body, or is it something which is set up every five years to take a look at the issues pertaining to the States?

The second question pertains to the phrase 'any other matter' in Article 280 (3) (c). One would like to know if the Finance Commis-

sion is the sole arbiter and monitor in respect of all matters pertaining to State and Central finances.

The third question is, whether under Article 282 any kind of grant or assistance by the Centre to the States is precluded completely. The impression one gets now is that except in exceptional circumstances and only as a residuary power, there is nothing else which could be given to the States except under the dispensation of Article 275. This itself raises a number of issues which need to be debated.

Dr. H. K. Paranjape: The Finance Commissions have not done all that they could have by way of devolution of finances to the States. With the constitutional scheme that has been put forward in the 1950 Constitution, the interpretation has to be such that the total finances available to the different units, the States and the Union, should be such as to enable them to carry out the functions which have been given to them under the Constitution. The tax sources allotted to them are essentially meant for that purpose but the supplementary provision is really meant to take note of the fact that the Union List contains sources which are likely to be more flexible and more buoyant, hence the provisions for devolution of finances through the Finance Commission. By not taking this approach past Finance Commissions have permitted large amounts not required by the Union for its own functions to remain under the control of the Union Government, which they have then used for providing grants under Article 282 to the States in a manner not at all contemplated and perhaps not even legal.

A historical point which also needs to be mentioned in this context is that when the question of including Planning as one of the subjects in the List in the 7th Schedule of the Constitution was under consideration, Pandit Nehru originally thought of putting it in the Union List. But many members pointed out that it would not be appropriate and so it was put in the Concurrent List. The matter was very much under consideration at the time the final provisions in the Constitution were being made. If the idea was that this would be a body which would work in a manner which would out do the Finance Commission in the devolution of finances, how was it not taken up at all? The idea probably was to make the Planning Commission a body constituted under law with the provision in the Concurrent List but somehow this was not done. The Commission was set up by an executive order and because practically all the States were under one political party with Jawaharlal Nehru as the acknowledged leader, the Planning Commission's functions grew and nobody objected. But an adverse effect of this has been that the States have not obtained from past Finance Commissions the amounts that they would have been normally entitled to from the surpluses available with the Union Government because of the latter's larger tax collection powers. That is why the Union Government has been able to provide conditional grants in the State List, insisting on the particular manner in which the States should carry on the activities in their List - for example, in education (now it is Concurrent) or health or other matters which the Union Govern-

ment normally would not be entitled to do.

Prof. I.S. Gulati: It is very disturbing that Article 275 is so all-pervasive that all grants from the Centre should have been made under that Article and not under Article 282. From the very outset, the First Finance Commission's award covered not more than one-third of what the States even then required. From the States' point of view it has not been a happy position. While they would have liked the Finance Commission to let them have access to resources through tax sharing or through grants-in-aid of revenues as a matter of statutory right, they have had to depend on dispensations of the Commission covering much less than their total commitments, with nothing else to fall back upon.

Article 280(3) (c) whereby any other matter can be referred to the Finance Commission, again raises a few doubts. It uses the expression 'in the interest of sound finance', which really means that not all matters can be referred to the Finance Commission. Who decides the point?

Dr. G. Thimmiah: It is heartening that the mandate of the Finance Commission flows from the Constitution and not from any terms of reference or guidelines provided by the Union. If that is so, Article 280 (a) covers tax devolution and (b) grants. Does it necessarily mean that the Finance Commission should first recommend tax devolution and then come to grants or it can do the reverse?

Justice Qureshi: We do not mean to say that the so called terms of reference could not bind us. Our mandate does not flow from the Presidential Order, it flows from the Constitution and in

the light of the Constitution we will perform our duties. But over and above the Constitutional mandate, if there is anything in the terms of reference it would be only a view point which would be open to us to consider, but we are not bound by anything.

Dr. Raja Chelliah: According to Article 275 of the Constitution, Parliament may determine the grants-in-aid of revenues to be given to the States and provide for that by law. Until Parliament makes such a law, the President can issue an order regarding such grants but he shall not make such an order before listening to the recommendations of the Finance Commission. It seems therefore that it is open to Parliament to legislate grants-in-aid of revenues in addition to what might have been recommended by the Finance Commission. If this is so, the grants that are supposed to be recommended by the Planning Commission could be given a legal status by legislation by Parliament. Would that be in order? The grants, as Mr. Venugopal says, will go under 275 and not under Article 282. But they could be regularised, not sent in as ad-hoc recommendations of the Planning Commission but placed before Parliament and converted into law. Or, if we want to continue the present practices of Planning, should there necessarily be an amendment to the Constitution or, in the alternative, should we abandon the present practice?

Mr. Venugopal : There is nothing in the Constitution which precludes or prohibits a Finance Commission continuing for a period of five years and being replaced by another Finance Commission. Article 270 says that there shall be a Finance Commission for every period of five

years or for such period as may be fixed by the Government. The Finance Commission should continue for a full period of five years, and if it exists for a shorter period for any reason, another Finance Commission should come into existence straightaway so that there is no period without a Commission; in which event its tenure will in effect coincide with that of the Planning Commission. In practice, the Planning Commission covers not only the limited area given to the Finance Commission but a much broader area, but to the extent that the area is given to the Finance Commission, the latter would be the sole judge. In practice, the Planning Commission would first submit its recommendations to the Finance Commission in regard to the devolution of taxes and making of grants under Article 280 and then the Finance Commisssion would be the sole authority to finally decide what recommendations should be made to the President and therefore to Parliament, in regard to those areas. This is the ideal situation which should be brought about, which would be consistent with the provisions of Article 280(1) and also with the existence of a Planning Commission which has not been brought within the fold of the Constitution and which has not also been brought into existence by legislation.

Mr. Madhava Menon: It seems that what the Constitution-makers really wanted was a permanent Finance Commission but at that time there was not sufficient work for a permanent commission. Now, since numerous complex issues are thrown up and the resources to be distributed between the Centre and the States

are also large, the Finance Commission should be made a permanent body. It could even be a finance-cum-planning commission so that all these issues could be thrashed out and the devolution can take place strictly according to the terms of the Constitution. The members can change every five years as Article 280 demands.

In the present situation where the devolution which has taken place under Article 282 has reached such dimensions as to diminish the status of the Finance Commission and the transfers under Article 275, a Presidential reference under Article 143 is in the public interest. An exposition of the Constitutional intention by no less an authority than the Supreme Court is needed to get a clear picture of the status of the Finance Commission in respect of devolution. It would be in the fitness of things for the Ninth Finance Commission, in view of the controversy that has arisen and the total unconstitutionality of the Plan devolution that has taken place, to request the President to make a reference under Article 143 and get a quick opinion.

Mr. Salve : Is it mandatory for the President to appoint a Finance Commission? Is it not open to Parliament to decide and legislate upon the devolutions both for grants-in-aid and for distribution of taxes?

Mr. Venugopal : In regard to Articles 268, 269, 270 etc., where there is devolution of taxes to the States, there is an express provision. For example, Article 270 says, 'such percentage as may be prescribed shall devolve on the States'. That is in regard to income tax. Here,

'prescribed' means that until a Finance Commission has been constituted, it is prescribed by the President by order after considering the recommendations of the Finance Commission.

Then, 280 Clause I itself says, the President 'shall' within two years of the commencement of the Constitution and thereafter at the expiration of every fifth year, or at such earlier time as the President considers necessary by order, constitute a Finance Commission.

What was contemplated was a continuing body, but in fact, it has been truncated to two or three years and it has been extended from time to time. This is not in keeping with the wording of the Constitution. It will be more appropriate to have each Commission for the full period of five years, so that there is a permanent body with members changing after every five-year period.

D : THE NORMATIVE APPROACH

1

New Approaches for the Ninth Finance Commission : Some Possible Options

B.P.R. Vithal

Introduction

The main duty of the Finance Commission under the Constitution is to make recommendations in regard to the distribution between the Union and the States of the net proceeds of certain taxes, the allocation between the States of such proceeds and the grants-in-aid of the revenues of the States which are considered to be necessary. The submissions to the Commission by the different States will focus on these substantive issues. In this paper, we are however, not discussing these substantive issues but the approach that the Ninth Commission may be called on to adopt in considering these issues in the light of certain significant changes that have been incorporated in the terms of reference of the Ninth Commission as compared to the terms of previous Commissions. A somewhat similar situation was considered by the Seventh Commission and it took the view that "the Commission's freedom to take into account other factors is not inhibited"[1]. Our submission in an earlier paper has been that with the use of the word "shall" in para 4 of the terms of reference without the qualification "among other considerations" the Ninth Commission has in fact been so inhibited. But as pointed out by the Seventh Commission "the Commission's discretion in the matter of making recommendations on these matters is not limited in the Constitution". Our submission is that what is not limited

in the Constitution can not be limited in the terms of reference. We would therefore urge that just as the Seventh Commission took the view that "the contents of paragraph 5 of the Presidential Order were not constraints on the Commission in any way", the Ninth Commission also should specifically take the view that para 4 of the terms of reference can be taken as a guideline and not as a direction and that the Commission has the power to modify the terms of this paragraph in such a manner as it may consider fit, either in its own discretion or as a result of the submission made by the various State governments.

We would suggest that the first modification that the Commission should in its own discretion make to para 4 of the terms of reference is to so interpret and, if necessary, even amend it, as to make it equitable as between the Union government on the one hand and State governments on the other. There are two important aspects in which para 4, as now worded, discriminate against State governments. First, under para 4(i), while the Commission has been asked to adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre, it has also been asked in doing so to keep in view "the special problems of each State, if any", in the case of the Centre it has been asked to keep in view, among other things, committed expenditure or liabilities. This could mean that while in the case of the States, certain items of committed expenditure could be ignored on the ground that they do not fulfill the requirements of such norms as the Commission chose to adopt, the Commission will be forced to take all committed expenditure of the Centre into account irrespective of whether it satisfies any norm not. We shall be dealing later with the problems involved in adopting the negative approach in regard to committed expenditure. But quite apart from the problems, considerations of equality of treatment between the Union government on the one hand and the State government on the other require that the Commission should adopt the same standard for both. If therefore, the committed expenditure or liabilities of the Centre are being taken into account, similar expenditure or liabilities of the States should also be taken into account.

The Commission has pointed out in a letter to the State governments that, "as things stand today the surplus on revenue account is negative". The Commission then goes on to suggest certain measures by which this situation can be remedied and mentions, by way of example, reduction in staff and cut in subsidies. Dandekar also expressed the view that "the transfer of resources from the Union to the States can not also be pushed much further without enlarging inflationary deficits in the Union accounts"[2]. While this is generally true, it has to be pointed out that at least a part of the deficit of the Union is due to its excessive expenditure on items which are really the responsibility of the States under the Constitution. In this context it becomes necessary to point out that the Commission should take into account the committed expenditure or liabilities of the Union only in regard to those subjects which fall within the purview of the Union under the Constitution. There is no reason why what really represents an encroachment by the Union upon the jurisdiction of the States as laid down in the Constitution should be perpetuated by being accepted as a committed expenditure or liability of the Union. Gulati and George have observed that "what seems to be called for is to move away from commitment to existing patterns and levels of committed expenditure at the Centre or in the States and an effort towards the effective realisation of distribution of responsibilities between the Centre and the States as originally envisaged in the Constitution"[3]. Even if this task is not done in its totality, at least in respect of the committed expenditure in the Union budget which pertains to subjects which are in the States' list, the Finance Commission should take a view that it need not accept these commitments in the same manner as it may feel called upon to accept the commitments of the Centre in regard to its legitimate field such as national security, etc. The Commission could thereby help in correcting the distortion in the distribution of expenditure between the Union and the States that has come about quite contrary to even the existing provisions in the Constitution.

The other aspect in which para 4 deals differently with the Union government and the State governments is in regard to

para 4(ii) and 4(iii). These paras deal with resource mobilisation, financial discipline and the need for speed, efficiency and effectiveness of government functioning. The present wording is such that there is room for doubt whether these two items are to apply to both the States and the Centre. The Commission should, in fairness, interpret these two items so as to make them applicable to both the States and the Centre.

The Normative Approach

A norm can be of two types: one, a norm for measurement or judgement and the other, a prescriptive norm. A measurement norm is meant to evolve some objective criterion by which several disparate items can be measured and thereby compared. A prescriptive norm, on the other hand, is a standard which is selected as something which ought to be achieved. The subjective element would be much greater in a prescriptive norm than in a measurement norm. The problems involved in evolving either of these norms in the case of resources are much less complicated than in the case of expenditure. Methodologically, there may be quite a few technical problems in evolving norms for resource mobilisation also. But there would not be much difference of opinion or controversy about selecting a prescriptive norm for resource mobilisation. The difference between different States and considerations such as their level of development etc., would be taken into account, in any proper exercise, in the methodology for estimating their revenue potential. But, given a certain potential which would naturally differ from State to State, to expect that a certain given percentage of this potential ought to be tapped would not be too controversial. In this paper we propose to deal more with the approach to be adopted in evolving norms rather than with the actual methodology. We shall therefore not deal with norms for revenue resources but will concentrate on norms for expenditure.

The task of a Finance Commission in assessing the receipts and expenditure on revenue account generally has two aspects; one is to establish the base level and the other is to make

forecasts for the period covered by the award. Previous Commissions have generally taken the committed expenditure, subject to certain scrutiny and adjustment, as the base level. But for their forecasts for the award period they also followed a kind of normative approach. Given the present terms of reference the question would be as to how the normative approach will be applied to the committed expenditure at the base level itself. According to the wording of the terms of reference as they stand, committed expenditure of the States need not be taken into account. But we have suggested above that the Commission should, in its discretion, modify these terms of reference so as to take into account the committed expenditure or liabilities both for the States and the Centre. We are aware of the fact that taking into account committed expenditure may result in some inequity between the poorer and more backward States and the prosperous and more developed States, in that the latter have reached a higher level of committed expenditure and this higher level gets built into the forecasts, if it is accepted as the base level. Even so, there will be difficulties in finding any alternative approach that would be both reasonable and generally acceptable. We cannot have a situation where a normative approach applied to the base level will result in a State stagnating at the present level merely because its committed expenditure is already higher than the norm. Just as in the case of egalitarian policies in society, so also here, any practical approach to greater equality between different entities can be based only on differential rates of growth for the future and not either on a net negative rate of growth or even on stagnation by those who might have already reached certain higher levels. As Dandekar points out, "the indirect transfer of resources from the better placed States to the poor States has been achieved with admirable approval of even the States which lose in the process. But again this cannot be pushed much further without raising a protest from the more developed States which must be avoided"[4]. We have therefore to consider how the normative approach will be reconciled with the level of committed expenditure.

The evolution of a norm has three aspects: one, specification of the items, two, the level and three, the per unit cost. Of these three the simplest would be the per unit cost because this can be worked out by comparing the costs for the same unit in different States and taking either the average or the most efficient cost. The problems of judgement really would arise in regard to the other two aspects. If the normative approach is applied fully to the base level itself, ignoring committed expenditure, it might mean that a judgement is being made in regard to items of revenue expenditure already incurred. The committed expenditure represents the socio-economic judgement of a duly elected government; to say that some of the items already committed would not be taken into account in calculating expenditure would amount to sitting in judgement over the actions of a competent and duly elected government. In making forecasts for the award period the norms for the rate of growth of different items can be differentially set. This also would involve an act of judgement on the part of the Commission, but this is a judgement for the future and not a judgement on an action already taken by a competent authority. This judgement will be made in coming to a decision regarding devolution; in other words the Commission would in effect be saying that the devolution recommended by it is related to what it considers necessary for achieving certain norms during the forecast period. This would not prevent the duly constituted government from taking other decisions, so long as they are able to raise other resources to implement those decisions and this would then come under the item in the terms of reference which requires linking of expenditure and revenue raising decisions. We would therefore urge that for the base level, by and large, committed expenditure should be taken into account. This does not mean that no judgement will be exercised. A broad normative approach can be applied to this also, but this should be only to the extent of judging *inter se* levels of different States and not by way of exercising a value judgement on what the State governments might have done in pursuance of certain policy decisions of theirs. Whatever correction is found necessary, as a result of different States being at different levels at the base level, it

should be achieved by assuming different rates of growth during the forecast period.

This approach would assume that resources have been found for the base level of expenditure including existing devolutions, i.e., there is no deficit on revenue account. To the extent there is a deficit a correction can be made either in the expenditure or the revenue assumed. In other words, the Commission would be accepting that it is the prerogative of the State government to determine its own pattern of expenditure to the extent that resources have been found but not where such expenditure is in excess of resources. In matching expenditure and resources also a judgement would be involved, but that would be a legitimate exercise of discretion. To this base level the norms evolved by the Commission would be applied to see whether an individual State is above the norm or below it. This factor would then be taken into account in deciding future devolutions. In this the Commission would also have a make a judgement about the period of time in which they would expect the imbalances in the base level to be corrected. In other words the correction of the imbalances between States at the base level would be the chief determinant of the decisions regarding future devolutions and grants-in-aid. This would involve assuming lower rates of growth for some items for some States which might have already reached higher levels but it would not mean that any item of committed expenditure is altogether left out of consideration. To put it somewhat loosely, this would mean that the Commission would encourage some States in some aspects and dampen some others in other aspects, but would not act in such a way as to give the impression that it is putting the stamp of approval or disapproval on specific acts or schemes of States or that it is negating the specific actions of any particular State. The norms chosen by the Commission should be taken only as the criteria selected by it for determining the *inter se* distribution of resources between States and not as a judgement on the decisions of State governments in regard to various items of revenue expenditure.

In regard to norms different views have been expressed. Thimmaiah has taken the view that "it would be better to cover all items of expenditure under the revenue account leaving out only the uncommon items"[5]. On the other hand Lakdawala took the view at a seminar in Hyderabad, that the norms should be aggregate norms which are generally acceptable and not norms for individual items[6]. Where norms are selected for purposes of *inter-se* judgement only, they can be norms for broad categories because they are meant only as tools for helping to arrive at a just and rational decision regarding the transfer of resources. But if the norms are taken as what we have called prescriptive norms then this would create a problem. It is easy to select norms for any expenditure item and work out the unit cost on the basis of previous experience or even on a normative basis. But the achievement of the norm does not depend merely on the expenditure of the unit cost. There are many steps in between which cannot obviously be spelt out in a norm. For instance, for primary education the norm can be based on the number of teachers required or on the number of children in the relevant age-group etc. But the achievement of any target of education requires several detailed decisions. Obviously the Finance Commission cannot go into such details without becoming a Planning Commission. For the same reason, the condition stipulated in para 4 (iii) is also almost impossible to fulfil. Here again the process of financial transfers can merely ensure a certain administrative framework which is considered necessary for fulfilling a particular task. It is not possible to say whether, having set up such a machinery, it would function with "speed, efficiency and effectiveness". Even after adequate money is provided for the minimum machinery considered necessary, there are so many other factors involved in speed, efficiency and effectiveness that it is not clear how the Finance Commission will be able to ensure these. Obviously, the terms of reference envisage that the Finance Commission will function not merely as the Planning Commission for the revenue plan but also as a programme evaluation organisation.

Even if the norms evolved are made conditional, there are practical difficulties in ensuring that the conditions are observed. In the past the grants for upgradation of levels of administration had been made conditional in this manner, but the experience of both the achievement and the monitoring in this regard has not been happy. It cannot be said that the difference in levels of different States in regard to items for which specific grants had been given has been reduced. If now we take up not merely certain selected items but the entire revenue expenditure, the monitoring will become a monitoring of the entire budget of the State. There is no machinery which can undertake such a monitoring. The Finance Commission is itself not a continuing body. If this task is left to the Union Finance Ministry we would be giving the Union government a power and a role in regard to State budgets which the Constitution itself has not given it. In practical terms also the task will be so complex that it will degenerate into a token exercise except in cases where, for political reasons, the Union government would like to use this as a means of exercising control over some State government. Now that the distinction between Plan and non-Plan has been removed, it can be argued that the monitoring in regard to certain Plan targets at least can be done by the Planning Commission. But this raises issues regarding the respective roles of the two Commissions which are discussed later.

The task before the Commission is to decide the devolution of certain taxes as well as grants-in-aid of revenue. To do this a certain judgement is necessary on the part of the Commission in regard to the resources and the requirements of the Union and the States. Based on such a judgement the Commission will provide resources to different States for achieving certain levels in regard to different items of revenue expenditure. The normative approach is a tool or a method which can be used in making such a judgement and may be an improvement over the attempts made in this regard by previous Commissions. The Commission will naturally spell out the normative approach it has adopted and this would itself be a

guideline and an incentive for utilising the devolved resources and grants-in-aid for this particular purpose. But it would not be admissible to go beyond this and make the transfer of resources conditional on the achievement or observance of certain norms since this would go against the spirit of the Constitution. It can be argued that the legal difficulty involved in making devolution conditional can be got over by attaching the conditions to grants-in-aid. It is well known that the extent of devolution and the magnitude of grants-in-aid are inversely related - the larger the devolution the lesser the need for grants-in-aid. The objection to devolutions across the board has been that they can be regressive, in that they benefit the prosperous States as much as they benefit the poorer States, despite any corrective mechanism that may be introduced in the formula for distribution. On the other hand the advantage of devolution is that it is unconditional and elastic whereas grants-in-aid would be restrictive and inelastic. The relative role of devolutions and grants-in-aid in the total transfers has been an issue to which every Commission has addressed itself. The Seventh Commission had noted that the States had "stressed the point that the fiscal transfer should be affected mainly, if not wholly, through devolution of taxes".

We are clearly of the view that the grants-in-aid element in the transfer scheme should as far as possible be a residuary item and the attempt should be to make the bulk of the transfers through tax sharing. It would therefore be a short sighted policy and contrary to the spirit of the Constitutional provisions to deliberately increase the role of grants-in-aid merely to acquire the right of making the transfers conditional.

Plan and Non-Plan Revenue Expenditure

Item 4(i) of the terms of reference of the Commission states that the Commission shall "adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre". The corresponding provision of the terms of reference of the Eighth Commission

mentions "requirements on revenue account of States for non-Plan expenditure". Because of this difference of the wording of this particular clause it has been rightly inferred by the Commission that it "has been asked to consider the total receipts and expenditure on the revenue account without any distinction between the Plan and non-Plan". In its letter to the State governments the Commission has stated that "this means that the Commission will have to get an idea of the revenue component of the next Plan as well as the contemplated additional resource mobilisation efforts". The implication of this is that these two will be incorporated in the Finance Commission's forecasts for revenue receipts and expenditure and then a normative approach will be applied. This will mean that the assistance required for the revenue component of the Plan will now be covered by the devolutions and the grants-in-aid recommended by the Finance Commission. In that case the Gadgil Formula will have to be replaced since there would be no need or justification for a 30 per cent grant component in the Central Plan assistance and the residuary part of the Plan will be only its capital component. There are, however, practical difficulties in such a procedure being adopted since this will require the work of the Eighth Plan to be finalised before the Ninth Finance Commission completes its work. The normal schedule of work of these two is such that it would be difficult for this to be done. But, more importantly, the Eighth Plan work, if it is to be done on the present basis, cannot be completed unless the award of the Ninth Commission is known since this will determine both the resources of the States and the magnitude of Central assistance. We will then be caught in a vicious circle - the Eighth Plan cannot be formulated unless the award of the Ninth Commission is known, while this award can not be finalised till the Eighth Plan outlays are known. The abolition of the distinction between the Plan and non-Plan revenue expenditure cannot therefore be done without a fundamental change in existing procedures of Plan formulation and in the relative roles of the Finance and Planning Commissions.

This difficulty can be got over by interpreting the terms of reference in such a manner that the present procedure can be reversed. After all the terms of reference merely stipulate that the Commission shall adopt a normative approach in assessing the receipts and expenditure on the revenue account of the States and the Centre without any specific mention of Plan or non-Plan expenditure. They do not suggest any particular procedure regarding the manner in which the consequences of this abolition would be dealt with. It is the Commission that has drawn the inference that the abolition of this distinction will mean that the revenue component of the Eighth Plan as prepared by the Planning Commission, as well as the contemplated additional resource mobilisation for that Plan will have to be taken into account while making its own recommendations. Therefore the Finance Commission is free to adopt any procedure so long as it takes all revenue expenditure into account and adopts a normative approach. We have discussed above how the normative approach can be applied to the committed expenditure at the base level. At the base level we have both non-Plan and Plan committed expenditure. In the previous procedure the committed expenditure in respect of the Plan was treated on a separate footing and after a measure of scrutiny, it was added on to the expenditure at the base level so that for the forecast period it became non-Plan expenditure just as the other items. Now that there is no distinction between Plan and non-Plan such a separate treatment would not be necessary. The entire committed expenditure, both Plan and non-Plan can be examined with reference to such norms as the Commission may select. The forecast for the period of the award can also be made on this basis without making any such distinction. The Commission would be free to adopt such norms as it considers desirable in respect of all items of revenue expenditure without any distinction of Plan or non-Plan. We have suggested earlier that the Commission should set itself a modest objective for the task with which it is concerned viz: the correction of imbalances between the States at the base level. These imbalances are so substantial, and the total resources likely to be available for transfer to the States are so

limited, that it would not seem possible to correct the existing imbalances within the period covered by this award. Therefore some modest target will have to be set for this period by the Finance Commission taking all these factors into account.

According to this procedure the Plan will be finalised subsequently by the Planning Commission. They will have before them the award of the Finance Commission, which, unlike the awards of the previous Commissions would cover some sectors which traditionally form part of the Plan. The norms adopted by the Commission and the transfer of resources made by them on the basis of such norms would become the minimum targets for these sectors, so far as the Planning Commission is concerned. Nothing, however, prevents the Plan exercise from attempting to do more than what these norms anticipate, if additional resources can be found for this purpose either by additional resource mobilisation by the States or by further Plan transfers from the Centre to the States through the Planning Commission. The terms of reference have removed the distinction between Plan and non-Plan on the revenue side but this need not be interpreted to mean that in the succeeding Plan nothing can be done over and above what the Finance Commission may have taken into account in arriving at its own forecast of revenue expenditure.

In regard to the distinction between Plan and non-Plan in so far as revenue resources are concerned, it is interesting to note that the Eighth Commission also was asked to take into account the "revenue resources of the State including targets set for additional resource mobilisation". On the resources side therefore there was, even then, no distinction of Plan and non-Plan as there was on the expenditure side. The Ninth Commission has in its letter specifically taken note of the fact that, "the Eighth Finance Commission was also asked to keep in view the additional resource mobilisation efforts for the Plan". It is surprising that the Commission should quote the terms of reference of the Eighth Finance Commission and yet draw the inference that the additional resource mobilisation refers to "contemplated additional resource mobilisation efforts". The

significance of the mention of the "targets set for additional resource mobilisation for the Plan" was discussed in great detail in the report of the Eighth Commission. There was some difference of opinion between the members of the Commission in this regard but the entire discussion related to additional resource mobilisation during the Sixth Plan period and not to such additional resource mobilisation contemplated for the forecast period for that Commission viz., the Seventh Plan period. The Eighth Commission came to the conclusion that "the only possible interpretation of these words is that the targets set for the annual Plan for 1983-84 had to be taken into account". That means they were taking into account the additional resource mobilisation during the Sixth Plan period and not such additional resource mobilisation contemplated for the forecast period by the Commission viz., the Seventh Plan period. The Eighth Commission came to the conclusion that "the only possible interpretation of these words is that the targets set for the Annual Plan for 1983-84 had to be taken into account". That means they were taking into account the additional resource mobilisation for the base year and not for the forecast period. It is therefore not clear on what basis the Ninth Commission has inferred that the abolition of the distinction between Plan and non-Plan means that "the contemplated additional resource mobilisation efforts" should be taken into account. No doubt, if a State's effort happens to be below any norm that the Commission may adopt under the normative approach, then that State would, by inference, have to undertake additional resource mobilisation in order to come up to the norm adopted. But we cannot reverse this position and assume that there is some additional resource mobilisation for the Eighth Plan which the Ninth Commission has to take into account in fixing its own norm. On the revenue resources side also, therefore, the normative approach will require that the Finance Commission finish its work first on a normative approach before the Planning Commission finalises the Eighth Plan rather than vice versa.

The Roles of the Finance and Planning Commissions

The argument so far proceeds on the assumption that the respective roles of the Finance and Planning Commissions remain what they have been. Now that the Ninth Finance Commission, according to its terms of reference, has to take into account Plan revenue expenditure also, there is no valid reason for making this assumption and then trying to see how best the work of the two Commissions can be coordinated. The Commission has also been asked to keep in view the objective of generating surpluses not for the "Plan" but for "capital investment". This, taken with the modifications in the terms of reference of the Ninth Commission compared to those of earlier Commissions, provides a sufficient basis for this Commission to take the view that it can cover the entire Plan revenue expenditure and leave to the Planning Commission only the task of planning capital investment. If the Finance Commission chooses to take such a radical view of the opportunities provided by its terms of reference, there may be a considerable body of opinion that would support such a modification in the relative roles of the Finance and Planning Commissions. There have been criticisms, from time to time in the past, of the fact that the Planning Commission is only a wing of the Union government and is not a statutory body like the Finance Commission. In the latest of these criticisms Dandekar has observed that, "the Planning Commission - leaves for (the States) hardly any sphere which they may call their own - the successive Planning Commisions have imposed and promoted unitary elements into the system"[7]. Apart from such criticism of the method of functioning of the Planning Commission, there has also been a view that while the transfers recommended by the Finance Commission are statutory in nature, the Central assistance distributed by the Planning Commission is purely discretionary, even though a major portion of it is regulated in accordance with the Gadgil Formula. The effect of bringing Plan revenue expenditure within the purview of the Finance Commission would therefore be to enlarge the sphere of statutory transfers and to that extent restrict discretionary transfers. The only argument against

enlarging the scope of the transfers through the Finance Commission used to be that these tend to be regressive in character. But even here the view has changed and as Gulati and George point out, "It must be said to the credit of the recent Finance Commissions that progressiveness of statutory transfers has been improving compared to that of Plan assistance". Even after pointing out that the non-Plan surpluses of the States have "tended to be extremely regressive" they go on to say that, "the Finance Commission cannot simply get away by saying that its task is only to meet non-Plan deficits and that the Planning Commission is to be concerned with Plan finance"[8]. With the present terms of reference the Ninth Finance Commission certainly cannot take this view.

Therefore there would be a considerable body of opinion that would support any initiative taken by the Ninth Commission to so interpret its terms of reference, particularly the normative approach taken with the removal of the distinction between Plan and non-Plan revenue expenditure, as to cover the whole revenue component of the Plan. In this view of the matter the Finance Commission need not wait for the Planning Commission to plan exercises and take into account the revenue component as formulated by the Planning Commission. It can extend the scope of its normative approach to cover the entire revenue component of the Plan in its own forecasts and recommendations. The Planning Commission would then be concerned only with the capital component of the Plan and, if it is so desired, it can prepare an overall plan of which the two parts would be the revenue component as recommended by the Finance Commission on the basis of its normative approach and the capital component as formulated by the Planning Commission itself.

There may be no theoretical objection to such an approach but, as pointed out earlier, there would be certain practical difficulties in view of the fact that the Finance Commission is not a permanent continuing body. The normative approach that the Finance Commission can adopt, in the limited time available to it, will not be able to cover all the details

that would be necessary for the norm to be converted into practical schemes. The finalisation of such details requires not only time but an iterative process with the States. The nature of the discussions which the Finance Commission has with the States is different from those which the Planning Commission has and these may not be sufficient for formulating detailed schemes intended to make the norms operational. Of course, a view can be taken that it is precisely these details that the Centre should try not to work out or dictate. Dandekar specifically makes the point that "a Planning Commission should function and perform in essentially the same manner as does the Finance Commission"[9]. If such a view is taken then this particular objection would have been met. The Finance Commission would merely prescribe broad norms and make devolutions and grant-in-aid on that basis and it would be left to the States to work out the details necessary for achieving the stipulated norms.

Another objection to this procedure could be that it is not possible to divorce the revenue component of the Plan totally from capital investment. There are several items in the revenue component which will require corresponding capital investment for their fulfilment; for instance under health, the staff will be in the revenue budget while the buildings would be in the capital budget. This would be true of most of the sectors. This, however, need not be an insurmountable difficulty. A provision can be made that, in preparing the capital Plan, the Planning Commission will first take into account the capital requirements of the revenue component of the Plan as recommended by the Finance Commission. Notwithstanding this, a view can be taken that this would not be the best way of planning for the development either of a State or of the country. It can be said that a more rational and logical way of planning would be to take an overall view of the resources available after meeting commitments at the existing level and then decide on the priorities. These priorities would then dictate how much of the Plan outlay would be required for expenditure of a revenue type and how much would be available for capital investment. On the other hand the revenue and capital components of the Plan

being dealt with by two different Commissions and by two different methods of transfer of resources would make it difficult to take such an integrated view of the planning process.

The separation of the revenue component from capital investment in the process of decision-making may also give rise to certain apprehensions. In the present process where a total view is taken of the process of development, the decisions regarding capital investment are also tempered by considerations such as the overall level of development of a State, the distortions in its economy etc. If decisions regarding capital investment are taken in isolation and made the sole duty of a particular body or authority then quite unconsciously and unintentionally only economic criteria may be applied in arriving at such decisions. There is no doubt that this is how such decisions should be taken, but other factors do have to be taken into account even in deciding capital investment. It can be argued that provision can always be made for taking into account such factors, such as the backwardness of a given area etc., even when a separate authority takes decisions on capital investment. But the experience of existing all-India financing institutions is such that it would appear that despite specific directions on such matters and even special schemes for such areas, the pull that well developed areas can exert on capital investment cannot be fully countered. There may, therefore, be a view that on balance, it would be more conducive to the overall development of a given area to consider its plan for development in its totality and not separate it into revenue and capital components and make such separation almost rigid by making two different authorities responsible for the two components.

It will thus be seen that the terms of reference of the Ninth Commission can be so interpreted as to have far reaching consequences both in regard to the relative roles of the Finance and Planning Commissions as well as in regard to the Gadgil Formula for Central assistance. These are all matters which fall within the purview of the National Development Council.

Apart, therefore, from the general point that the terms of reference of the Finance Commission should be finalised after consulting a body like the National Development Council, at least, in regard to the specific issues affecting the previous decisions of that Council and the planning process, which by convention have been within the sphere of that Council, the National Development Council should have been consulted before they were referred to the Finance Commission. This situation can be remedied even now. A final decision on the recommendations of the Finance Commission is taken by the Union government. In view of the far reaching implications these recommendations may now have in regard to Central assistance for the Plans and the planning process itself, at least those parts of the recommendations of the Ninth Commission which impinge on these aspects should be referred to the National Development Council before a final decision is taken by the Union government.

Conclusion

Para 4 of the terms of reference has features which are unique to this Commission. When the four parts of this para are read together a consistent scheme emerges, the objective of which seems to be the generation of revenue surpluses through financial discipline. In the case of the previous Commissions also mention used to be made of better fiscal management and economy in expenditure consistent with efficiency. Even if this had not been mentioned, it is but natural that any authority that is concerned with the distribution of taxes between the Union and the States as well as the determination of the need for grants-in-aid would take into account the question whether the bodies to which financial resources are being transferred have been utilising such resources in a prudent manner. What makes para 4 unique is that the various considerations have been mentioned more explicitly and in greater detail than before. As mentioned earlier, an inconsistency in the pattern as set out in para 4 is that except in regard to the normative approach, the other considerations relating to discipline and efficiency seem to apply only to the

States and not to the Centre. We have already urged that the Finance Commission should interpret this para in such a manner that it applies equally to both the Centre and the States. Nobody can gainsay the fact that governments need to exercise financial discipline. The question, however, is what is meant by financial discipline? Obviously, it is no longer possible to make a balanced budget the test of financial discipline. However, even if such a test is applied, it would appear that it is the Union government which would fail and not the State governments. From all available reports it would appear that ever since the rules regarding overdrafts have been made more stringent the States have followed this discipline. If, therefore, this is the only criterion of financial discipline, then we have a situation where there is already an instrument available to the Union government to ensure that the States follow this discipline in as much as they have the power to prevent the States from running into overdrafts. What is needed, if at all, is some similar mechanism in the case of the Union government itself. However, balancing the budget is no longer an adequate test for financial discipline. But the question is whether the financial policies of a government whose overall budget is balanced can still be faulted on the grounds of financial indiscipline. Besides financial discipline there are the concepts of financial prudence and financial propriety. One view could be that prudence and propriety are the elements of discipline while another view could be that these are different stages at which, if checks are not applied, transgression will ultimately lead to financial indiscipline.

Whatever these nuances may be, the question is how far the Finance Commission can go in providing mechanisms for ensuring financial discipline. The Commission will certainly take these factors into account in determining the quantum of devolution and the need for grants-in-aid. It can, in so determining, also provide incentives for resource mobilisation, financial prudence etc.; but it should not go beyond this and prescribe any specific conditions as such. In this connection it may be relevant to point out that Article 280 of the Constitution under which the Commission is appointed deals with the distribution

of taxes but has not mentioned any considerations of this nature. It is not as if the Constitution makers were not aware of such considerations or of the fact that there may be governments that would flout even such considerations. That is why it has been provided under Article 360 that, in a situation where a government behaves in this manner, the Union can give "directions to any State to observe such canons of financial propriety as may be specified in the directions". Therefore while any tendency to enter into commitments beyond the available financial resources may be curbed as being financial indiscipline, this approach cannot be extended to passing judgements on the nature of schemes even where a government has found the necessary financial resources for it. Individual schemes or actions of government cannot be judged on the grounds of being financially imprudent. That privilege belongs to the legislature. A duly elected government has the right to raise resources and to expend them in such manner as it deems fit subject to the provisions of the Constitution and the approval of the legislature. These actions, cannot, therefore, be questioned on grounds of financial propriety or prudence so long as these conditions are met. The various considerations mentioned in para 4 have, therefore, to be taken into account against this political and Constitutional background.

Over the past three decades the eight Commissions that have been constituted so far have earned the confidence of the States despite the fact that they had been appointed and their terms of reference had been drafted unilaterally by the Union government. The awards of the successive Commissions have been generally well received by the States perhaps because each Commission has improved over the previous Commission in regard to the quantum of the transfer of resources from the Union to the States. However, even in regard to those aspects of the award which relate to the *inter se* distribution of taxes among the States there has not been much acrimony although there has naturally been some disappointment on the part of some States. One major criticism of the awards of the Finance Commissions used to be that their transfers were generally regressive in nature in their

distribution among the different States. But even here the position has changed and as pointed out earlier, it is now conceded that statutory transfers have become progressive compared even to Plan transfers.

The nature of federal financial relations and their contours are determined by the provisions of the Constitution but the content of these relations and the manner in which they have evolved over the past three decades has been determined to a great extent by the awards of the successive Finance Commissions. The fact that these awards have inspired confidence among the States has helped in federal financial relations evolving along healthy lines and in their being strengthened. This process has been an evolutionary process and much of the acceptability of the process so far arises from this. Each Commission has broken new ground, both *suo moto* and as a result of its terms of reference being different. But every departure from past practice has been modest and has found acceptability because of its being in the direction of strengthening the resources of the States. Even where certain criteria of financial performance or discipline were introduced in the course of devolution or grants-in-aid, they were rendered acceptable because of the overall package being beneficial. The issue here was as between the States, namely that if a State that had not raised resources had been penalised in some manner, States who had done so lent support to such a measure. The Union was not in the picture in this regard. These considerations, therefore, weighed in favour of the horizontal distribution of resources rather than the vertical distribution and this was crucial to their acceptability.

In the evolution of federal financial relations in our country the awards of the Finance Commission have played somewhat the same role as judicial interpretation in the case of Constitutional evolution. Article 280 itself is very brief and, therefore, leaves considerable scope for the Commissions to exercise their own discretion. The exercise of this discretion has been sought to be guided by the Union government through the terms of reference. But the Commissions have happily taken the

view that while on the one hand they cannot go beyond the provisions of the Constitution, on the other, they need not feel constrained by any factors other than the Constitutional provisions. It would be relevant to quote here what has been said about judicial interpretation in the context of the American Constitution. "Judges in the mainstream of our Constitutional practice are much more respectful of the framers' intentions, understood as a matter of principle.... They accept the responsibility the framers imposed on them, to develop legal principles of moral breadth to protect the rights of individuals against the majority. That responsibility requires judgement and skill, but it does not give judges political licence"[10]. We can substitute here "the rights of the States against Union" for "the rights of individuals against the majority". The important point here is that the process requires judgement and skill but it does not give "political licence". Our endeavour above also has been to emphasize that no part of para 4 of the terms of reference should be interpreted in such a manner as to pass judgement on the actions of State governments as represented in their budgetary provisions and schemes, which are essentially in the nature of political decisions.

The Ninth Finance Commission has to determine its own approach against this broad background. The new elements in its terms of reference do permit of a sweeping change being brought about in the nature of federal financial relations if they so desire. But, from what has been said above, it will be clear that in such matters change has to be brought about in a manner that is acceptable and without drastically upsetting the delicate balance that might have already been established in Centre-State financial relations. The normative approach may have the merit of objectivity but it has the risks of conditionality and consequently increased Central control. Bringing Plan revenue expenditure within the purview of the Finance Commission may have the merit of rationality but it also has far-reaching institutional implications. A balance has, therefore, to be struck between contrary considerations of this type. In a democratic federal policy this balance has to be struck as a result of a political process. There is a platonic element in the support

that the normative approach has received from experts. Thus, as Socrates puts it, those "qualified for the command of a ship - must and will be the steerer, whether other people like or not". It is "the possibility of this union of authority with the Steerer's art"[11] that the prescription of norms by experts provides and that appeals to them. But in a democracy experts can only show the way, the choice will have to be left to others. We would, therefore, urge that the Commission should look upon its task as only making a beginning in the new directions opened to it. It should take such a measured step as would be sufficient to establish the new direction but would not be so large as to unduly disturb the equilibrium that the old relations and procedures might, in the course of practice and over a period of time, have already established.

Notes

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Evolving Fiscal Norms for Central and State Governments : Some Methodological Issues

M. Govinda Rao

Working of the Finance Commissions in the past has been criticised for two important reasons. First, the guidelines given to the successive Commissions and their own hesitancy confined them to a much narrower role than was envisaged in the Constitution [Chelliah et al 1981]. While the Constitution does not make a distinction between Plan and non-Plan sides, over the years the Finance Commissions have been led to confine their scope to assessing the needs of the States to meet only their non-Plan needs. Secondly, the practice of taking budgetary gaps to represent fiscal needs of the States and filling the gaps through grants-in-aid has been vehemently criticised for its disincentive effects on States' revenue raising effort and expenditure economy. [Thimmiah, 1981, Rao, 1987]. The approach followed by the Commissions, it is necessary to state, did encourage fiscal profligacy though it is difficult to assign the exact role of this factor in the deteriorating fiscal trends at both Central and State levels.

In recent years, the growth of revenue expenditures has outpaced revenue receipts. While the revenue receipts grew at an average annual rate of 14.5 per cent during 1975-76 and 1986-87, revenue expenditure grew at a higher rate of 17.2 per cent. This has brought about the era of government dissaving beginning from 1982-83; the combined revenue deficit of the Central and State governments is estimated at Rs 10,132 crore which is expected to form 3.1 per cent of GDP. This implies that

investible savings of this magnitude are being diverted to meet public consumption. The large debt servicing liability that is left by this would only result in the vicious circle of more revenue deficits - larger public dissaving - higher net interest burden leading to even more deficits. It is in this context that the departures suggested in the terms of reference of the Finance Commission, that it should adopt a normative approach to assess total revenue receipts and revenue expenditures of the Centre and States without making a distinction between Plan and non-Plan expenditures, assume significance.

In fact, the need to reverse the trend of governmental dissaving by raising more resources and/or curbing uneconomic spending by both the Central and State governments has long been recognised. At the Central level, towards this, the Union Finance Ministry brought out the Long Term Fiscal Policy (LTFP) in December, 1985. Unfortunately, the norms fixed in the LTFP were not adhered to and the intended objectives were not fulfilled. Public savings did not increase as contemplated, the contribution of public sector undertakings did not show the desired improvement, reversing the declining share of direct taxes could not be achieved, subsidies could not be reduced as laid down and the budgetary deficits could not be contained as envisaged. At the State level, the approach adopted by the Finance Commissions in fact encouraged fiscal profligacy. Even when some attempts were made to adopt norms, the Planning Commission's reassessment legitimised their non-fulfilment. In view of these factors, the reference to the "normative approach" in the terms of reference enables the Ninth Finance Commission to make a desirable move towards the adoption of an appropriate basis for assessing the States' revenue account needs. The Commission should seize this opportunity and evolve an approach that would induce fiscal discipline in the country.

However, it is necessary to bear in mind that in adopting a suitable approach, the Commission cannot be expected to become a full-scale investigation body exploring in detail the transactions in the entire public sector. The principal

objective of the Commission should be to lay the stepping stones towards building a proper environment for putting in greater effort in mobilising revenue and curbing uneconomic spending. The purpose of this paper is to highlight some important issues towards developing a suitable normative framework that can be adopted by the Finance Commission.

Evolving the Basic Approach

The substantive clause of Article 280 of the Constitution requires the Finance Commissions to recommend primarily (i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds, and (ii) the principles which should govern the grants- in-aid of the revenues of the States out of the Consolidated Fund of India. Through these instruments of tax devolution and grants- in-aid, the Commission is expected to resolve vertical and horizontal fiscal imbalances in the federation.

In meeting the problem of vertical and horizontal fiscal imbalances, proper consideration should be given to three important issues. First, both the revenue sources and expenditure functions of the Centre and the States should be appropriately balanced. Second, the expenditure requirements of different States in excess of their revenues should be provided for, so that individuals, irrespective of the State of residence, are entitled to a certain minimum standard of basic public services. Third, the problem of vertical and horizontal imbalances should be harmonised without creating disincentive effects on revenue mobilisation efforts and economy in spending.

The emphasis therefore has to be on balancing revenue capacities and expenditure needs rather than filling the gaps between projected revenues and expenditures. In this task, we may take the measurement of revenue capacities and expenditure needs at the State level as the starting point. This gives us an estimate of the minimum transfers necessary to balance

capacities with needs. The assessment of Central resources and expenditure needs would give us an idea about the amount of surplus available for distribution. It is necessary to ensure that the normative surplus of the Centre should at least be equal to the total normative deficits of the States having excess expenditure needs over their revenue resources so that we are not left with any revenue deficit in the economy as a whole. If these are not matched, the norms will have to be reworked to ensure this overall balance.

This, however, gives only the minimum that the State should receive. The requirement of tax sharing necessitates making devolution to all the States including those with no normative deficits. Therefore the total amount to be transferred has to be determined exogenously, keeping in view the overall developmental needs and priorities. Then, by appropriately choosing the proportion of shared taxes and grants-in-aid and by giving an appropriate weight to the backwardness factor even in the distribution of shared taxes, the required degree of progressivity may be brought about.

It must be emphasised that as all the fiscal parameters of the Centre and States - normative revenues, expenditures and deficits - are to be determined simultaneously, the desired results would have to be achieved through simulations. It is only through this procedure that the minimum amount required to be transferred to enable the States to meet their expenditure needs and the surplus available from the Centre for this purpose can be matched. Adopting such an approach would help to reverse the current trend of growing revenue deficits too. The broad method of applying norms to the revenues and expenditures of the Centre and State governments are outlined in the following sections.

Financial Norms for the Centre

Fixing financial norms for the Centre undoubtedly is an uphill task. Unlike in the case of the States where the norms can be fixed by making inter-State comparisons, no such method

can be evolved in the case of the Central government. The norms fixed in LTFP cannot be taken as they are, for they have not been found to be realistic. International comparison to fix the norms too does not lend itself for easy operational use as the economic situation varies widely from country to country. The Commission has to devise the norms on the basis of its own judgement, and in doing so, the norms adopted should have the same basis as that adopted for the States.

Broadly, in fixing norms, the Commission may proceed in the following manner. First, the tax revenue to be generated by the States on a normative basis can be translated into growth rates and the Central tax revenues may be required to grow at the same rate. In the past, in fact, the growth of Central tax revenues has been slightly lower than that of the States in spite of the Centre having potentially more buoyant tax handles. The requirement that the Central taxes should grow at least at the rates of growth of State taxes would be a realistic norm. Besides, in cases where under-exploitation of revenue sources can be clearly identified, the potential from such sources may be separately estimated and added to the total revenue potential of the Centre. Targets for non-tax revenue may be fixed, like in the case of the State governments, on the basis of the estimated investments made by the Central government.

This approach needs a little more elaboration. Essentially, the method implies specifying normative rates of growth for individual tax revenue items and supplementing this with known and identifiable sources of revenue which are underexploited. Excise duties, for example, can be broken up into specific and ad-valorem components. While the former may be required to grow at least at the rate of growth in real incomes, the normative growth for the latter should be equivalent to the growth of sales tax. In the case of direct taxes, the Commission may fix the target on the lines of LTFP which had targetted that the direct tax ratio to GDP should rise from 1.5 per cent estimated in 1985-86 to 2.1 per cent in 1987-88. However, instead of showing a rise, it fell from 2 per cent in 1985-86 to 1.7 per cent

in 1987-88 (estimated). It is in respect of direct taxes that underexploitation of existing potential is considered to be very high. Given that there exists considerable potential for raising revenue from the income tax by withdrawing exemptions, deductions, concessions and reducing widespread evasion, the Commission could broadly indicate the additional revenues the Centre could raise, so as to be in consonance with the overall revenue targets. This could be done not necessarily by raising tax rates but also by widening the tax base. In the case of Customs duties it may not be possible to fix any norms as such, because their revenue collections depend essentially on the import policy and quantum of imports. In this case, the past trend modified to take into account possible import policy changes may have to be taken as the norm. In the case of non-tax revenues, as mentioned earlier, the potential may be estimated on the lines of estimated loans advanced and interest rate charged (for interest receipts) and estimated investments and rates of return normatively fixed (for returns from departmental and non-departmental undertakings).

There are, however, two important issues that need to be taken note of. First, what if the Central government fails to fulfil the targets? In particular, failure to fulfil targetted collections in individual income tax and Union excise duty might result in the loss of revenue to the States. It is necessary to provide adequate safeguards so that inability on the part of the Central government to reach the revenue targets does not result in penalising the State governments. Second, the method of raising resources by the Central government itself may be looked into. It may be necessary to broadly indicate the targetted composition of Central revenues. From the equity and efficiency point of view, it is necessary that the direct-indirect tax mix be specified so that one does not always go in for picking the goose which squeaks the least. Equally important is the issue of increasing administered prices versus enhancing excise duties. In a public monopoly situation, the economic effects of the two measures are identical. However, from the point of view of federal finance, while the latter yields additional revenue to the States, the former does not. It would

be in the federal spirit to resort to administered price increases only to the extent of compensating 'justifiable' cost increases and leave resource mobilisation to the instrument of taxation. From the point of view of the economy, an increase in public sector savings only if achieved by improving productivity would result in the overall improvement of real savings in the economy. Increases in public sector savings achieved merely by raising administered prices would only result in the fall in savings in other sectors. As regards excise duty alterations, it should be in the interest of the economy to have stability - to adhere to the original resource mobilisation parameters envisaged for financing the Plan.

Given the normative revenue - GDP ratio and the ratio of targetted revenue surplus to GDP, the expenditure - GDP ratio of the Central government may be easily determined. Fixing norms for individual expenditure items, however, is a more difficult task. Norms for subsidies, like in LTP, may be fixed so that they grow only at the rate of growth of GDP. Interest payments should be fully allowed for and administrative expenditure should not increase at a rate faster than that of GDP. Defence is the other major expenditure item and its need should be determined in consultation with the Defence and Finance Ministries, keeping in view the expenditures on defence in the neighbouring countries and within the overall parameter of revenue expenditure not exceeding total revenues. This will eliminate financing revenue expenditures out of borrowings. A view has also to be taken on the desirability of the Central government's involvement in State subjects through the Centrally sponsored schemes.

Financial Norms for the States

Norms for the States' receipts and expenditures have to be developed by making inter-State comparisons. Thus, taxable capacities of the States can be estimated by adopting either the representative tax system approach or the regression approach. In the latter, it is possible to make improvements in the estimation by combining the cross-section with time-series in

a "covariance" model. In this, effort indices can be directly derived by specifying dummy variables to different States. Non-tax revenue capacities may be estimated by using realistic norms of revenues. In the case of States' expenditures, however, developing norms is much more difficult and therefore merits more detailed discussion.

Normative assessment of expenditures essentially implies estimation of 'expenditure needs'. This may be broadly defined as the justifiable cost of providing an average (or any other specified) standard of services. To estimate expenditure needs, therefore, we are required to measure the standards of public services provided and the justifiable cost of providing them.

Estimation of expenditure needs to enable the States to provide average standards of public services implies implicitly equalisation in the standards of physical services. But equalisation of per capita expenditures does not necessarily result in equalisation in the physical standards of services. Per capita expenditure variations can also result from differences in the cost of providing public services among different States and differences in the productivities in their provision. Cost variations may, of course, also be due to reasons which may not be justifiable such as high salaries, over-employment and wastages.

Equalisation of physical levels of services, however, presents severe problems of measuring the standards of physical services themselves. The output of the government sector is non- rival and non-excludable and therefore, cannot be quantified easily. Hence, the output has to be measured through the expenditures incurred and here the problem of developing norms becomes all the more difficult. Nevertheless, two alternative methods are suggested below to estimate the expenditure needs of the States.

It has been suggested that expenditure needs can be measured by normatively determining the physical levels of services. Accordingly, short term norms can be derived from the long term goals specified by various national Commissions

and national agencies. The physical targets to be achieved, thus derived, may be translated into normative expenditures by multiplying the targets with realistic or justifiable unit costs. (Thimmaiah, 1987). Thus, educational expenditures may be derived from the goals specified in the Directive Principles of State Policy and National Education Policy. The Minimum needs Programme is expected to give norms for housing for the poor and for rural health; the National Police Commission is expected to provide norms for police services and the National Policy of Health is supposed to lay down guidelines for health services. Similarly, in respect of other services, the Commission may request the respective departments of Central and State governments to provide targets to be translated into expenditures for relevant years.

There are, however, several operational problems with such an approach. First and the most important is that given the resource constraints, it may not be feasible to provide standards of public services as targetted by various national commissions. The targets fixed by these commissions/conferences take only a sectoral view and although these objectives are laudable and desirable, they can not be achieved within the available resources and the time frame of the Commission. The Commission will have to take an overall view to determine the extent of services to be equalised keeping in view the resource availability. Second, "public services" within a major expenditure category itself consists of several services and it will be extremely difficult to go into the details of each of the subcategories and try to equalise them. In fact, such an exercise cannot be done within the tenure of the Commission. This is the problem of measuring justifiable unit costs. It may not be possible to measure unit costs in all the cases due to the problem of identifying and measuring the public service itself. And third, in addition to the expenditures incurred on the services concerned, there are other supporting expenditures which do not directly go into the services in question but, nevertheless, are required for the provision of these services such as travelling, administrative overheads and provision of other incidental facilities. For all these reasons, it seems reasonable only to bring

about some relative parities in the services among the States. Trying to achieve absolute standards of services as set out in the national commissions and committees, though desirable, may not be feasible.

One method of estimating the expenditure needs is to analyse the underlying reasons for the differences in expenditures among the States and evolve behavioural norms. Expenditure incurred on a particular service by a State depends upon the ability of the State to provide the service, the need for the particular service and the cost of providing it. The cost of providing the service in turn may be on account of factors such as average salary levels or environmental factors such as large area (or smaller density of population) and physical terrain. The ability factor influences the level of public services provided - more the ability of a State, higher is the level of public services. The need variable also represents the quantity of public service required in the State as represented by the specific population groups the public service caters to.

The assessment of non-Plan expenditure may proceed along the following lines. First, the 'average' behavioural relationship between per capita expenditures and different ability, need, input price and environmental cost variables may be estimated in a regression equation. Essentially, in the model, expenditure variation among the States may be taken as a function of vectors of variables representing ability, need, input prices and environmental costs in different States. Variables representing input price differences may again be classified according to whether they are within or beyond the control of the State governments, thus, expenditure on the ith service in the jth State is functionally shown as:

$$Eij = f(Aj, Qij, Pij, Cij)$$

where Eij = Per capita expenditures on ith service in jth State.

Aj = Vector of ability variables in the jth State.

Q_{ij} = Vector of need factors for the ith service in the jth State

P_{ij} = Vector of input price differences for the ith service in the jth State

C_{ij} = Vector of environmental cost variables relevant for the ith service in the jth State.

By regressing per capita expenditures of the States on these variables, the behavioural relationship between per capita expenditures and these explanatory factors may be estimated.

These parameter estimates, however, only provide the average behavioural relationship from which norms can be developed to determine expenditure needs. The approach however, can be uniform for all categories of expenditures. On the general and administrative services, for example, expenditure need has to be computed as the justifiable cost of providing an average standard of services. In the case of social and community services, on the other hand, expenditure need on the non-Plan side should be taken as the justifiable cost of providing the existing standards of services. The raising of the standards of these services in the below average States to the average levels has to be undertaken on the Plan side. At the same time, recurring expenditure commitments for providing the existing levels of services should be provided for even in the States where the levels are above the average.

To estimate expenditure needs in respect of general and administrative services, actual values of 'need' and 'environmental cost' variables for each of the States and average values of ability and input price variables may be substituted. This would give us the per capita expenditure required to be incurred for providing physical standards of services by a State having an average ability, taking into account various environmental and other cost disability factors. As regards salary levels, instead of the average, any other normative (justifiable) level can be taken to estimate the normative expenditures, as the

salaries are taken at normative levels, expenditures are reckoned at justifiable costs. Further, as the average behavioural relationship with the need variable is considered, expenditures on account of over-employment in performing a public service are ignored. By taking into account the effects of environmental factors such as physical terrain and population density, the justifiable cost of providing average physical levels of services is taken into account. As the expenditure assessment is made on the basis of average behavioural relationship as estimated in the regression equation, evaluation is done at average productivity levels and excessive expenditures arising from wastages are not considered.

In the case of social services, two alternative methods may be employed to assess expenditures. In the first, normative expenditures may be estimated from the expenditure determinants model similar to the one employed in the case of administrative services with some modifications. Here, per capita expenditures on the services may be explained by different variables representing quantity and quality, input cost and environmental cost variables. By substituting actual values of quantity, quality and environmental cost variables and the average values of input-cost variables the justifiable cost of providing the actual standards (quantity and quality) of services may be estimated. Thus, the States providing higher standards of these services are allowed to do so, but their expenditures are reckoned at justifiable costs. In the case of those States having below average standards of services, equalisation may be attempted by bringing them up to the average level at justifiable costs. This can be achieved by substituting the average or any other specified target level achievable in the target period and input cost variables and actual values of environmental cost variables in the equation.

The second method would be to measure the average cost of providing the service. All-States' average per capita expenditure (or per student expenditure in the case of education) may be taken as the first approximation of average costs. To this, cost disabilities arising from specific

geographical features of each State may be added to estimate justifiable costs. This may be multiplied with the beneficiary population groups to arrive at normative expenditure estimates. In the case of below average States, to this must be added the justifiable cost of enrolling additional student population according to specified targets as above. Selected categories of social services such as primary education or basic medical facilities may be chosen for the purpose of equalisation.

This approach can be adopted in all cases where revenue expenditure largely determines the standard of public services. Largely, general and social services fall into this category. In respect of these services, the linkage between capital and revenue expenditures is not very strong and raising standards of these services does not involve a substantial amount of capital outlay. Nevertheless, in the case of certain categories of expenditures, some provision will also have to be made for capital upgradation. Provision for more police housing, larger jail capacity, building of courts, school buildings, primary health centres and hospitals are cases in point. Clearly, capital expenditures on these do not involve large outlay, nor is the provision of these services to be determined on the basis of inter-sectoral linkages to be incorporated in the planning exercise.

However, the linkage between the service levels and capital expenditure requirements is quite strong in the case of economic services. Also, their provision involves strong inter-sectoral linkages. In the case of these services, therefore, a slightly different approach is called for. In respect of important items expenditures will have to be derived by using engineering norms depending on the existing capital infrastructure. The spending on these services is guided by the requirements of inter-sectoral consistency as determined by the planning process. In other cases, where the linkage is not very strong the approach similar to the one described above for general and social services may be employed.

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Normative Approach: Genesis and Applicability

Atul Sarma and M.R.S. Kalyani

Before we take up the specific aspect of the terms of reference to the Ninth Finance Commission (NFC) which the paper is addressed to, we would like to make a few observations on the terms of reference to the Finance Commissions generally. Article 280 under which a Finance Commission (FC) is empowered to remedy vertical and horizontal imbalance in Indian fiscal federalism clearly specifies the functions which a Finance Commission is expected to perform. Even so, with the sole exception of the First Finance Commission each of the successive Finance Commissions has been provided a number of guidelines (directions in the case of the Ninth Finance Commission). In addition, each of the successive Finance Commissions has been referred to a number of additional points under 280 (3)(c). While the latter is perfectly legitimate under the Constitutional provision, the former is subject to question.

In both the cases, however, the question that arises is: what are the forces that have led to providing guidelines/ directions and to referring the additional points to Finance Commissions? With a hind sight one can argue that the Constitutional mechanism provided to correct vertical and horizontal imbalances as visualized was completely inadequate in the context of the role assigned to the public sector in economic management and development of the country. Incidentally, it is puzzling that even though there was a considerable debate on planned development and, in fact some Plans were formulated prior to Independence, the need for planned development in the framework of the federal structure was not taken into account while providing a mechanism in the Constitution

for correcting horizontal and vertical imbalances. Therefore, subsequently when the Planning Commission was constituted by the Government of India for pursuing certain goals such as economic growth, balanced regional development, better income distribution etc., (whether any of them is achieved is another matter given the supremacy of the Central government in fiscal and monetary resources under the Constitution) much larger transfer of resources than is warranted for performing the traditional functions of a State government was certainly involved. We submit therefore that the Constitutional mechanism provided with a restrictive view of the role of the public sector, viz., a quinquennial commission cannot be expected to meet the requirements of a continuous planning process. It can be argued that the guidelines/directions given and additional points referred to the successive Finance Commissions essentially reflect the problems that have emerged from the incompatibility of the Constitutional mechanism with the planned path of development in the federal framework.

We may elaborate the point a little further. While the First Finance Commission was given no guidelines at all, the Second and the Third Finance Commissions were given almost identical guidelines. These two Finance Commissions were required to take into account the Plan requirements of the relevant plans and the tax efforts made by the States. Up until the Third Finance Commission, the guidelines can be interpreted as attempts to integrate the need for fiscal transfers arising from the planning process with the restrictive fiscal transfers as visualized in the Constitution on the one hand, and to induce the Finance Commission to keep a watch over the tax performance of the States on the other. Broadly speaking, more elaborate guidelines given to the subsequent Finance Commissions upto the Eighth Finance Commission reflect the Central government's attempts (i) to establish conventions for the respective jurisdictions of the Finance Commission and the Planning Commission for operation, (ii) recognize explicitly the fallout of Plan financing on State finances, (iii) induce States to make optimal tax effort and equalize certain services. The fear of the investible resources for planning purposes being affected by

higher transfers under successive Finance Commissions as also the deficits on the revenue account being experienced by the Central government led to an additional guideline beginning from the Seventh Finance Commission which was related to resources of the Central government and its liabilities. Thus the guidelines basically reflect the Central government's perception of the problems arising out of the Constitutionally conceived role of the Finance Commission in fiscal transfers simultaneously with the necessities resulting from a much wider role of public sector in the framework of a mixed economy. Needless to add, the supremacy of the Central government in fiscal and monetary resources enabled it to give guidelines/directions in which the Finance Commission is to function.

With the guidelines as given to the Ninth Finance Commission a full circle has been completed in one substantive sense. It is that as in the First to Fourth Finance Commissions the guidelines to the Finance Commission do not recognize the distinction between Plan and non-Plan expenditure. These guidelines seem to have an underlying perception of the Central government that there was something basically wrong with the approach made by the successive Finance Commissions in assessing the resources and expenditure of the States. Such an approach was favourable neither to higher resource mobilization nor to better fiscal management. In fact, it has stifled the effectiveness of the government functioning and delivery system. To correct these unhealthy trends in State finances a new rationale for the co-existence of the statutorily provided mechanism and the Planning Commission can be provided by way of demarcating the role of the Finance Commission in revenue accounts and that of the Planning Commission in capital investment in place of non-Plan and Plan accounts in the preceding period.

It is true that all the first eight Finance Commissions either on their own or under compulsion restricted themselves to the non-Plan part of State finances. The only exception was the Third Finance Commission which made recommendations for grants for planning purposes, although it was not accepted

by the Government of India. It is also true that all the preceding Finance Commissions took a partial view of State finances and adopted a gap-filling approach to fiscal transfers. As a result the fiscal transfers made under the statutorily provided Finance Commission accounted for only about 45 per cent of the total transfers made to the States.

Despite these limitations, however one important working convention had been established over the years. For example, the Finance Commission would deal with the non-Plan revenue and capital accounts while the Planning Commission with Plan revenue and capital accounts. But the guidelines/ directions to the Ninth Finance Commission imply a complete departure from the above convention in that the Ninth Finance Commission should consider the revenue account of the Central and State governments in totality. In addition, the Ninth Finance Commission should make a normative approach in assessing the receipts and expenditure on the revenue account of both the levels of government. In this paper we will examine a little closely the operational aspects of the normative approach which the Ninth Finance Commission is required to make while assessing the receipts and expenditures on revenue account.

It will be useful to indicate at this stage the broad methodologies that were adopted by the preceding Finance Commissions in assessing the non-Plan receipts and expenditures. First, the forecast of receipts and expenditures submitted by the State governments were "cleaned" and made comparable. Second, growth rates of each tax and non-tax revenue item and every broad category of expenditure based on time trends and on functional basis for taxes occasionally were worked out. Third, these growth rates were suitably adjusted on the basis of judgement, *a priori* information and in certain cases on the basis of norms. Two examples of using norms can be given. In assessing the deficit/ surplus of State Electricity Boards, norms relating to plant load factor and transmission and distribution losses were introduced by the Eighth Finance Commission. Similarly, in providing for maintenance and up keep of assets

created, norms were used by the same Finance Commission but then no Finance Commission can be said to have assessed the expenditure needs and revenue efforts on the basis of any normative physical standards.

Such an attempt was not made even by the Sixth, Seventh and Eighth Finance Commissions which were required to consider the requirements for upgradation of standards of administration in non-development sectors. Even prior to this requirement, the First and the Third Finance Commissions made recommendations for specific grants on their own. The First Finance Commission identified eight States for special assistance for expanding primary education facilities on the basis of some judgement rather than on the basis of any normative standards. The Third Finance Commission identified ten States for the purpose of giving grants for improving road communications.

Being required to take into consideration the expenditure needs for upgradation of general administration, the Sixth Finance Commission restricted itself to the revenue expenditure needs for upgradation of general administration. It covered general administration, administration of justice, jails, police, primary education, medical and public health, welfare of Scheduled castes, Scheduled tribes and backward classes for special dispensation. Its broad approach was to raise the per capita expenditure level on these services in the deficient States to the all-States average by way of making provision for it in grants-in-aid.

In regard to similar guidelines, the Seventh Finance Commission identified (1) administration of taxes, (2) treasury and accounts administration, (3) judicial administration, (4) general administration consisting of revenue, district as well as tribal administration and the secretariat services, (5) police and (6) jail as the sectors and services in non-development sectors requiring upgradation of standards. It was indicated that it examined the relative position of the States in physical terms and determined the need to make provision for upgrada-

tion of standards in relation to certain norms. The above services were provided from both revenue and capital grants.

But it is not clear what exactly were the norms and how the cost of attaining the norms was worked out. The fact that it did not make a provision for any State larger than that proposed by the State itself indicates that the determination of the provision for upgradation of services lacked the required objectivity because it is perhaps the proposals made by the States which constituted the basis for providing special assistance for the upgradation of services.

In response to the corresponding terms of reference, the Eighth Finance Commission expanded the list of sectors and services comprising the non-development sector to nine by including three sectors services viz., education, public health and training. The Eighth Finance Commission identified the major components in each of the above services, determined absolute physical norms on the basis of judgement and worked out the quantum of special assistance for upgradation of the above services taking the level of achievement and unit cost. Ten States were provided grants-in-aid both for revenue and capital purposes although no such distribution was made as was done by the preceding Finance Commission.

The above discussion brings out the following points. First, the Constitutional provisions did not debar the Finance Commissions from considering both the revenue and capital needs of the States. It is the Finance Commissions themselves which put restrictions on their operation. Second, from the interpretation of the coverage of non-development sectors given by the Seventh and the Eighth, it is apparent that it is again the Finance Commissions which gave restrictive interpretation of the coverage of non-development sectors. Third, even in the restricted sectors and services selected for upgradation, the Sixth Finance Commission attempted to equalize per capita revenue expenditure while the Seventh and Eighth Finance Commissions examined the disparities in the selected sectors in physical terms, but attempted in an arbitrary

manner to upgrade the selected services to a level fixed on some judgement. Finally, none of the Finance Commissions attempted to estimate expenditure needs and revenue efforts of the State governments with reference to any normative standards. The limitations in the approach of the preceding three Finance Commissions to upgradation of services are noticeable despite the fact that a member of the Planning Commission was also made a member of Finance Commission beginning from the Sixth Finance Commission presumably with a view to taking an integrated view of the fiscal transfers to States.

The failure in making a comprehensive approach and in evolving an appropriate methodology for upgrading services in the States is reflected in the increasing disparity in administrative, social and economic infrastructures among the States when they are examined in physical terms. This can be clearly seen from the table below. For illustration we have taken a few characteristics of administrative, social and economic infrastructures in physical terms and calculated coefficients of variation for 1971 and 1981. The table brings out that the coefficients of variation increased over 1971 with respect to all the characteristics except for irrigated area as a percentage of net cropped area in which case the coefficient of variation somewhat declined.

In this background the operational implications of requiring the Ninth Finance Commission "to adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre....." can be examined.

To start with, it can be observed that this directive is a major departure from the corresponding guidelines given to the preceding three Finance Commissions. In one respect this directive is restrictive while in another respect it is wider in scope. It is restrictive in the sense that like the Seventh Finance Commission the Ninth Finance Commission is debarred from examining capital investment needs of the States even in respect of the non-developmental sectors. It is wider in scope in

the sense that the Ninth Finance Commission unlike its four immediate predecessors should consider revenue needs and efforts disregarding the distinction between Plan and non-Plan. It follows from the above that the Ninth Finance Commission is required to consider the total revenue needs and efforts of the States while the Planning Commission is to deal with the capital investment requirement.

Intertemporal Disparity in Administrative, Social and Economic Infrastructure

Item	1971 co-efficient of variation	1981 co-efficient of variation
A. Administrative infrastructure		
1. Number of Policemen per 10,000 of population	1.119	1.209
B. Social infrastructure		
1. Number of primary schools per 10,000 of population	0.658	0.688
2. Number of dispensaries per 10,000 of population	0.841	0.938
C. Economic infrastructure		
1. Irrigated area as a proportion of net cultivated area	0.630	0.588
2. Per capita consumption of power	0.682	0.747
3. Length of roads per 10,000 of population	0.584	0.922

Source: 1973 and 1983 Issues of Statistical Abstract of India.

This new operational distinction will hinder the equalization of services across the States almost in the same way as the dichotomy between Plan and non-Plan expenditure did. It is because equalization of services involves both revenue and capital expenditure while the Ninth Finance Commission will have to consider the revenue expenditure only. We give an illustration to make the point clearer.

Suppose the Ninth Finance Commission attempts to equalize health services. Taking certain relative norms, it identifies the gaps in terms of physical criteria such as number of doctors, nurses, medical equipment, hospital buildings, etc. Since the Ninth Finance Commission is supposed to consider the revenue expenditure needs, it can provide for the required number of doctors and nurses but not for medical equipment and buildings. In a situation like this a State will have the means to appoint doctors and nurses regardless of whether or not medical equipment and hospital buildings can be provided. These kinds of incongruities arose in the years of dichotomy between Plan and non-Plan expenditure. Thus, even while considering revenue expenditure needs in their totality the scope for equalizing the services will be very limited.

Since a member of the Planning Commission is also on the Finance Commission, it can be argued at least theoretically that the Planning Commission dealing with capital investment will immediately, as a follow up measure, provide for the required investment on medical equipment and buildings. Does it not then mean that a part of the investible resources gets preempted with the recommendations of the Finance Commission? There is one other problem. The planned investment in the State as well as in the Central sectors under the Eighth Plan which is yet to be formulated will also have a revenue component. How does the Ninth Finance Commission estimate the revenue component of the non-existing Eighth Plan? We would suggest a way out while discussing the coverage of the items of expenditures that should be assessed by the Ninth Finance Commission.

The normative approach can be interpreted in terms of absolute or relative norms. While it will be possible or even desirable to take a relative norm in assessing the revenue accounts of the States, the revenue account of the Central government has to be assessed on the basis of an absolute norm. The question is: how does one go about fixing absolute norms for the assessment of the Central government receipts and expenditures on revenue account?

In the past the Finance Commissions have not subjected the forecast of the Central government receipts and expenditure to as much close scrutiny as was done in the case of State government forecasts. This differential approach certainly led to unequal treatment of the two levels of government.

Because of the difficulties of evolving absolute norms in assessing the revenue accounts of the Central government, the two levels of government may be treated still more unequally. The difficulties are, of course, genuine. For example, what absolute norm could one fix for defence expenditure claiming a sizeable portion of the total revenue expenditure of the Central government?

The normative approach in assessing the revenue expenditure of the Central government can be made in the following directions. For almost every function allocated to the States, there is a department/ministry at the level of the Central government. This can be justified on at least three grounds. A department/ministry at the Central level can (a) provide those services which have spill-over benefits across the States, (b) coordinate the activities of the States and (c) carry out research and development programmes and disseminate knowledge and experiences of other States. But the level of expenditure incurred by the Central level department/ministry is far higher than what can be justified on legitimate grounds. For example, the Central government expenditure on public health which is a State subject increased from a mere Rs 25 crore in 1962-63 to Rs 294 crore in 1984-85. Similarly, the Central government expenditure under Centrally sponsored schemes

shot up from Rs 148 crore in 1973-74 to Rs 1311 crore in 1984-85. In areas of the above types, the Ninth Finance Commission should be able to fix norms on an objective basis.

For other services the desirable level in physical terms, taking into account appropriate determinants as also normative unit cost, should be determined. In the services provided by the Centre comparable to those of the States, the unit cost adopted for the States should be used. In other feasible cases, the unit cost should be worked out on the basis of men and material requirements per unit of output/services.

The revenue receipts of the Central government should be assessed on the basis of norms consistent with a federal system. There are numerous examples of Central government measures which adversely affect States' legitimate claim on Central resources or which have an adverse impact on State expenditures. A few examples can be given for illustration. Although the States' efforts for developing various infrastructural facilities contributed to the emergence of Corporation Tax as one of the major sources of revenue, this tax had been excluded from the divisible pool of income tax beginning from 1959 thereby denying the States a share in an expanding source of revenue. In the recent past public sector bonds offering an income tax free interest rate had been floated, which had obviously an adverse impact on the divisible pool of income tax as also on States' share in small savings. Again, the Central government mops up a large amount of resources by raising the administered prices of certain public sector monopoly goods as has been done recently in the cases of petroleum, coal and steel. Some of these products being major inputs in State government projects or their undertakings such as State Electricity Board, Road Transport Corporation, any hike in prices pushes up the cost unexpectedly. It can also be argued that since the effect on the economy of a rise in administered prices or in Union excise duties on this type of goods can be expected to be the same, resources of an equal magnitude could be mobilized by raising Union Excise duties in which case the States could get a share. After identifying all such Central government measures affect-

ing the States' claims on federal resources and the measures having adverse impact on State finances, the Ninth Finance Commission should fix appropriate norms which will contribute to healthy Centre-State financial relations.

The revenue potential of Central taxes should be assessed on the basis of optimal exercises while the contribution from Central public undertakings which are the major sources of non-tax revenue receipts should be on the basis of physical performance criteria comparable to those adopted for State undertakings.

In assessing the revenue position of the State governments the following two general points have to be noted. First, the fiscal measures are, no doubt, expected to serve important economic objectives but they cannot be entirely independent of the interplay of political forces. Second, the resource allocation as well as tax measures depend on the objective conditions prevailing in a State. Both these points suggest that the normative assessment of revenue and expenditure should not be so rigid as to curb the States' autonomy in fiscal decisions. The other point to note is that the methodologies adopted should be as simple as possible and the assessment should be realistic.

As regards the assessment of revenue receipts a distinction has to be made between tax revenue and non-tax revenue. In assessing tax revenue on a normative basis the fiscal effort relative to fiscal capacity of each of the States has to be considered with reference to the all-States' average tax efforts or the efforts of the best performing State relative to the respective fiscal capacities. The Representative Tax System Approach which is a well-developed methodology and has in fact been used in some of the older federal systems like Canada can be adopted. This approach involves an assessment of taxable capacity of each State in terms of tax-base potential for each tax and the determination of the standard rate of tax. By applying a standard rate to the estimated potential tax base of each tax and then aggregating tax potential of all the taxes, the potential tax

revenue can be estimated. While some empirical studies using this methodology have been carried out even in the Indian context, the realistic assessment on the basis of this methodology is circumscribed by the availability of the right type of data and the variability of tax base. For example, for the assessment of the potential base of sales tax, tax exportation has to be estimated and adjusted appropriately. The data base for such an estimate may not be adequate. The problem relating to the variability of tax base can be illustrated taking the example of agricultural income tax. Agricultural income tax as it is levied today is essentially a tax on income from plantation. Since plantation is not equally important in all States, standard tax rate based on an all States' average rate will be unrealistic to estimate the potential of agricultural income tax. Therefore, due caution has to be taken in making assumptions in using a proxy data base wherever needed.

Non-tax receipts mainly consist of contributions from public undertakings. In assessing the contributions from public undertakings, as pointed out earlier, similar physical norms should be adopted both for Central and State undertakings. Some of the preceding Finance Commissions while assessing contributions from State Electricity Boards (SEB) and Road Transport Corporation (RTC) adopted norms regarding plant load factor and Transmission and Distribution losses in the case of SEB and number of workers per bus in RTC. But because of lack of will or because of inherent weakness of these undertakings or because of certain compulsions, these norms could not be realized in reality rendering the assessment based on such physical norms unrealistic. This in turn had an adverse impact on the finances of some of the State governments. Despite such hazards, the fixation of physical norms with reference to all States' average can be expected to create pressures on the public undertakings to perform better.

The real difficulty arises in setting physical norms in terms of all States' average for the undertakings which are set up with some social goals specific to a State and which are brought into existence by way of nationalization of sick private

industries. The number of such public undertakings is quite large in some States. In such cases an attempt has to be made to fix norms in absolute terms.

The assessment of revenue expenditure needs of State governments on the basis of relative physical norms is a far more difficult task. The first problem relates to the coverage of the items of revenue expenditure that should be considered by the Ninth Finance Commission. Following a narrow interpretation, only the essential public services can be covered as was done by the Seventh Finance Commission when it was required to consider upgradation of general administration. If it is interpreted in a wider sense, the Ninth Finance Commission should cover all the services. While there is a case for equalizing all the services-administrative, social and economic - across the States, the Ninth Finance Commission should not take upon itself to equalize economic services. It is true that the implementing capability of the economic departments of the State governments does depend on revenue expenditure. But then the nature of capabilities that are required depends on the level and the composition of capital investment that will be postulated in the planning process. The level and composition of capital investments depends on the endowments - physical and human - and various other factors which vary from State to State. Moreover, planning for economic development of a State involves much deeper understanding of its economy as also constant monitoring which cannot be expected of a quinquennial commission with limited resources - time and expertise - at its command. Therefore the Ninth Finance Commission would do well in not attempting to equalize even the implementing capability of the economic departments of a State under assumptions which can at best be informed guesses and at worst arbitrary. To put it the other way, the Ninth Finance Commission should assess the expenditure needs keeping in view the objective of equalizing the administrative and social infrastructures. In doing so, it should cover both the revenue and capital expenditure requirements of the State governments regardless of the direction given to the Ninth Finance Commission in its terms of reference.

Given this coverage of the Ninth Finance Commission, the Planning Commission will have to interpret the capital investment in a wider sense. It will include investment on construction and plant and equipment relating to economic services under the Eighth Plan, upkeep and maintenance requirements of the assets created under the preceding Plans and the requirements of strengthening implementing machinery. This coverage is consistent with the objectives the Planning Commission is expected to pursue.

Assuming that the coverage of the services suggested above will be accepted by the Ninth Finance Commission, we may discuss in brief the operationalization of the normative approach. The normative approach in this regard should be directed to equalizing services in physical terms across the States. In other words, taking a relative physical norm in terms of all-States average level and better still, the highest level achieved in any of the States, the expenditure requirement of each of the States should be assessed. This will involve identification of (a) the States having a gap between the all-States average level and the existing level of services in physical terms (b) normative inputs - men and materials - required for providing one unit of each of the services. In determining (a), the level of services has to be normalized by taking an appropriate accessibility criterion. For example, the provision of drinking water should be considered taking a reasonable distance factor. In determining normative unit cost i.e. (b), the differential prices of material inputs across the States have to be taken into account. The difference between the normative physical level and the existing level of each of the services has to be multiplied by the corresponding unit cost to estimate the expenditure needs for each of the services.

It is apparent that such exercises will involve a wide spectrum of data. Some of the administrative and social services may not be amenable to consideration in physical terms. Besides, certain services e.g. maintenance of law and order which greatly depend on the local conditions cannot reasonably be considered for rigid standardization. In such cases the assessment of expenditures has to be based on judgement.

The major points that have emerged from the above discussion may be summed up as follows:

1. The incompatibility of the perception of the role of public sector, as reflected in the Constitutional mechanism, for vertical and horizontal fiscal imbalances with the actual role assigned to it in planned development has led to the present dichotomy in fiscal transfers.

2. This dichotomy was greatly responsible for partial assessment of fiscal needs and efforts resulting in disparity in the efforts as well as in the levels of services across the States.

3. Changes in terms of reference to the successive Finance Commissions essentially reflect the Central government's perception of the problems arising out of such a dichotomy and its attempts to resolve them.

4. The normative approach that is required to be made by the Ninth Finance Commission in assessing revenue and expenditures on revenue account will perpetuate the partial assessment of fiscal needs of the States as the distinction between Plan and non-Plan accounts did.

5. For operational efficiency it is suggested that the Ninth Finance Commission should attempt to equalize the administrative and social services across the States assessing fiscal needs in totality i.e. including both revenue and capital needs. The Planning Commission should cover the fiscal need-both revenue and capital - for economic services.

6. For practical reasons the scope for following a normative approach in assessing the revenue and expenditures of the Central government will be limited and this in turn will enhance the unequal treatment of the Central and State governments.

7. It is suggested that in the case of the Central government the normative approach should be interpreted so as to neutralize the adverse impact of numerous Central measures on State finances.

8. It is suggested that tax potentials of the Central government should be based on optimal exercises while that of State governments on the Representative Tax Systems approach.

9. The contribution of public undertakings of both Central and State governments should be assessed on the performance norms.

10. Fiscal needs of the States should be assessed in physical terms with reference to the all-States average.

11. It is suggested that the normative approach should not curb a State's autonomy in allocation of resources or in taking fiscal decisions.

Normative Approach and the Finance Commission : Some Reflections

P. R. Panchmukhi

In his letter addressed to the Chief Ministers of the State governments, the Chairman of the Ninth Finance Commission has specially drawn attention to para 4 of the Presidential Order appointing the Ninth Finance Commission. He points out "there is a distinct change in the approach of the present Commission as evidenced from para 4 of the Order. Instead of identifying non-Plan revenue deficit as in the past, the Commission has been asked to adopt a normative approach in assessing receipts and expenditure, without distinction between Plan and non-Plan. Consequently, emolument provisions and other items of expenditure would have to be judged in the light of norms and not with reference to any specific cut off date." Thus, the main point of departure of the Ninth Finance Commission's approach is the proposed adoption of a normative approach. In the terms of reference proper, there is no amplification of what this normative approach actually means. In the present paper an attempt is made to examine the possible interpretations and implications of this normative approach.

The earlier Finance Commissions used to follow an approach of receiving from the State governments the forecasts of revenues and expenditures on non-Plan account and then subjecting these forecasts to reassessment wherein invariably the receipts got scaled up and expenditures scaled down causing the State non-Plan surpluses if any, to be expanded or

deficits if any, converted into surpluses or at least reduced. Divergence of the rates of growth as adopted by the Finance Commissions from the rates as adopted by the State governments was responsible for the divergence of the reassessments from the forecasts. The State governments and the Indian federal financial system seemed to have accepted this philosophy of reassessment as an inevitable and natural concomitant as it were of a federation. The very title of the chapter in the Finance Commission Reports, "Reassessment of the Forecasts of the State governments", questioning the credibility and trustworthiness of the State governments' exercise, went through without strong protests (though with some murmurs) and resistance. Mutual trust, it need hardly be emphasised, is the very foundation of a healthy federation. The mechanism of forecasts and reassessments induced the State governments to present their forecasts in such a way that the reassessed figures of expenditures and receipts would turn out to be favourable to them in the ultimate analysis. This has further strengthened the mutual distrust between the State governments on the one hand and the Finance Commissions on the other.

The extent of deviation of the reassessments from the forecasts can be taken to reflect the extent of mutual distrust or as a measure of the coefficient of distrust.

The following tables indicate the extent of distrust that the Seventh and Eighth Finance Commissions have exhibited in their policy of reassessment.

Percentage change in reassessments over State Forecasts

State	Revenue Receipts		Revenue Expenditures	
	Seventh FC	Eighth FC	Seventh FC	Eighth FC
Andhra Pradesh	26.98	16.87	-27.22	-26.79
Assam	24.47	15.78	-32.95	12.08
Bihar	35.38	32.25	-39.36	17.03
Gujarat	9.87	34.19	-24.59	-20.66
Haryana	-17.23	12.68	-29.97	15.36
Himachal Pradesh	48.57	46.32	-13.65	-29.26
J & K	-3.40	43.24	-45.33	-21.63
Karnataka	10.80	14.33	-32.98	-32.25
Kerala	12.82	20.88	-34.63	-21.45
Madhya Pradesh	7.17	10.09	-30.38	-22.01
Maharashtra	2.47	8.12	-30.56	-21.05
Manipur	-14.19	113.12	-34.50	-24.49
Meghalaya	33.11	48.83	-39.00	-29.70
Nagaland	12.00	41.19	-34.44	-36.72
Orissa	2.83	18.09	-11.30	-20.95
Punjab	18.93	19.73	-27.57	-26.11
Rajasthan	8.21	10.44	-35.21	-28.66

Cont.

State	Revenue Receipts		Revenue Expenditures	
	Seventh FC	Eighth FC	Seventh FC	Eighth FC
Sikkim	-7.70	25.70	-2.57	-40.17
Tamil Nadu	14.75	29.55	-22.73	-32.04
Tripura	-8.91	69.13	-31.90	-47.07
Uttar Pradesh	10.08	39.91	-44.74	-36.95
West Bengal	5.70	16.03	-33.62	-27.64

Eighth Finance Commission

Percentage change in reassessments over the Centre's Forecasts

	Revenue Receipts	Revenue Expenditure	Capital Receipts	Capital Disbursement
Central Govt.	-5.32	-13.50	20.49	9.28

One may notice that so far as the revenue receipts are concerned, the majority of the States find their forecasts of revenue receipts reassessed in the upward direction by the Seventh Finance Commission. The extent of the upward scaling has been in the range of 2.5 per cent to 48.6 per cent. Only in the case of 5 States: Haryana, Jammu & Kashmir, Manipur, Sikkim and Tripura the State forecasts were considered to be over-estimates and hence they have been scaled down. As against this one notices that without exception, in the case of all the

States, the revenue expenditures have been scaled down by the Seventh Finance Commission. The extent of this scaling down ranges between 2.5 per cent to 45.3 per cent. It is interesting to note that the revenue expenditures of the States have been scaled down by the Seventh Finance Commission to a significantly larger extent in the case of all the States whose level and rate of development is not very satisfactory. For example, the less developed and developing States like Assam, Bihar, Jammu & Kashmir, Karnataka, Kerala, Madhya Pradesh, Manipur, Meghalaya, Nagaland, Rajasthan, Tripura, Uttar Pradesh and West Bengal experienced more than 30 per cent scaling down in their revenue expenditures. It is significant that the majority of the States from this group are backward in respect of the development and maintenance of the physical and social infrastructure. Jammu & Kashmir and Uttar Pradesh found their revenue expenditures cut down by 45 per cent. Obviously, it is these States where the maintenance of the social and physical infrastructure is very poor and the axe of the Finance Commission has fallen precisely on such States.

If we consider the Eighth Finance Commission's recommendations, a more or less similar pattern emerges. Practically in the case of all the States, the revenue receipts have been reassessed in the upward direction wherein the extent of reassessment varies between 8 per cent (Maharashtra) to 113 per cent (Manipur). It is interesting that some of the less developed States found their revenue receipts reassessed in the upward direction by more than 30 per cent. For example, Uttar Pradesh, Tripura, Nagaland, Meghalaya, Manipur, Jammu & Kashmir, Himachal Pradesh and Bihar belong to this group of less developed States. When we consider the revenue expenditures, on the other hand, most of the States experience a scaling down effect in the process of reassessment. The extent of downward reassessment varied between 21 per cent (Orissa) to 47 per cent (Tripura). Only in the case of three States: Assam, Bihar and Haryana, there is a marginal upward reassessment ranging between 12 to 17 per cent. In the case of less advanced States like Uttar Pradesh, Rajasthan, Nagaland, Madhya

Pradesh, Andhra Pradesh, etc., the extent of upward reassessment was 20 to 37 per cent.

From the above discussion it appears that the Finance Commission, as an apex body to effect the statutory transfer of resources, has distrusted the State governments to a significant extent. On an average, the coefficient of distrust in the case of the Eighth Finance Commission seems to be higher than the coefficient of distrust in the case of the Seventh Finance Commission so far as revenue receipts are concerned. Though in the case of expenditures the coefficient of distrust is smaller in the case of Eighth Finance Commission, it is surely of a very high order. This is evident from the following table.

Coefficient of Distrust of all State governments (percentage)

	Revenue Receipts	Revenue Expenditures
Seventh Finance Commission	9.61	-33.13
Eighth Finance Commission	25.18	-20.97

It is quite interesting and revealing that the coefficient of distrust in the case of the Central government is of a relatively lower magnitude. The Seventh Finance Commission has not given data of Central government forecasts and Finance Commission reassessment, while the Eighth Finance Commission Report gives these data. We find that the revenue receipts of the Central government have been actually scaled down by 5.32 per cent and the Central government revenue expenditures have also been moderately scaled down to the extent of 13.5 per cent. On capital account the capital receipts have been scaled up to the extent of 21 per cent and capital disbursement scaled up to the extent of 9.3 per cent. On the whole, one gets an impression from these limited data

published in the Report of the Finance Commission that the coefficient of distrust in the case of the Central government is of a relatively modest order as compared to that of State governments. The fact that there is distrust in the case of the Central government forecasts also is worth noting.

The above discussion raises a basic question as to why it is that the Finance Commission's estimates and the State and the Central government's estimates diverge so far as the receipts and expenditures are concerned. Since the divergence is observed in the case of the exercises of almost all the Finance Commissions in the past the question becomes all the more serious. Does it mean that the State governments in particular and the Central government in recent years, have not learnt the methodology of developing their forecasts of receipts and expenditures, the methodology which is acceptable to the Finance Commission? Or does it mean that since in any case the Finance Commission is going to reassess, it is advantageous to the State governments to adjust their forecasts in such a way that the reassessments - expected as well as actual - would not be too unfavourable to them? This only implies that the mutual disbelief feeds on itself and in this context honesty will not be the best policy.

So far as the methodology of developing the forecasts and also presenting the reassessments is concerned one feels that there is no set methodology adopted by both the State governments and the Finance Commission. Only in the case of the Seventh Finance Commission a fairly rigorous statistical exercise was attempted with the assistance of the National Institute of Public Finance and Policy to estimate the elasticities of revenue receipts. In the ultimate analysis however, these elasticities also do not seem to have been used in the actual exercise of reassessing the receipts. Similarly, in the case of expenditures also an element of judgement seems to have been used amounting to arbitrariness in developing both the forecasts and reassessment. There is no way to find out how more than two scores of State governments have developed their

forecasts. Finance Commission Reports only mention State forecasts and reassessments. The rates of growth of receipts and expenditures adopted are sometimes uniform for some States and different for others. Similarly, in the case of expenditures also the reassessments are based essentially upon judgement in the context of different States. If this is so, can this approach not be considered as normative? In fact the method (there is obviously no single method adopted for different States) adopted by the Finance Commissions is essentially normative in nature both with regard to the receipts and expenditures. Then why should the terms of reference of the Ninth Finance Commission emphasize the adoption of a normative approach in assessing the receipts and expenditures?

The following distinguishing points may be noted in the case of the terms of reference of the Ninth Finance Commission. The Presidential Order requires that there will be a 'normative approach in assessing the receipts and expenditures on the revenue account of the States and the Centre' and not reassessment. This according to us is a favourable development in the sense that the Finance Commissions are expected not to distrust the State forecast by 'reassessing' the forecasts. However, in order that the Finance Commission undertakes this exercise in the true spirit of healthy federal financial relations, this assessment needs to be done in full collaboration with the State governments. It may be useful if the Finance Commissioners of the State governments are co-opted as members of the sub-group that may be constituted by the Finance Commission for the purpose of the exercise.

The approach that the Ninth Finance Commission is expected to adopt would become truly normative if the special problems of each State are specifically recognized in the process of assessment. The fact that some of the States are reeling under severe drought conditions during the past four or five consecutive seasons may be one of the specific problems of the States, which needs to be considered in this normative judgement. Similarly, in some States even though the overall

per capita magnitudes relating to the physical and the social infrastructural development are fairly favourable, the intra-State inequalities with regard to rural-urban disparities, rural disparities and urban disparities deserve special consideration in the normative approach. The States are likely to emulate standards and levels of public services obtaining in the neighbouring States to start with and in the most progressive States in the ultimate analysis. The normative approach needs to consider these policy orientations and people's expectations regarding these levels. Since in the letter of the Chairman of the Ninth Finance Commission, it has been indicated that the receipts and expenditures without distinction between Plan and non-Plan need to be assessed by adopting a normative approach, such broader policy orientations and expectations of the people regarding the 'development' of the services and their maintenance become quite relevant considerations. It is satisfying that the scope of the Finance Commission is fairly widened to consider both the Plan and non-Plan aspects of the financial position of the States and the Centre. Such an overall perspective was not taken by apex agencies so far. If the Ninth Finance Commission fulfils this need then possibly it may pave the way for healthier Centre-State financial relations. At the same time one faces a question about this wider ambit of the Finance Commission's purview because then what will be the role of the Planning Commission in this context. The Planning Commission may turn out to be largely an advisory body without its present crucial position of, by and large, determining the annual and Five Year Plans of the States and the Centre. If Plan and non-Plan finances together have to be considered by the Finance Commission (though for a better scrutiny of non-Plan finances only) then the exercises made by the Commission for estimating the Plan component may have to become binding on the Planning Commission. In any case, this suggests that the roles of the two bodies need to be clearly defined to avoid an overlap or conflict.

While the adoption of a normative, State-specific approach in assessing the receipts and expenditures on the reve-

nue account of the States is welcome, the way the terms of reference have been mentioned in the Presidential Order do not seem to be quite in order. The relevant terms of reference say, "in making its recommendations Finance Commission shall 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 Centre such as, defence, security, debt servicing and other expenditures or liabilities." While the special problems of each State 'if any', are to be considered, the special requirements of the Centre which are clearly articulated with open endedness 'have to be' necessarily taken into account. This wording gives an impression that the problems of the Centre have to be compulsorily taken into account, whereas it is up to the Finance Commission to get convinced that there are special problems in the case of particular States and only then these problems should be taken into account. The debt servicing and other committed expenditures or liabilities are the problems of the States also, which are not clearly mentioned in the terms of reference. In this background, the normative approach may be dubbed to be in favour of the Centre. As stated earlier the value of the coefficient of distrust in the case of the Central government (as seen for the Eighth Finance Commission) even though moderate might itself be responsible for indicating the necessity of taking a normative approach with a special mention of the problems of the Centre. Critics may allege that even a small magnitude of reassessment of the Centre's finances by the Finance Commission was not tolerated and hence under the guise of the normative approach, the Finance Commission is expected to safeguard the interest of the Central government. It may not be proper to reach this conclusion before it is known what will be finally done by the Ninth Finance Commission. However, the working of the earlier Finance Commissions in this regard has only strengthened the fear of the critics with regard to the new normative approach to be adopted by the Ninth Finance Commission.

Some of the other terms of reference of the Ninth Finance Commission also seem to indicate this pro-Centre bias strengthening the doubts about the 'normative approach'. For example, the Terms of Reference No. 7 relating to the merger of additional duties of excise in lieu of sales tax with basic duties is not unexceptionable, particularly because the latter are levied and collected by the Union and may be distributed between the Union and the States, while the former have to be distributed among the concerned States. Again, in the Terms of Reference No. 9 relating to relief assistance, the pro-Union government bias seems to be evident. The Commission has been asked to examine 'the feasibility of establishing a National insurance fund to which the State government may contribute a percentage of their revenue receipts.' A reference to such a fund is made in the Terms of Reference (No. 6) of the Sixth Finance Commission also. It says, 'The Commission may .... examine *inter alia* the feasibility of establishing a National Fund to which the Central and State government may contribute a percentage of their revenue receipts.' (please note the portions underlined). The natural calamities which affect the entire nation in the ultimate analysis are essentially national calamities, and are in the nature of national public bads. The measures to tackle such public bads must be considered as the collective responsibility of the nation as a whole and not the responsibility of only the region or the States where the incidence of the natural calamity falls. Though at the time of the Sixth Finance Commission this seems to have been appreciated, at the time of the Ninth Finance Commission, however, all of a sudden, the approach has changed.

On the whole, we may conclude that the normative approach is desirable but this approach should not be ad-hoc or arbitrary as in the case of the earlier Finance Commissions. The normative approach may pave the way for healthy federal financial relations if the State-specific norms and judgements are adopted and the State representatives are co-opted in the exercise of developing the assessment of receipts and expenditures on revenue account. It would do great credit to the

Ninth Finance Commission if the misgivings about the role of the Finance Commission are dispelled by its sincere adoption of the normative approach involving the equal treatment of equals and unequal treatment of unequals and also fairly equitable treatment of the Centre and the State governments. It is only by adopting such norms in the normative approach that the Ninth Finance Commission's terms of reference can be said to mark a major departure from the accepted practice.

PART II

Recommendations

Report of the Ninth Finance Commission

D.T. Lakdawala

The Second Report of the Ninth Finance Commission was submitted to the President on 18th December, 1989 and laid before the Lok Sabha along with the actions of the Central government thereon on 12th March, 1990. About two months have lapsed since its publication. The announcement of the terms of reference of the Commission in the Presidential Order dated 17th June, 1987 had given rise to a strong protest from the opposition States and to a vigorous controversy among the students of Indian federal finance. Later, during the discussions and deliberations some of the methodologies regarding the adoption of norms had come in for severe criticism. But the Report has surprisingly aroused much less discussion so far. This may be due to a number of reasons. The Finance Commission has dealt tactfully with the points that disturbed the States; the First Report dealing with the recommendations for 1989-90 skillfully prepared the concerned parties for what has followed in the Second Report; consultations with experts were more frequent. The government and the opposition during the tenure of the Commission have now changed sides so that some who had taken cudgels against the terms of reference are a party to accepting most of its recommendations. It may also be that since the Ninth Finance Commission Report is accepted, it is felt that nothing can immediately be done to upset it and that further discussion is futile or it may be that inspite of the envisaged departures in approaching the problem of Centre-State and inter-State transfers the results are so similar to the earlier ones that there is little new to complain about. Since, however, our major interest is in evolving a long-term satis-

factory system of Centre-State transfers, a scientific discussion of the Report will be useful and productive.

From the viewpoint of the States as a whole, the most strategic question is the determination of the quantum of transfers as a whole from the Centre to the States. The Indian Constitution limits the types of transfers the Finance Commission can recommend. The States have to be assigned a share of income-tax; they may be given and are now given a share of excise duties. 85 per cent of shareable income tax and 45 per cent of excise proceeds are now prescribed as the States' shares. The States in need of assistance are given grants under Article 275. Now under some sub-headings all States are recognised as eligible for grants, but these have played a minor part in the transfers of the Finance Commission. The States have insisted on transfers being mostly given in terms of shares in divisible taxes and the Finance Commissions have recognised their legitimacy. The Ninth Finance Commission has been more liberal in the use of grants and has recognised a special category of it — deficits on Plan revenue account. It has also provided a much larger sum by way of the Centre's contribution of 75 per cent towards a Calamity Relief Fund. Even so, the statutory grants for 1990-95 are estimated to amount to only 17.1 per cent of the transfers. Income tax and excises have in the 'eighties grown much less rapidly (14.26 per cent and 14.57 per cent respectively) than corporation tax (15.39 per cent) and customs duties (20.12 per cent) and non-tax revenues have risen much faster (19.3 per cent) than tax revenues (16.3 per cent) so that the statutory transfers are likely to diminish when the shares of divisible taxes are kept constant. This experience is likely to be repeated in 1990-95. The transfers to States are estimated to amount to 22.7 per cent of total Central revenue receipts compared with 24.1 per cent according to the Eighth Finance Commission's recommendations. A question which deserves deep consideration at our meeting is: Why inspite of the greater financial difficulties of the States, the avowed policy for greater decentralization, and the quasi-judicial mechanism of the Finance Commissions have the statutory transfers to the States become more or less constant in terms of

percentages of the Central revenues? Some tentative lines of reply may be attempted.

To be fair to the Finance Commissions it must be noted that they have tried to be responsive to the criticism of the States to the extent it lay within their domain. The Ninth Finance Commission has, for example, examined in detail the revenue and expenditure forecasts of the Centre and also put them to some normative tests. Unlike in the case of States where one can compare performance of one State with that of others to arrive at norms, there is only one Centre and the other countries are so different that comparisons do not help. Perfect symmetry was, therefore, not possible, but all sincere efforts were made to put the Centre's forecasts to as rigorous tests as those of the States. The often made criticism that much less percentage changes are made in Central forecasts than in the States' or that there have been much greater changes in the actuals of the Centre by itself does not mean much. The more important fact is that the Finance Commissions have mainly to confine their attention to the current side, and throughout the 'eighties the Centre had a deficit on revenue account. More recently, almost the entire Central Plan has been financed from borrowing including deficit financing, and both these do not directly concern the Finance Commission. It is borrowing and deficit financing which explain the apparent affluence of the Centre. The States get a small share of the money so acquired by way of Plan assistance but they bear the full impact of the consequent price rise. No sharing formula or grants can tackle this problem at the root. The more promising lines of attack are economy and efficiency of expenditure, prevention of tax leakages and evasion and dropping activities are important but less so. The level at which the Centre and the States have to discharge their functions in the light of their importance to the national economy and the expenditure just needed for them if efficiency was considerably stepped up were the main issues. By their tenure and nature, the Finance Commissions are not equipped to deal with these problems and have not done so. The consequent disappointment to the States and the Centre was natural but also unavoidable.

There are some incidental complaints of States which can be more easily dealt with. The States have often demanded that the corporation tax should be included in the divisible pool. In so far as each Finance Commission decides the quantum of transfers first and the ways of transfer later it should not matter whether a tax is included or not in the divisible pool, till the States shares in the divisible taxes have reached their maximum. The inclusion of corporation or some other tax in the divisible pool should mean that shares in the already divisible taxes will be simultaneously reduced. It is difficult to prove that the States' cooperation is needed in the successful administration of one Central tax more than the other. But the flexibility of different taxes differs so that in the intervening period between two Finance Commissions, the inclusion or exclusion of one tax may make a difference. Also since it is customary to fix different distribution formulae for different taxes, different States may fare differently if the corporation tax is included. It is likely that the more industrially developed States may gain more. Irrespective of the gains and losses to the individual States if an amendment of the Constitution is not thought inadvisable it may be worthwhile fixing the States' shares as a proportion of the total Central revenues and imparting any flexibility needed in assistance through grants under Article 275. This will avoid much of the Centre-State conflicts on the use of Central surcharges and use of prices of Central enterprises rather than excises to get more revenues.

The major changes that were expected in the recommendations of the Ninth Finance Commission were in the inter-State distribution of Central transfers because of the new approach implied in the terms of reference. The approach earlier adopted was picturesquely described by some economists as a "gap-filling" approach. The tax and expenditure forecasts of the States were made on the basis of past trends: tax devolutions were prescribed, and grants under Article 275 were recommended to fill the non-Plan deficits if any. The description was not completely accurate, as successively more and more modifications were made in tax and revenue

expenditure forecasts and in the case of interest on loans and returns from public sector enterprises even some norms were prescribed. Grants often included upgradation purposes and were sometimes given also to achieve certain goals in developmental fields. The terms of reference of the Ninth Finance Commission laid down two new procedures - adoption of a normative approach in assessing the receipts and expenditure on revenue account and of not confining to tax revenues as existing on a particular date or to non-Plan expenditure. The first change had aroused an apprehension among the States that by prescribing norms there would be attempts at encroachment on their powers by the Commission. This fear had been met by the assurance that norms were only for the purpose of recommending transfers and the States were free to attempt better services out of their own resources by taxing more or taxing less if their citizens were satisfied with less services. It had also been pointed out that the prescription of norms in this manner was essential if economy and resource mobilization were to be encouraged. The second change of including Plan expenditure was essential if the States with deficit on non-Plan account - generally very poor States like Uttar Pradesh, Orissa, etc., - were to be enabled to plan on lines somewhat similar to the States with substantial surpluses on non-Plan account. The major problem in the second job was that the Finance Commission had less competence than the Planning Commission to recommend the State Plan size and the pattern of sectoral allocation and had no jurisdiction on assistance through loans which was more important in Plan assistance and linked with Plan grants hitherto.

It is interesting to know how both these issues were methodologically tackled by the Finance Commission. As far as the tax norms are concerned the Second Report of the Ninth Finance Commission adopted the modified representative tax system approach which implies that you calculate for each State the tax revenues that would be obtained if the tax bases had been exploited to an average extent. For fees and user charges actuals have been used, and for dividends and interest, normative returns. Expenditure has been divided into four major

categories; general services, economic and social services, social welfare services and maintenance. The average behaviour has been taken as the norm for a substantial part of non-Plan revenue expenditure. For social and economic services the justifiable costs of providing the existing level of services has been estimated and for expenditure on social welfare services certain uniform levels are fixed. For maintenance engineering norms are applied. Since the norms are broadly the averages it is not surprising that while the revenue and expenditure forecasts worked out by the basis of norms differ from the trends worked out on the conventional methods for individual States, for the States as a whole the sum totals hardly differ. The normative tax estimates for 14 major States were more than the conventional ones by less than one per cent and the normative non-Plan revenue expenditure estimates were less by 3.5 per cent. To give more time for adjustment only 50 per cent of the net improvement noticed in the case of ten major States because of the adoption of norms was adjusted.

While it has not always been thought advisable for the Finance Commission to change the combined States' shares of income and excise duty collections every Commission has changed the formula for inter-State distribution. Each Commission has given its own line of thinking, but it is difficult to trace any principles except the desire to make the distribution more progressive. The Ninth Finance Commision has done likewise. As a result of the changes in the inter-State distribution formula, it suggests as well as other changes, among non-special category States Rajasthan, Orissa, Uttar Pradesh and Haryana have relatively gained in that order whereas all others have lost. The biggest loser is West Bengal. It is surprising that the poorest State, Bihar, has gained less in percentage terms than the average. Among the special category States the only gainer is Jammu & Kashmir. For States like Mizoram, Arunachal Pradesh and Goa which acquired Statehood only recently no comparisons are possible. The per capita transfers increased by 169 per cent. Among the non-special category States they varied from Rs 1,190 for Haryana to

Rs 2,529 and Rs 2,517 for Rajasthan and Orissa; among special category States the variations were much higher - Rs 2,705 for Assam to Rs 30,753 for Mizoram and Rs 24,115 for Nagaland.

The question of Plan transfers is treated in an interesting manner. On the assumption that the revenue Plan expenditure of the 14 major States will increase at 7 per cent per annum, it will rise to Rs 40,000 crores in the Eighth Plan. This figure is redistributed among the States to make the per capita expenses more progressive and equitable and a minimum of revenue Plan expenditure for 1990-5 is arrived at for each State. To enable the weaker States to spend more on the Plan, they will be given 50 per cent of the shortfall between this amount and 40 per cent of their revenue surplus on the non-Plan account plus the expected receipts on revenue account from the Gadgil formula of Plan assistance. This will be Plan deficit grant which will amount to Rs 8,674 crores for 1990-95. It is interesting to note that the Ninth Finance Commission has found out a skillful way of helping the weaker States to implement a better Plan without encroaching on the legitimate functions of the Planning Commission regarding the size of the State Plans, their sectoral allocation, and Plan assistance.

An important exception that should be noted when talking of norms is that for well-known reasons these are not applied to special category States which are more liberally treated and only as specific cases as before. As a result the financial allocations to them work out to a higher percentage than before and much higher in proportion to population. The Ninth Finance Commission has for 1990-5 recommended 15.44 per cent of the total transfers to be made to them compared with 14.06 per cent by the Eighth Finance Commission. The population of the special category States is only 5.2 per cent, so that the per capita transfers are about thrice. The Planning Commission treats them equally liberally. This has for a long time been accepted as natural, but some means to ensure that this money is well spent and brings proportionate results is called for. The special category States are very keen on the establishment of equitable standards among them.

There is one long-standing problem which the Ninth Finance Commission has solved more satisfactorily than the earlier ones - the question of satisfactory arrangements for financing of relief expenditure by States affected by natural calamities. The relief expenditure was at the time of the Eighth Finance Commission to be met from the margin money which was calculated by averaging the non-Plan expenditure of the State over the past few years booked under the heads accommodating the relief expenditure. The margin money was to be equally shared between the Centre and the States. Items of direct relief expenditure and expenditure on repairs and restoration of public assets were to be covered, but not on relief employment. Expenditure in excess of margin money was to be borne by the State government out of advance Plan assistance if needed. Every time there was a natural calamity, a Central team visited the scene to determine the ceiling under various headings of relief and there was some hot wangling. Apart from the general complaint of inadequacy of famine assistance, the States bitterly complained of the time taken by the Central team and the ad hoc nature of its recommendations. The Ninth Finance Commission has redressed this complaint by creation of a Calamity Relief Fund of Rs 804 crores a year to which the Centre contributes 75 per cent and the States 25 per cent. The fund has to be deposited in a nationalized bank. The State will have more autonomy in drawing on it to the extent necessary to deal with a natural calamity. If more is needed, the State will have to draw on its own resources though some temporary credit may be extended. Any unspent money in the Fund at the end of the Plan should revert to the State. This new arrangement may prevent much friction between the Centre and the States.

While the Finance Commission looks after the revenue deficits of the State, and the Planning Commission takes care of the Plan needs, revenue and capital, there is no mechanism to look after the non-Plan capital requirements of the States. Large sums are needed to repay the Plan loans taken earlier from the Centre, but apart from the share in small savings there is no regular major source of non-Plan capital receipts which can

provide for repayment. This was regarded as one of the important causes of unauthorised overdrafts by the Fifth Finance Commission. Since then the Finance Commissions have been asked to determine this gap and suggest measures to meet it. The Sixth, Seventh and Eighth Finance Commissions have suggested writing off of some debts and rescheduling of some repayments which fall due in their period. This is a very unsatisfactory way of dealing with the problem because a rescheduling by one Finance Commission creates hopes of the next doing so and the extent cannot be known in advance. The Ninth Finance Commission has been more wisely asked to deal with the fundamental problem and suggest corrective measures with particular reference to investments in infrastructure projects and linked with improvements in managerial and financial efficiency. As long as capital expenditure is incurred for purposes which do not give enough returns to pay the interest and meet the repayments the regular revenue account has to provide for the remainder. Since the Planning Commission thinks there is no purpose in providing for any amortization for repayment of Central Plan loans which will reduce the immediate availability of Plan funds the Finance Commission has recommended that the Plan loans from the Central government should be limited for non-special category States to the extent of Plan grants and the terms of Plan loans should have relation to the terms on which the Centre has obtained these loans and the gestation period of the projects financed from them. The rest should be obtained from the market for repayment of which a separate amortization fund as determined by the Reserve Bank should be created. The implications of these on the poorer States' ability to get funds and the budgetary burden have not been considered. It is obvious that the remedy can create its own problems.

Inspite of the specific recommendations of Finance Commissions no satisfactory mechanism has been created to monitor the impact of the Commission's recommendations on State finances and financial policies. The Finance Commissions have themselves no time to examine this impact with the result that there is no sufficient link between the

recommendations of successive Finance Commissions. The norms that the Ninth Finance Commission has set will need special watching. It is hoped that this time the Central government will make special efforts to make adequate follow-up arrangements.

The working of both the Eighth and Ninth Finance Commissions have brought to light the somewhat casual attitude of the government to the Finance Commission. The Eighth Finance Commission had complained that for a long time after it was set up, no satisfactory office arrangements were made leading to a delay in its Report and the Central government deciding to implement its recommendations for four years instead of five. The frequent changes in the membership of the Ninth Finance Commission are a legitimate cause of concern. One would have thought that membership of a statutory Commission was a great honour and that one who accepted this responsible position undertook not to seek or accept any other responsibility until this work was completed. At least the government should not be a party to tempting him to do so by offering him alternative assignments till the Report was submitted. The departures from this etiquette make a mockery of a statutory Commission.

Appraising the Second Report of the Ninth Finance Commission : Some Central Issues

Amaresh Bagchi*

The terms of reference of the Ninth Finance Commission (NFC) had given rise to controversies never witnessed before. The publication of the First Report of the Commission had also generated considerable heat. The reactions to the Second Report - which is the final one - have been, in contrast, quite muted. Acceptance of its recommendations without reservation by the Centre even after a change of Government must have been a pleasant surprise even to the members of the Commission. What does it signify? Has the Commission succeeded in meeting its much criticised terms of reference and making every one better off and none worse off? Or has it performed a balancing act by applying methods which are far too technical for anyone not familiar with the intricacies of the tools of quantitative economics? Or is it because the affected parties are resigned to acceptance of the recommendations as a *fait accompli?* Since the Finance Commission's awards constitute the bedrock of federal fiscal relations in India and thereby of the federal polity, it is necessary that the approach and methodology evolved by the Ninth Finance Commission are spelled out and their implications analysed in terms which are intelligible to all. This note seeks to highlight the innovations or departures from the past made by the Ninth Finance Commission in their approach and methodology and focus attention on some of the central issues.

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* *The author wishes to thank M . G. Rao for helpful discussion and D. Maity for statistical assitance.*

The Backdrop

The main points of departure in the terms of reference (TOR) of the Ninth Finance Commission from those of the past Commissions, it may be recalled, were:

- enjoining a normative assessment of the receipts and expenditures on the aggregate revenue account of the States and the Centre (both Plan and non-Plan, unlike in the past);
- explicit attention to the need for providing adequate incentives for better resource mobilisation and financing discipline - as well as closer linking of expenditure and revenue-raising decisions and for speed and efficiency in the government's expenditure programmes;
- stipulating the aim of generating surpluses in the budgets of the Centre and the States for investment, and not merely balancing the revenue budget; and
- calling upon the Finance Commission (FC) to assess the debt position of the States and suggesting corrective measures and exploring the feasibility of a new way of providing disaster relief.

Understandably, the emphasis on a normative approach and fiscal discipline combined with the need for providing incentives for better resource raising and use stemmed from the anxiety to correct the imbalances that had surfaced on the fiscal scene in India in recent years with a growing deficit on the revenue account of the Centre and also of the States. The "gap-filling" approach which had dominated the Finance Commission's perception of their task in the past had come in for criticism from almost all quarters as it tended to undermine the incentives for efficient fiscal management. The awards of the past FCs had also been criticised for their failure to correct the vertical and horizontal fiscal imbalances in the economy and thereby to arrest the aggravation of disparities

in the levels of income among the States, in other words, for failing to allocate revenues between the Centre and the States adequately on the one hand, and ensure their equitable distribution among the States on the other. Taking due note of their TOR, the Ninth Finance Commission stipulated the following objectives as basic to their approach:

> "(a) phasing out the revenue deficit of the Centre and the States in such a manner that the deficit is reduced to zero or a relatively small figure by March 31, 1995;
>
> (b) equity in the distribution of fiscal resources both vertically and horizontally; and
>
> (c) promotion of fiscal discipline and efficiency in the utilisation of resources."

Implementation of these principles called for a normative assessment of the fiscal needs and capacities of the respective governments. This in many ways constitutes the keystone of the Ninth Finance Commission's Second Report. Indeed, adoption of the normative approach, it is stated by the Commission itself, constitutes "the first basic departure this Commission made from the practice of the previous Commissions". The second basic departure has been the inclusion of the Plan component in its consideration of the revenue budget. This was in keeping with the intention of the TOR and felt necessary for moving towards restoration of balance in the revenue budgets of the Centre and the States.

The Commission has relied upon econometric techniques as also its own judgement in evolving a normative basis for assessing the revenue needs and capacity of the government at the Centre and the States. Unquestionably, these mark a major advance towards application of scientific techniques in policy making in the country in a very sensitive area. The important question is, do the recommendations flowing from these approaches and principles help achieve the objectives in view? The question can be dealt with in three parts,

viz.,

(a) Do the recommendations take care of the vertical imbalances adequately?

(b) Will they also help to phase out the revenue deficits in reality?, and

(c) Do they help to reduce the horizontal imbalances and redress the regional disparities?

There are several other issues arising from the Commission's Report (such as assessment of the debt position and formulating a disaster relief scheme). However, the central issues are the manner in which the Ninth Finance Commission has addressed the task of redressing the vertical and horizontal imbalances and restoring the fiscal health of the economy. This note focusses mainly on the three questions posed above.

Central Issues

Correction of Vertical Imbalance

A persistent criticism of the federal fiscal system in India has been that the unitary elements which are already embedded in the Indian Constitution have gained further strength over the years with concentration of fiscal powers in the Centre and growing dependence of the States on transfers from the Centre. The institutions contemplated in the Constitution to safeguard the fiscal autonomy of the States, it is widely felt, have not helped to correct this imbalance.

Acknowledgedly, in the distribution of responsibilities and powers delineated in the Indian Constitution, there is a chronic imbalance with concentration of fiscal powers in the Centre. This is not uncommon in federal constitutions. It was precisely in recognition of this imbalance that the Constitution makers provided for the setting up of a Finance Commission periodically to oversee the transfer of federal funds

to the States in a manner which will find acceptance by all concerned. It is generally recognised that the institution in the shape of FCs has provided a mechanism for transfer of resources from the Centre to redress the vertical imbalance inherent in the Constitution. Despite limitations, the mechanism has been a great help in preserving the federal structure by ensuring the flow of funds required by the States to meet their fiscal gaps. However, with the emergence of the Planning Commission and the practice on the part of the Centre of making discretionary transfers, a large part of the federal transfers started flowing under the umbrella of the Plans or at the Centre's behest. Although application of the Gadgil formula brought in a measure of objectivity in the Plan transfers, the fact that the Planning Commission was a creature of the Centre and not a statutory body continued to be a point of discord. Besides, about one-fifth of the total transfers takes place at the discretion of the Centre. Questions were also raised about the legal propriety of allowing sizeable amounts to be transferred by the Centre under Article 282 of the Constitution which alone provided for such a channel since that Article, it was contended, permitted only transfers under exceptional circumstances for a public purpose, being put under a heading described as "Miscellaneous Financial Provisions".

Whether the practice of channelling large amounts of federal funds to the States under the cover of Article 282 has been legitimate under the Constitutional provisions and therefore whether all federal transfers should have been brought under the purview of the Finance Commission are questions on which opinions sharply differ. One view, strongly espoused by a member of the Ninth Finance Commission has been that under the Constitution the Finance Commission had the jurisdiction to examine the entire gamut of federal transfers and not merely the revenue gaps.

Questions of constitutionality apart, such a task, many would agree, would obviously require creating an institution of the dimension of the Planning Commission which is already there. With the NDC to endorse the basic approaches of the

Planning Commission, it is generally felt that the Finance Commission's task is better focussed on consideration of the revenue side of the budgets. In any case, the inclusion of revenue component of the Plan in the Ninth Finance Commission's TOR removes a lacuna which had restricted the scope of Finance Commission's assessment since the Fourth Commission. With Plan revenue expenditure coming under the consideration of the Ninth Finance Commission, it may be expected that the proportion of transfers ordained by the Finance Commission - called "statutory transfers" - would have gone up. To that extent the Ninth Finance Commission's award would help to correct an anomaly that had crept into the system because of a dichotomy in the revenue budget between the Plan and non-Plan components. The more substantive question pertaining to correction of vertical imbalance is, will the recommendations of the Ninth Finance Commission lead to a fair distribution of the aggregate government revenue between the Centre and the States, keeping in view their respective responsibilities and functions under the Constitution? And will their dispensation reduce the dependence of the States on the Centre? None of these questions admits of a straightforward answer and will no doubt engage the attention of scholars of federal finance in India. A few observations however might be in order.

On the face of it, the Ninth Finance Commission's recommendations do not seem to disturb the existing position significantly in as much as the proportion of aggregate transfers to the States envisaged by them in the total revenue receipts of the Centre remain virtually the same (22.74 per cent as against 22.65 per cent in 1985-90). However, in judging the vertical equity of devolution decided by a Finance Commission, one may also like to look at the respective shares of the Centre and the States in the aggregate revenue and expenditures of the government (Centre and States taken together) and see whether they match.

Figures of aggregate revenue receipts of the Centre and the States, the States' own source revenue and the revenue

accrual to the States (after devolution) since the mid-70s are given in Table 1 along with computations for 1990-5 based on the Ninth Finance Commission's estimates and recommendations. It will be seen that while the States' own sources contribute roughly one-third (33 to 35 per cent) of the total government revenues, with the devolution of funds from the Centre the revenue accruing to the States goes up to 55 to 60 per cent of the total. As against this, around 55 per cent of the total revenue expenditure of the government takes place under the aegis of the States and Union Territories (Table 2). Thus the federal transfers can be said to be more than adequate to meet the revenue gaps of the States. Whether and, if so, to what extent this trend is likely to be maintained or undergo a change is difficult to figure out in the absence of estimates of the transfers which are going to be made finally by the Centre through all the available channels. On the expenditure side, data for 1990-5 which would be comparable with those of earlier years are not available. However, rough calculations indicate that the revenue accrual to the States under the Ninth Finance Commission's dispensation is likely to decline significantly (from around 60-62 per cent of the total in the preceding ten years) to about 55 per cent. There would in all probability be a decline in the States' share of the total revenue expenditure also, leaving an overall surplus with the States (though the exact proportions are difficult to specify in the absence of comprehensive estimates of revenue and expenditures). In a way the Ninth Finance Commission's award thus seems to restore the respective shares of the Centre and the States in the overall revenue and expenditure of the Government (after devolution) to the position obtaining before the sharp rise that took place in the States' share in the wake of the Seventh Finance Commission's award and seeks to correct the imbalance which resulted in large revenue deficits at the Centre. If, however, as anticipated by the Ninth Finance Commission, the States are to have an overall revenue surplus, their share in the aggregate revenue expenditure also has to decline. This is probably going to happen. (These observations should be taken as tentative as the Ninth Finance Commission has not given any estimate of the likely share of the States in the

aggregate revenues and revenue expenditure at any one place and it is difficult to say for certain how the picture will look after taking all the relevant figures into account.)

This does not imply any reduction in the share of the States in the Centre's (gross) revenues which, as noted earlier, remains at about 23 per cent. Nor does it necessarily imply a discriminatory ceiling on the States' expenditure growth. The main factor which seems to contract the States' share in the overall revenue is that the Ninth Finance Commission has assumed a lower revenue growth for the States than that for the Centre. For tax revenue of the States, the Ninth Finance Commission has assumed a growth of 11.5 per cent per annum while for the Centre a growth of 12.8 per cent has been assumed. Non-tax revenue of the Centre is also assumed to grow at a higher rate. Non-Plan revenue expenditures of the Centre are also assumed to grow at a rate of 9.75 per cent while that of the States seems to be assumed at a little over 8 per cent.

This by itself does not warrant any conclusion that the Ninth Finance Commission's dispensation has been tilted towards the Centre rather than to the States. For apparently, the estimates of the revenue needs of both the Centre and the States have been arrived at on a "normative basis", keeping in view their Constitutional responsibilities and revenue raising capacities. If the dispensation is to be faulted, one has to question the norms. Appraisal of the methodology used in deriving the norms is beyond the scope of this paper but a few points are noted here.

Briefly, in the case of the States in essence the norms have been derived on the basis of averages. For tax revenue the norm is "what a particular State would be able to raise by way of tax revenue, had it exploited its tax bases to an average extent". For non-tax revenue the actuals have been used for certain items (fees and user charges) while for some (dividends and interest to be received) normative rates of return have been used. Similarly, for a good part of non-Plan revenue expenditures, the average behaviour has been taken as the norm and the attempt

has been to estimate expenditure needs to arrive at justifiable costs of providing an average standard of service (in the case of general services) or the existing level of services (in the case of social and economic services). Allowance has been made for cost disability factors.

For the Centre, the Ninth Finance Commission's approach has been to assess what the Centre can be expected to raise by way of revenue, given the levels of taxation, etc., while expenditures have been projected on the budget estimates for 1989-90, but going mainly by the actuals and assuming a higher growth rate of revenue and lower growth of revenue expenditure than projected by the Ministry of Finance. In moderating the growth rate of the Centre's revenue expenditure and assuming a higher growth of revenue than the projections of the Finance Ministry, the Ninth Finance Commission apparently had in mind the need to phase out the revenue deficits.

If the Ninth Finance Commission's projections of the Centre's revenue and expenditures materialise and the growth rate of GDP and prices (11 per cent per annum) do not exceed the underlying assumption, the transfers of the Central revenues ordained by the Ninth Finance Commission may not perhaps be regarded as unfair. Objections can be raised on grounds of accentuating the trend towards centralisation. But this probably is what would be consistent with the aim of gradually eliminating the deficits.

Vertical equity of the Ninth Finance Commission's transfers would obviously depend crucially on whether the fiscal scenario unfolds in the manner envisaged by the Commission. Indeed if the Ninth Finance Commission's projections materialise, the Centre's revenue deficit for the entire period 1990-5 should not exceed Rs 30,600 crore or so and the overall deficit should not go beyond Rs 11,000 crore. While questions may be raised about the vertical equity of the recommendations in which the Centre is permitted to finance a part of its revenue expenditure with borrowing (only in the case of a few States

is such a privilege allowed), on the whole, it may be argued, this is the best that could be done if the revenue deficits are to be phased out. But what are the chances that the outcome will be as envisaged by the Ninth Finance Commission?

Deficit Phasing Out

The fact that in the very first year (1990-1), the Centre's budget is showing a much larger revenue deficit than was assumed by the Ninth Finance Commission casts doubt about the realism of the Ninth Finance Commission's projections and assumptions. Vertical equity however carefully respected by a Finance Commission is thrown overboard if the Centre can expand its resource base (whether for capital or revenue expenditure) by borrowing unless a compensating or commensurate increase is also provided for in the transfers to the States. For all the improvements and sophistication in the methodology, the devolution scheme in the Ninth Finance Commission's recommendations does not take account of the dynamic context in which the Centre continues with large deficits, most of which represent borrowings from Reserve Bank resulting in pressure on prices and disarray in the budgets of both the States and the Centre. Despite the moderation made by the Ninth Finance Commission in its projections it is unlikely that the deficit/surplus levels of the Centre or the States will follow the envisaged pattern. In the case of the States one may overlook what a State does in reality. After all, the Ninth Finance Commission has laid down certain norms, it is for the States to accept or reject them - only those who do better will be rewarded in that their surpluses will be at their disposal while those who fail to come up to the norm will suffer. But if the Centre does not go by the norms, the entire scenario changes.

Given the compulsions of the Centre, it is difficult to see how the Finance Commission (or for that matter any authority other than the Parliament) can bind the Centre to a given revenue deficit. Whether there should be any such binding rate on the Centre is another matter. So long as the

Centre has access to such borrowing what does one make of the vertical equity of the FCs' awards? Similarly, questions can be (and have been) asked about the relevance of the Finance Commission's exercises unless sharing of the aggregate budgetary (and some would say, non-budgetary) resources of the public sector is considered in their totality.

This is not to belittle the value of the exercises done by the past Finance Commissions or the most recent. They do serve a very useful purpose in providing a basis for the allocation of government revenue in a fair and efficient manner. Nevertheless, it is necessary to draw attention to the limitations of the Finance Commissions' awards in ensuring vertical equity arising from the static assumptions which affect only the States' share and do not provide for alternative scenarios. Obviously some more thinking is needed to take account of contingencies instead of leaving it entirely to the Centre to decide how much of the aggregate resources of the government to command away with the States left to face the consequences.

Horizontal Equity

Results achieved by the Ninth Finance Commission's formulae for distribution of the transfers of the Centre's revenue among the States are unquestionably of great significance. Despite limitations especially of data, the methodology used for assessing the revenue and expenditure of the States seems to provide a way of bringing about a more equitable allocation of the devolution than in the past. This is evidenced by the fact that the differences in the per capita non-Plan revenue surpluses of the non-special category States are much less sharp under the Ninth Finance Commission's dispensations than in the past. The maximum surplus accruing to a State after the transfers works out to about 11 times of the minimum going to any State. Under the Eighth Commission's award the proportion was 31, while under those of the Seventh and the Sixth the proportions were 18 and 69 respectively (vide Table 3).[1]

That the allocation of the transfers among the States has been more equitable than that under the Eighth Commission's awards can be seen also by comparing the dispersion of the per capita devolution of taxes and grants. Figures of per capita share of taxes and grants and the total devolution from the Fifth Finance Commission onward are given in Table 4. The averages, standard deviation and coefficient of variation of the per capita transfers are also given in the table. It will be seen that as compared with the Eighth Commission's award, the coefficient of variation (CV) of per capita transfers (tax devolution and grants taken together) is higher under the Ninth Finance Commission's recommendations (0.25 as against 0.20). The CV would probably have gone up further had the Plan grants not been subjected to the limits set by the Ninth Finance Commission. It is worth noting that the CV in the tax devolution is lower in the Ninth Finance Commission's recommendations than under that of the Eighth Finance Commission. Even so the CV of the aggregate devolution is larger mainly because of the favourable assessment of the fiscal needs of poorer States and high weightage for grants in the devolution.

Given that the CV in the per capita SDP of the States is about 0.30, one would expect that an equitable system of transfers would have at least a similar dispersion along with a significant negative correlation with per capita SDP. A major deficiency in the statutory transfers in the past was that their distribution among the States has not been as equitable as would seem to be necessary to redress the disparities in their development for which per capita SDP is perhaps the best single index. While the grants-in-aid have been more dispersed, the devolution of tax revenues is not marked by a matching spread. Since in the past the proportion of tax devolution in the total transfers has been much higher than that of grants, the overall impact of the statutory transfers has been less equilibrating than was needed to compensate for the disparities in development.

Surprisingly, under the Ninth Finance Commission's award, the CV of the grants component turns out to be smaller

than that under the Eighth Commission's formulae although the CV in the total transfers, that is taking devolution of both taxes and grants-in-aid together, is appreciably higher. This may be partly because of the increase in the CV of tax transfers and a decline in the share of the tax devolution component in the total devolution (vide Table 5) and also because of the introduction of a "deficit" criterion in the formula for allocation of Union excise duties. One possible reason for the relatively low CV of the Ninth Finance Commission's grants could be that this component of the statutory transfers now includes grants for the revenue part of the Plan too and the Plan revenue grants by the Ninth Finance Commission have been bound by upper and lower limits. The fact that the per capita non-Plan revenue surplus is eleven times higher for one State than for another even with all the innovations brought in by the Ninth Finance Commission is to be regretted since it is this surplus that provides the base on which the development plans of the States are built. However, it must be acknowledged that it is a vast improvement from the disparities marking these surpluses in the past. The Ninth Finance Commission has obviously made a valiant effort in breaking away from the past to achieve greater horizontal equity but a lot more remains to be done. Treatment of special category States also has been ad hoc and needs to be brought on rational lines.

Concluding Comments

In sum, devolution of revenues from the Centre to the States recommended by the Ninth Finance Commission seems to provide an equitable and efficient basis for revenue sharing between the Centre and the States on the one hand and among the States on the other. The key to equity and efficiency in the recommendations lies in the adoption of an explicitly articulated normative approach. Even though in the end result the share of the States in the aggregate revenue receipts and current expenditures of the government seems to have gone down, the recommendations cannot be faulted on grounds of vertical inequity unless one finds serious flaws in the norms.

The value of the Ninth Finance Commission's exercises to achieve vertical equity is, however, considerably undermined by the absence of any formula or arrangement to face situations in which the Centre commands away a larger proportion of real resources through borrowing and deficit financing and the calculations of the FCs are thrown overboard. This is a lacuna in the fiscal federalism in India which will need more serious attention in the future than it has received so far. Alternatively, there must be a national consensus in adhering to the levels of the fiscal gaps projected by the Finance Commission, once these are debated and found acceptable. Otherwise the fiscal situation in the country, already quite perilous, cannot possibly be saved from disaster. In the matter of horizontal equity the Ninth Finance Commission's recommendations mark a definite improvement over the past and apprehensions raised by the First Report have been greatly allayed. However, there is need for moving further in the directions set by the Ninth Finance Commission in this regard. There is a great need to put in serious effort well ahead of the setting up of the next Commission for improving the methodology and, no less important, the required data base.

NOTE

1 The figures given in Tables 3 and 4 are not comparable with those computed for the article by the author on the First Report of the Ninth Finance Commission because of differing coverage of the grants component of the transfers (vide EPW, December 3, 1988). In the earlier computation, disaster relief and upgradation grants were not included.

Table 1
Revenue Accruals of the Union Government and the State governments

Year	Revenue Receipts Of Centre And States Rs. Crore	Own Revenue Of States Rs. Crore	Revenue Accruals Of States Rs. Crore	Revenue Accruals Of Centre Rs. Crore	Revenue Accruals To States (Col. 4 as %of col 2)	Revenue Accruals To Centre (Col. 5 as %of col 2)	States Own Revenue as % of Total Revenue % (Col. 3 as % of Col. 2)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1974-75	11048	3716	6004	5044	54.34	45.66	33.64
1975-76	13687	4591	7475	6212	54.61	45.39	33.54
1976-77	15258	5387	8652	6606	56.70	43.30	35.31
1977-78	16435	5688	9401	7034	57.20	42.80	34.61
1978-79	18775	6487	11008	7767	58.63	41.37	34.55
6th Finance Commission (Avg) 1974-75 to 1978-79	15041	5174	8508	6533	56.30	43.70	34.33
1979-80	21211	7452	13060	8151	61.57	38.43	35.13
1980-81	23835	8491	15036	8799	63.08	36.92	35.62
337							
1981-82	28881	10407	17504	11377	60.61	39.39	36.03
1982-83	33086	12026	20243	12843	61.18	38.82	36.35
1983-84	36959	13609	22908	14051	61.98	38.02	36.82
7th Finance Commission (Avg) 1979-80 to 1983-84	28794	10397	17750	11044	61.69	38.31	35.99
1984-85	42933	15313	26220	16713	61.07	38.93	35.67
1985-86	51011	18091	31906	19105	62.55	37.45	35.46
1986-87	58434	20581	35981	22453	61.58	38.42	35.22
1987-88	66838	23797	42167	24671	63.09	36.91	35.60
1988-89(RE)	76962	26851	47589	29374	61.83	38.17	34.89
8th Finance Commission (Avg) 1984-85 to 1988-89	59236	20927	36773	22463	62.02	37.98	35.37
1989-90(BE)	89678	30429	52625	37053	58.68	41.32	
1990-95#	685273	218771	378634	306639	55.25	44.75	31.92

Note:# As per NFC's estimates and recomendations. The computation is as follows :

Revenue Receipts (Rs. Crore) :		
Centre (gross)	:	466502
less Finance Commission transfers	:	106062
Plan transfers	:	53801
Centre (net)	:	306639
States:		
Own Revenue	:	218771
Add Finance Commission transfers	:	106062
Plan transfers	:	53801
States(net)	:	378634

Table 2

Share of Centre and the States in Total Revenue Expenditure of the Government

	Combined Centre, States & UTs (Rs. Crore)	States & UTs (Rs. Crore)	Share of States & UTs in Total (percent)	Share of Centre (Percent)
1974-75	9882	5602	56.69	43.31
1975-76	11847	6522	55.05	44.95
1976-77	13863	7555	54.50	45.50
1977-78	14986	8381	55.93	44.07
1978-79	17348	9872	56.91	43.09
6th Finance Commission (Avg) 1974-75 to 1978-79	13585	7587	55.81	44.19
1979-80	20356	11512	56.55	43.45
1980-81	23711	14136	59.62	40.38
1981-82	27864	16193	58.12	41.88
1982-83	33451	19354	57.86	42.14
1983-84	39139	22691	57.98	42.02
7th Finance Commission (Avg) 1979-80 to 1983-84	28904	16777	58.02	41.98
1984-85	47329	27118	57.30	42.70
1985-86	56031	31362	55.97	44.03
1986-87	66189	35960	54.33	45.67
1987-88	77014	43205	56.10	43.90
1988-89(RE)	90077	49674	55.15	44.85
8th Finance Commission (Avg) 1984-85 to 1988-89	67328	37464	55.77	44.23
1989-90(BE)	100504	56439	56.16	43.84

Table 3

Per Capita Non-Plan Revenue Surplus of the States According to the Recomendations of the Finance Commissions

(Rs.)

	Sixth Finance Commission	Seventh Finance Commission	Eighth Finance Commission	Ninth Finance Commission
Non-Special Category States :				
Andhra Pradesh	15.21	178.03	333.82	576.96
Bihar	29.89	159.96	132.48	442.67
Gujarat	120.32	331.66	629.89	947.48
Haryana	217.84	509.69	920.12	1489.36
Karnataka	80.47	263.40	478.84	1008.09
Kerala	3.41	94.41	228.35	135.30
Madhya Pradesh	37.61	218.85	356.05	345.48
Maharashtra	135.74	465.53	885.37	1501.73
Orissa	30.89	27.91	47.18	172.54
Punjab	234.71	473.58	927.41	723.56
Rajasthan	26.01	77.57	97.33	208.25
Tamil Nadu	42.67	140.43	601.53	756.85
Uttar Pradesh	30.02	183.50	309.88	204.72
West Bengal	21.17	143.13	29.66	383.13
Average	**55.48**	**215.58**	**380.80**	**578.73**
Proportion of Maximum/Minimum	**68.76**	**18.26**	**31.27**	**11.10**

Table 4

Average and Dispersion of Per Capita Transfers# under the Finance Commissions' Awards

(Rs.)

	Share of Taxes	Grants	Total		Share of Taxes	Grants	Total
	Non-Special Category States				Special Category States		
5th Finance Commission							
Avg	16.82	1.91	18.73	Avg	12.56	65.28	77.85
S.D	1.00	2.67	2.75	S.D	4.16	95.12	95.50
C.V	0.06	1.40	0.15	C.V	0.33	1.46	1.23
6th Finance Commission							
Avg	23.61	6.09	29.70	Avg	22.40	95.90	118.29
S.D	0.98	8.07	7.91	S.D	0.23	52.17	52.18
C.V	0.04	1.32	0.27	C.V	0.01	0.54	0.44
7th Finance Commission							
Avg	57.06	1.68	58.74	Avg	47.22	189.82	237.04
S.D	4.20	3.24	6.40	S.D	16.98	167.61	164.99
C.V	0.07	1.93	0.11	C.V	0.36	0.88	0.70
Cor.Coeff. with SDP	-0.68*	-0.41	-0.66*	Cor. Coeff. with SDP	0.16	-0.14	-0.12
t-Values	-3.23	-1.58	-3.03	t-values	0.40	-0.34	-0.31
8th Finance Commission							
Avg	83.83	5.89	89.72	Avg	310.13	175.65	485.78
S.D	13.42	6.91	18.02	S.D	152.87	105.15	257.73
C.V	0.16	1.17	0.20	C.V	0.49	0.60	0.53
Cor.Coeff. with SDP	-0.86*	-0.28	-0.75*	Cor. Coeff. with SDP	0.04	0.05	0.05
t-Values	-5.73	-1.02	-3.87	t-values	0.11	0.12	0.11
9th Finance Commission							
Avg	173.19	28.03	201.22	Avg	716.88	393.77	1110.66
S.D	32.43	22.86	50.34	S.D	363.45	237.21	600.13
C.V	0.19	0.82	0.25	C.V	0.51	0.60	0.54
Cor.Coeff. with SDP	-0.75*	-0.60**	-0.76*	Cor. Coeff. with SDP	-0.15	-0.13	-0.14
t-Values	-3.90	-2.63	-4.00	t-values	-0.45	-0.38	-0.42

Note : # Percapita annual averages.
For the absolute figures vide Appendix Tables A to E.
* Significant at 1% level of significance.
** Significant at 5% level of significance.

Table 5

Components of Devolution Under Finance Commissions' Awards

(Rs. Crore)

	Tax Devolution	Deficit Grants	Other Grants	Total Grants	Total Devolution (Statutory)
Fifth Finance Commission	3592.52	486.22	–	486.22	4078.74
	(88.08)	(11.92)		(11.92)	(100.00)
Sixth Finance Commission	6944.50	815.84	928.78	1744.62	8689.12
	(79.92)	(9.39)	(10.69)	(20.08)	(100.00)
Seventh Finance Commission	18811.25	136.92	387.38	524.30	19335.55
	(97.29)	(0.71)	(2.00)	(2.71)	(100.00)
Eighth Finance Commission	33124.96	968.17	1420.86	2389.03	35513.09
	(93.28)	(2.73)	(4.00)	(6.73)	(100.00)
Ninth Finance Commission	87882.00	15017.18	3137.25	18154.43	106036.43
	(82.88)	(14.16)	(2.96)	(17.12)	(100.00)

Note:Figures in parentheses indicate percentages of the total.

APPENDIX TABLES

Table A Fifth Finance Commission's Award (1969-70 to 1973-74) Per Capita Annual Rs.				Table B Sixth Finance Commission's Award (1974-75 to 1978-79) Per Capita Annual Rs.			
States	Share of Taxes	Grant	Total	States	Share of Taxes	Grants	Total
NON-SPECIAL CATEGORY STATES							
APR	15.90	2.97	18.87	APR	23.93	8.64	32.57
BHR	17.94	0.00	17.94	BHR	23.84	3.43	27.28
GUJ	17.26	0.00	17.26	GUJ	24.81	0.00	24.81
HAR	14.99	0.00	14.99	HAR	21.52	0.00	21.52
KAR	15.55	1.22	16.77	KAR	23.60	0.00	23.60
KER	17.25	4.68	21.93	KER	23.51	18.12	41.63
MPR	16.48	0.00	16.48	MPR	23.65	0.00	23.65
MAH	19.31	0.00	19.31	MAH	25.64	0.00	25.64
ORS	16.70	9.57	26.26	ORS	22.92	25.62	48.55
PUN	16.60	0.00	16.60	PUN	22.70	0.00	22.70
RAJ	16.41	3.96	20.36	RAJ	22.84	15.79	38.63
TND	16.95	1.11	18.06	TND	24.36	0.00	24.36
UPR	17.13	0.00	17.13	UPR	22.93	3.96	26.89
WBN	17.00	3.28	20.28	WBN	24.23	9.67	33.90
Avg	16.82	1.91	18.73	Avg	23.61	6.09	29.70
S.D	1.00	2.67	2.75	S.D	0.98	8.07	7.91
C.V	0.06	1.40	0.15	C.V	0.04	1.32	0.27
SPECIAL CATEGORY STATES							
ASM	14.74	11.29	26.04	ASM	22.11	30.41	52.52
HPR	14.15	17.38	31.53	HPR	22.69	84.75	107.44
J&K	17.97	31.78	49.75	J&K	22.72	67.06	89.78
MNP	6.20	42.26	48.46	MNP	22.21	188.73	210.95
MEG	14.58	21.56	36.13	MEG	22.48	130.65	153.13
NAG	13.95	297.00	310.95	NAG	22.14	41.63	63.77
TRP	6.36	35.73	42.09	TRP	22.41	128.05	150.46
Avg	12.56	65.28	77.85	Avg	22.40	95.90	118.29
S.D	4.16	95.12	95.50	S.D	0.23	52.17	52.18
C.V	0.33	1.46	1.23	C.V	0.01	0.54	0.44

Table C

Seventh Finance Commission's Award

(1979-80 to 1983-84)

Per Capita Annual

Rs.

States	Share of Taxes	Grants	Total	SDP (1973-76)
NON-SPECIAL CATEGORY STATES				
APR	57.00	0.74	57.75	928
BHR	62.49	1.83	64.32	645
GUJ	57.58	0.00	57.58	1134
HAR	48.64	0.00	48.64	1399
KAR	55.08	0.00	55.08	1045
KER	61.00	0.33	61.34	948
MPR	59.78	2.48	62.26	776
MAH	55.50	0.00	55.50	1349
ORS	62.69	13.01	75.70	793
PUN	50.78	0.00	50.78	1586
RAJ	52.64	1.15	53.79	853
TND	61.75	1.14	62.89	942
UPR	55.40	1.94	57.34	715
WBN	58.52	0.91	59.44	1033
Avg	57.06	1.68	58.74	1010.43
S.D	4.20	3.24	6.40	264.18
C.V	0.07	1.93	0.11	0.26
Cor. Coeff. with SDP	-0.68	-0.41	-0.66	
SPECIAL CATEGORY STATES				
ASM	51.06	2.23	53.29	791
HPR	52.33	101.95	154.28	1068
J&K	54.15	74.16	128.31	811
MNP	54.23	224.45	278.68	870
MEG	56.02	148.87	204.89	850
NAG	47.52	590.87	638.40	820
SKM	3.12	236.71	239.83	820
TRP	59.30	139.32	198.62	830
Avg	47.22	189.82	237.04	857.50
S.D	16.98	167.61	164.99	82.67
C.V	0.36	0.88	0.70	0.10
Cor. Coeff. with SDP	0.16	-0.14	-0.12	

Table D

Eighth Finance Commission's Award

(1984-85 to 1988-89)

Per Capita Annual

Rs.

Sates	Share of Taxes	Grants	Total	SDP (1976-79)
NON-SPECIAL CATEGORY STATES				
APR	91.24	4.69	95.94	1006
BHR	101.16	5.42	106.58	755
GUJ	72.19	3.66	75.85	1590
HAR	57.22	1.50	58.73	1895
KAR	80.43	0.70	81.14	1202
KER	89.36	2.08	91.44	1162
MPR	93.81	5.71	99.52	895
MAH	73.44	0.51	73.95	1670
ORS	106.51	23.74	130.26	918
PUN	64.32	3.68	68.01	2250
RAJ	76.13	6.83	82.96	1127
TND	91.96	0.82	92.78	1165
UPR	84.72	2.71	87.43	870
WBN	91.04	20.44	111.48	1247
Avg	83.83	5.89	89.72	1268.00
S.D	13.42	6.91	18.02	415.86
C.V	0.16	1.17	0.20	0.33
Cor. Coeff. with SDP	-0.86	-0.28	-0.75	
SPECIAL CATEGORY STATES				
ASM	105.26	29.92	135.18	960
HPR	219.22	100.66	319.87	1230
J&K	212.17	109.64	321.81	1100
MNP	357.87	203.19	561.06	859
MEG	309.58	177.14	486.72	1046
NAG	663.14	411.47	1074.61	1100
SKM	317.06	204.30	521.36	1100
TRP	296.77	168.86	465.63	1082
Avg	310.13	175.65	485.78	1059.63
S.D	152.87	105.15	257.73	102.94
C.V	0.49	0.60	0.53	0.10
Cor. Coeff. with SDP	0.04	0.05	0.05	

Table E

Ninth Finance Commission's Award

(1989-90 to 1994-95)

Per Capita Annual

Rs.

States	Share of Taxes	Grants	Total	SDP (1982-85)
Non-Special Category States				
APR	185.43	18.72	204.15	2053
BHR	206.66	32.17	238.83	1323
GUJ	143.10	13.44	156.54	2919
HAR	124.33	7.01	131.34	3043
KAR	154.83	3.96	158.79	2461
KER	180.83	32.76	213.59	2144
MPR	184.67	36.99	221.66	1860
MAH	142.90	3.91	146.81	3384
ORS	252.30	74.51	326.81	1728
PUN	135.10	14.17	149.27	4013
RAJ	183.07	75.86	258.93	1820
TND	199.65	6.32	205.97	2142
UPR	158.70	40.86	199.56	1713
WBN	173.07	31.75	204.82	2230
Avg	173.19	28.03	201.22	2345.21
S.D	32.43	22.86	50.34	717.51
C.V	0.19	0.82	0.25	0.31
Cor. Coeff. with SDP	-0.75	-0.60	-0.76	
Special Category States				
ARP	1104.92	653.55	1758.47	2746
ASM	196.67	65.35	262.02	1863
GOA	488.32	245.69	734.01	4437
HPR	444.68	206.89	651.57	2103
J&K	521.05	268.22	789.27	2380
MNP	683.12	361.15	1044.28	2205
MEG	573.65	270.97	844.63	1960
MIZ	1504.32	905.09	2409.40	1778
NAG	1161.11	686.70	1847.81	2268
SKM	567.61	348.48	916.09	2570
TRP	640.27	319.42	959.69	1784
Avg	716.88	393.77	1110.66	2372.18
S.D	363.45	237.21	600.13	718.70
C.V	0.51	0.60	0.54	0.30
Cor. Coeff. with SDP	-0.15	-0.13	-0.14	

The Final Report of the Ninth Finance Commission : A Preliminary Examination

S. Guhan

This note is confined to a preliminary examination of the Ninth Finance Commission's scheme of transfers to the 14 major (i.e. non-special category) States to meet the deficits in their non-Plan and Plan revenue accounts during 1990-5. We concentrate on the logic of the scheme with particular reference to the allocation of Plan deficit grants. We show that the pattern of this allocation, *inter-se* among the States, is irrational and inequitable within the framework of the Ninth Finance Commission's own procedures and assumptions and within the constraint of the sum available to finance these deficits. We also indicate two alternatives which would have resulted in rational and equitable solutions.

The Ninth Finance Commission's scheme of transfers from the Centre to the States for 1990-5 on the revenue account (vide Table 1) is based on the following sequence of steps:

1. Estimation, on a so-called normative basis, of tax revenues, non-tax revenues, and non-Plan revenue expenditures for each State.
2. Deriving therefrom the 'normative' non-Plan revenue surplus or deficit for each State.
3. Adjusting the above deficit in the case of States in which the combined effect of the normative estimates of revenues (tax and non-tax) and of

non-Plan revenue expenditures represents an improvement over corresponding "conventional" estimates based on trend projections i.e., in cases where the adoption of normative estimates results in an increase (reduction) to the non-Plan revenue surplus (deficit), or a turn - around of deficit to surplus with reference to the figures obtained on the basis of the "conventional" estimates. The adjustment amounts to reducing (increasing) the surplus (deficit), arrived at on the normative basis, by an amount equal to 50 per cent of the improvement. No adjustment is made in the case of four States in which both the normative and conventional estimates result in deficit but the normative estimates result in a larger deficit vis-a-vis conventional estimates.

4. Devolution of income tax and basic Union excise duties and grants in lieu of the tax on railway passenger fares on the basis set forth in Chapter V of the Report.

5. Adding (2), (3) and (4) above, the post-devolution net non-Plan revenue surplus or deficit is arrived at for each State. The amount of the deficit is covered in full through a "non-Plan deficit grant" under Article 275 in the case of States which are left with a post-devolution net non-Plan revenue deficit.

6. With the post-devolution non-Plan revenue position being settled on the above basis, the Ninth Finance Commission proceeds to work out a Plan deficit grant in the following manner:

   i. The minimum per capita Plan revenue expenditure is estimated for each State as set forth in Appendix 7 to the Report and on that basis, the share of each State in the total minimum Plan revenue expenditure of all 14 major States in 1990-5 is worked out assum-

ing that this total will be Rs 40,000 crore.

ii. The following resources are assumed to be available in each State towards meeting the minimum Plan revenue expenditure as computed above:

a. (no more than) 40 per cent of the non-Plan revenue surplus from each of the States having such surpluses.

b. A grant on the basis of the Gadgil formula (with certain adjustments) as applicable during the Seventh Plan period assuming that the total amount of such grants for all 14 States will be Rs 10,000 crore during 1990-5.

iii. The Plan deficit grant is determined as 50 per cent of the deficit that remains after deducting the amounts at (1) and (b) above from the minimum Plan revenue expenditure to States which have such 'Plan deficits'

The procedures and assumptions used in the Ninth Finance Commission's estimation of so-called normative tax revenues and non-Plan revenue expenditures involve statistical strategems (e.g., the modified representative tax system method for estimating tax revenues), assumptions relating to returns from non-tax revenues, ad-hoc assumptions relating to specific non-Plan revenue expenditures (e.g., interest payments), procedures for estimating expenditures on general services and social and economic services on a normative basis, procedures for adjustment of pay scales and the use of ad-hoc rates of growth of projecting revenues and expenditure during 1990-5. The data base involved and the logic, reasonableness and realism of these procedures and assumptions will no doubt be debated in detail at a technical level while lay politicians and civil servants (who are also required to understand the implications of the Report) may feel one with Justice Qureshi, Member of the Commission, when he says: 'The

normative estimates derived from the econometric models is a mystery'. They may also be inclined to agree with him that' .... life is not all law or logic. It is not susceptible to algebraic equations, econometric models or any other theoretical formula. Life is full of contradictions, conflicts and compulsions. Hence, things have to be seen realistically and not theoretically'!

However, for the limited purposes of this notice, we shall assume as given the Ninth Finance Commission's normative estimates of revenues and non-Plan revenue expenditures and (resulting therefrom) the 'normative' non-Plan revenue surplus or deficit. We shall treat these as "prescriptive" estimates rather than as "normative" estimates so that they are not taken, without further analysis, to imply any valid value judgement that the States should endeavour to manage their fiscal affairs in accordance with the Ninth Finance Commission's presumptions, assumptions, and projections.

Proceeding to the next step, the logic of the adjustments made by the Ninth Finance Commission to these normative estimates will require some discussion. For this purpose we have rearranged in Table 2 the data in Annexure III.19 of the Report in order to bring out the typologies of various States: in the 5 States in Category I (Bihar, Gujarat, Haryana, Maharashtra and Punjab) normative tax revenues are higher than trend-based 'conventional' tax revenues while normative non-Plan revenue expenditures are lower than corresponding conventional estimates. In the case of Tamil Nadu (Category II), both normative tax revenues and normative non-Plan revenue expenditure are higher than corresponding conventional estimates but the two taken together result in a net improvement. While making adjustments in these 6 cases, the Ninth Finance Commission's implicit assumption is that these States can be reasonably expected to bridge only 50 per cent of the net improvement entailed in raising additional revenues and in reducing (Category I) or upgrading (Category II) expenditures. Let us accept this broad judgement and the adjustments made accordingly.

Category III consists of Orissa and Uttar Pradesh. Their situation is the same as that of Tamil Nadu in that both normative tax revenues and non-Plan revenue expenditures are higher than the corresponding conventional estimates except that the resultant net position in these two States is a worsening of the deficit rather than an improvement. Nevertheless, by the same logic as that applied to the 6 States in Categories I and II, the worsening can also be expected to take place only to the extent of 50 per cent of the difference between the normative and conventional estimates. There is no reason, therefore, why a similar adjustment should not be made to the normative estimates in these two States as well.

It will be seen that in all the 6 States in Category IV (Andhra Pradesh, Karnataka, Kerala, West Bengal, Madhya Pradesh), and Category V (Rajasthan), normative tax revenues are lower than conventional tax revenues which means that the adoption of anything less than the conventional estimates for tax revenues will imply a sacrifice of revenue realisable on trend projections. In other words, on the tax revenue side, no 'adjustment' is required from these States; they just have to safeguard existing revenues. In this view, it will be appropriate to adopt the conventional estimates for tax revenues in the case of all these 6 States and to confine the 50 per cent allowance to expenditure-related improvement (Category IV) or worsening (Category V).

On the basis of the foregoing discussion we have indicated the appropriate adjustments to be made to the (strictly) normative estimates of the post- devolution non-Plan revenue surplus or deficits of the 14 States and the modified normative estimates that result. With reference to the Ninth Finance Commission's modified normative estimates, our reckoning does not involve any change in respect of 6 States (Categories I and II). Orissa, Rajasthan and Uttar Pradesh continue to be post-devolution non-Plan deficit States but their combined deficit decreases somewhat, from Rs 1363.57 crore (assumed by the Ninth Finance Commission) to Rs 1162.44 crore. The remaining 5 States (Andhra Pradesh, Karnataka, Kerala, Madhya Pradesh,

West Bengal) end up in our reckoning with larger post devolution non-Plan revenue surplus vis-a-vis the Ninth Finance Commission's estimates.

We shall now turn to our main concern viz., the procedures followed by the Ninth Finance Commission to arrive at their Plan deficit grants. It must be pointed out at the outset that these procedures, besides being highly arbitrary, seriously invade the jurisdiction of the National Development Council and of the Planning Commission since the Ninth Finance Commission has proceeded to (a) estimate Plan revenue expenditures during the Eighth Plan and (b) provide grants to various States by way of assistance to State Plans in significant deviation from the Gadgil formula approved by the Ninth Finance Commission[1]. The fact that its terms of reference could be interpreted to permit the Ninth Finance Commission to take into account the requirements of States on their Plan revenue account as well does not mean that the Ninth Finance Commission, on its own, should have arrogated to itself the task of estimating the minimum Plan revenue expenditure for each State. Pending the finalisation of the Eighth Plan, the Ninth Finance Commission could have adopted either of two alternatives consistent with due recognition of, and respect for, the role of the Planning Commission. One would have been to arrive at such estimates on the basis of a formal consultation with the Planning Commission. The other would have been to place at the disposal of the Planning Commission the total quantum of Plan deficit grants for allocation to the States having regard to their revenue Plan outlays in the Eighth Plan, after they are finalised, according to a formula to be approved by the National Development Council in modification of the existing Gadgil formula. Without considering these options, the Ninth Finance Commission has blatantly transgressed into the domain of the NDC and the Planning Commission. Not only that, the Ninth Finance Commission has proceeded to estimate minimum Plan revenue expenditures following an arbitrary and artificial method. In arriving at the Plan financing deficits as well, the Ninth Finance Commission has made the arbitrary assumption that only 40 per cent of the post-devolution non-

Plan revenue surplus of the surplus States will be available towards financing the Plan revenue component[2].

Anomalies follow aggression and arbitrariness. Even taking the minimum Plan revenue expenditures (as arrived at by the Ninth Finance Commission) as the basis, it can be shown that their scheme of Plan deficit grants is irrational and inequitable. For this purpose, we reasonably assume that the entire non-Plan revenue surplus of the States (and not just 40 per cent of it) will be available, along with the Gadgil formula grant assumed by the Ninth Finance Commission for financing the Plan revenue outlay. This will mean that in the case of 3 out of the 10 States for which the Ninth Finance Commission has provided Plan deficit grants, viz., Andhra Pradesh, Punjab and Tamil Nadu, no Plan deficit grants will be required since their non-Plan revenue surpluses,if fully deployed for the purpose, along with the Gadgil grant would be more than adequate to finance their Plan revenue outlays. In the case of Andhra Pradesh, for instance, 48 per cent of the post-devolution non-Plan revenue surplus would be sufficient to meet the bill; in the case of Punjab the required proportion will be 44 per cent; and in the case of Tamil Nadu it will be only 41 per cent.

In the case of the other 7 States for which Plan deficit grants have been provided by the Ninth Finance Commission, Table 1 shows the deficit on the Plan revenue account (after netting out the post-devolution non-Plan surplus in full and the Gadgil grant) and the percentage of the deficit that is met in each case by the Ninth Finance Commission's Plan deficit grant. It will be seen that with reference to the deficits on the Plan revenue account, the incidence of the Plan deficit grants is highly skewed. The percentage of deficit financing is 74.79 for Bihar, 95.27 for West Bengal, 77.11 for Madhya Pradesh, 50.08 for Kerala and 50 per cent each for the 3 post-devolution non-Plan revenue deficit States namely, Orissa, Rajasthan, and Uttar Pradesh. There is thus a patent lack of equity in the Ninth Finance Commission's determination of Plan deficit grants.

In Table 3, we present two alternative schemes for arriv-

ing at Plan deficit grants which would have been more equitable. For this purpose, we assume that (a) post devolution non-Plan revenue surplus or deficits will be on the basis of the appropriate adjustments to strictly normative estimates as worked out in Table 2 (b) minimum Plan revenue expenditures are as worked out by the Ninth Finance Commission (c) the entire post-devolution non-Plan revenue surplus along with the Gadgil Plan grant will be available for meeting the Plan revenue outlay and (d) the total quantum of Article 275 grants for meeting non-Plan and Plan deficits provided by the Ninth Finance Commission will be maintained without any change.

The Ninth Finance Commission's scheme involves Rs. 1363.57 crore by way of non-Plan deficit grants and Rs. 8673.62 crore by way of Plan deficit grants adding upto a total sum of Rs. 10037.19 crore by way of Article 275 deficit grants. On the basis of the adjustments we have made (vide Table 2) non-Plan deficit grants required will be only Rs. 1162.44 crore. A balance of Rs. 8874.65 crore will accordingly be available for being allocated towards meeting deficits on the Plan account without any increase to the total quantum of Article 275 deficit grants on the non-Plan and Plan accounts.

The first alternative would be to fully apply this "sum available" of Rs. 8874.65 crore for meeting the "Plan deficits" of the 5 States (Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh) having such deficits and to distribute it among them in proportion to their Plan deficits. In this alternative, the Plan deficit grant will meet 81.96 per cent of the Plan deficit uniformly in each of the 5 States, this being the proportion of the sum available (Rs. 8874.65 crore) to the total of the Plan deficits (Rs. 10827.90 crore). This will be a strictly equitable solution.

The second alternative we have explored is also equitable but in a broader sense. It takes into account the fact that but for the Ninth Finance Commission's ingress into specific Plan deficit grants, all States could have benefited from shares in the sum available in accordance either with the

formula for excise-sharing or the Gadgil formula, depending on whether the sum available is disposed of under the aegis of the Ninth Finance Commission or the Planning Commission. At the same time, the 5 Plan deficit States deserve special treatment. Combining these two considerations, our second alternative is based on distributing a portion of the sum available of Rs. 8874.65 crore to all 14 States with reference to their shares in basic union excise duties and allocating the balance as Plan deficit grants to the 5 Plan-deficit States such that in their case the total Plan-related transfer, secured through the extra excise-sharing and Plan deficit grants is a uniform percentage of the deficits on the Plan revenue account. As the calculations in the Annexure will show, the uniform percentage of Plan deficit financing that can be realised will be 59 per cent, a distinct improvement compared to only 50 per cent in the Ninth Finance Commission's dispensation for the most needy States viz., Orissa, Rajasthan and Uttar Pradesh. At the same time, this alternative ensures that the 9 surplus States do not go without any benefit at all. At the same time again, they altogether benefit only to the extent of 27.7 per cent of the sum available while they could have hoped to get 46 per cent under excise-sharing and 48.6 per cent under the Gadgil grant[3].

To sum up, the basic devolution scheme formulated by the Ninth Finance Commission is flawed in many respects. First, because the Commission has pre-empted and prejudiced the role of the National Development Council and the Planning Commission. Second, because the Ninth Finance Commission has not provided any convincing rationale from the planning point of view for arriving at its estimates of minimum Plan revenue expenditures. Third, because it has arbitrarily taken into account only 40 per cent of post-devolution non-Plan revenue surpluses as being available for Plan financing from the States. Fourth, because the Plan deficit grants recommended by the Ninth Finance Commission bear no rational or equitable relation to the deficits which they are designed to cover in part. These criticisms would hold good apart from, and in addition to, questions that could well be raised about the Ninth

Finance Commission's normative estimates of revenues and non-Plan expenditures, its determination of vertical tax sharing, and its criteria for the horizontal sharing of shareable taxes inter-se among the States.

In his remarkably forthright note of dissent, Justice A.S. Qureshi has referred to "the extreme casualness on the part of the Union government" towards the functioning of the Commission with reference to the delay in constituting it, the initial appointment of the Member-Secretary, his replacement at an advanced stage of the Commission's work and in leaving a Member's post unfilled for as many as ten months towards the end of the Commission's term[4]. The "casual attitude" seems to have persisted on the part of both the Union government and the Union Planning Commission despite the change in their composition. Otherwise, it is difficult to understand why they should have swallowed this Report (hook, line, and sinker) despite its patent infirmities involving both principles and procedures without subjecting it to a careful and critical examination. It will be interesting now to watch whether the Planning Commission and the Union government will be able to fit the dimensional magnitudes of the Eighth Plan within the procrustean framework laid down by the Ninth Finance Commission.

Notes

1. In this connection, the following extract from the speech of the Chief Minister of Tamil Nadu to the NFC (Madras, 24 February 1989) is highly relevant:

   "The terms of reference for your Commission have broken new ground in that you have been asked to assess the requirements of the States in their entire revenue account, both non-Plan and Plan. We are however not clear as to how you propose to take into account the Plan revenue expenditures of the States during the Eighth Plan period. These requirements will have to be derived with reference to the size of the Eighth Plan, the distribution of outlays between the Centre and various States and the scheme of financing in each

case. On all these matters it has been the past practice for the States to be individually consulted by the Planning Commission and for the Centre to collectively consult them at the National Development Council. Pending such consultations, we believe that the Finance Commission should not include ad-hoc provisions for Plan revenue expenditures on the basis of its own exercises or even on the basis of exercises which it might undertake in collaboration with the Planning Commission at the official level. Moreover, at present, Central assistance for State Plans is being provided on the basis of the Gadgil formula which was approved as far back as 1968 in the National Development Council. This formula should not be set aside or modified as a by-product of the Finance Commission's report without the States being given a full opportunity to understand and to react to all the implications that might be involved".

2. It may be pointed out while adopting the NFC's estimates, that the 40 per cent limitation on the States' own contribution to Plan financing from its post-devolution non-Plan surplus has no practical implication in the case of 7 States. These consist of (a) 4 States viz., Gujarat, Haryana, Karnataka and Maharashtra whose surpluses are so large that they do not in any case qualify for Plan deficit grants and (b) the post-devolution non-Plan deficit States viz., Orissa, Rajasthan and Uttar Pradesh who have no surpluses whatever to contribute. It also makes only a marginal difference in the case of 3 other States viz., Punjab and Tamil Nadu (which have relatively large surpluses) and Kerala (because of its negligible surplus). Only 4 States viz., Andhra Pradesh, Bihar, Madhya Pradesh and West Bengal stand to gain with the extent of gain being: Bihar Rs 1545.09 crores; West Bengal Rs 949.06 crores; Madhya Pradesh Rs 736.79 crores; and Andhra Pradesh Rs 341.25 crores.

3. The logic of this alternative is the same as that of compensatory discrimination formulae in favour of 'backward classes' in educational and employment opportunities which combine reser-

vations for the disadvantaged with a measure of opportunities available to all under 'open competition'.

4. In the history of Finance Commissions, vacancies have arisen on three occasions in the past and were promptly filled up in each case: V.P. Menon on his resignation was replaced by V.L. Mehta (First Commission); G. Swaminathan replaced P.C. Bhattacharyya on the latter's death and added a supplementary minute to the report (Fifth Commission); Justice T.P.S. Chawla replaced Justice Sabyasachi Mukherjee, when he resigned to become a judge of the Supreme Court and contributed a minute of dissent along with G.C. Baveja (Eighth Commission). In the case of the Ninth Finance Commission, R. Keishing (former Chief Minister of Manipur) was appointed to replace Lal Thanhawla 10 months after the latter's resignation and served the Commission for less than a month before its winding up. Although Justice Qureshi has pointed out that it is humanly impossible for a person to understand the problems of the Centre and twenty-five States and take a decision thereon within such a short time "it is to Keishing's credit that he has left his imprint by securing the Ninth Finance Commission's endorsement for special assistance to Manipur for preserving and improving the Netaji/INA memorial in Moirang (Manipur) and for tackling jhoom cultivation in his State" (p. 14 of the report).

Annexure

x represents the portion of the sum available to be distributed on the basis of excise-sharing..

p_i (i=1 to 5) are the Plan grants to the 5 States, di are their Plan deficits and ei are their excise shares. Then the equations to be solved for the 5 States are di-x(ei)-pi = k(di) where k is a constant subject to x + Σpi=sum available and p_i's having to be non-negative.

The actual equations will be:

1.	Bihar	$1203.45\text{-}x(.1330)\text{-}p_1 = k(1203.45)$
2.	Madhya Pradesh	$821.65\text{-}x(.0871)\text{-}p_2 = k(821.65)$
3.	Orissa	$1109.00\text{-}x(.0646)\text{-}p_3 = k(1109.80)$
4.	Rajasthan	$1920.80\text{-}x(.0666)\text{-}p_4 = k(1920.80)$
5.	Uttar Pradesh	$5773.00\text{-}x(.1885)\text{-}p_5 = k(5773.00)$
6.	$x+\Sigma pi = 8874.65$	

For p_i's to be non-negative, p_1 for Bihar (the State with the largest excise share in relation to its deficit) will have to be zero. The remaining 6 unknowns (x, k, p_2, p_3, p_4 and p_5) can then be solved from the 6 equations to yield x = 5356.71, k = .4080, p_2 = 19.53, p_3 = 310.46, p_4 = 780.31 and p_5 = 2407.75.

Table 1

Ninth Finance Commission's Scheme for Financing Deficits on Plan Revenue Account

(Rs crore)

States	Post devolution non-Plan surplus or deficit	Non-Plan deficit grant	Plan revenue grant (Gadgil basis)	Initial resources for revenue Plan financing	Minimum Plan revenue expenditure	Initial surplus or deficit	Plan deficit grant	Final surplus or' deficit	Proportion of initial deficit met by Plan deficit grant (per cent)
1. Andhra Pradesh	4289.22		947.00	5236.22	3345.20	1891.02	341.25	2232.27	
2. Gujarat	3957.94		435.00	4392.94	1779.20	2613.74	-	2613.74	
3. Haryana	2505.06		218.00	2723.06	844.40	1878.66	-	1878.66	
4. Karnataka	4670.09		476.00	5146.09	2206.40	2939.69	-	2939.69	
5. Maharashtra	11525.56		753.00	12278.56	3555.60	8722.96	-	8722.96	
6. Punjab	1400.45		258.00	1658.45	926.00	732.45	53.91	786.36	
7. Tamil Nadu	4296.04		648.00	4944.04	2454.00	2490.04	43.79	2533.83	
	32644.36		3735.00	36379.36	15110.80	21268.56	438.95	21707.51	

(Table 1 contd.)

(Rs crore)

States	Post devolution non-Plan surplus or deficit	Non-Plan deficit grant	Plan revenue grant (Gadgil basis)	Initial resources for revenue Plan financing	Minimum Plan revenue expenditure	Initial surplus or deficit	Plan deficit grant	Final surplus or' deficit	Proportion of initial deficit met by Plan deficit grant (per cent)
8. Bihar	2575.15		1267.00	3842.15	5045.60	-1203.45	1374.27	170.82	114.19
9. Kerala	2.29		486.00	488.29	1312.00	-823.71	412.54	-411.17	50.08
10. Madhya Pradesh	1227.98		942.00	2169.98	3528.80	-1358.82	1047.81	-311.01	77.11
11. West Bengal	1581.77		634.00	2215.77	3264.00	-1048.23	998.65	-49.85	95.27
	5387.19		3329.00	8716.19	13150.40	-4434.21	3833.27	600.94	86.45
12. Orissa	-528.48	528.48	493.00	493.00	1602.00	-1109.00	554.50	-554.50	50.00
13. Rajasthan	-486.49	486.49	552.00	552.00	2472.80	-1920.80	960.40	-960.40	50.00
14. Uttar Pradesh	-348.60	348.60	1891.00	1891.00	7664.00	-5773.00	2886.50	-2886.50	50.00
	-1363.57	1363.57	2936.00	2936.00	11738.80	-8802.80	4401.40	-4401.40	50.00
Total for 14 States	**36667.98**	**1363.57**	**10000.00**	**48031.55**	**40000.00**	**8031.55**	**8673.62**	**16705.17**	**62.21**

Table 2

Adjustments to Strictly Normative Estimates of Post Devolution

(Rs. crore)

States	NFC's modified estimates	Revenue improvement	Expenditure improvement	Total net improvement = (3+4)	NFC's adjustment	Strictly normative estimates = (2+6)	Appropriate adjustment	Appropriately adjusted Normative Estimatives (7 + 8)	Basis for appropriate adjust ment
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Category I									
1. Bihar	2575.15	43.84	184.89	228.73	114.35	2689.50	-114.35	2575.15	No change with reference to NFC
2. Gujarat	3957.94	61.73	156.79	218.52	109.25	4067.19	-109.25	3957.94	-do-
3. Haryana	2505.06	179.32	154.05	333.37	166.70	2671.76	-166.70	2505.06	-do-
4. Maharashtra	11525.56	512.39	2523.24	3035.43	1517.70	13043.26	-1517.70	11525.56	-do-
5. Punjab	1400.45	273.57	924.84	1198.41	599.20	1999.65	-599.20	1400.45	-do-
Category II									
6. Tamil Nadu	4296.04	797.92	-342.01	455.91	227.95	4523.99	-227.95	4296.04	-do-

Table 2(Cont.)

(Rs. crore)

States	NFC's modified estimates	Revenue improvement	Expenditure improvement	Total net improvement = (3+4)	NFC's adjustment	Strictly normative estimates = (2+6)	Appropriate adjustment	Appropriately adjustted Normative Estimatives (7 + 8)	Basis for appropriate adjust ment
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Category III									
7. Orissa	-528.48	68.07	-113.27	-45.20	-	-528.48	+22.60	-505.88	Add 50% of 45.20
8. Uttar Pradesh	-348.60	801.30	-959.76	158.45	-	-348.60	+79.23	-269.37	Add 50% of 158.45
Category IV									
9. Andhra Pradesh	4289.22	-295.94	1031.66	735.72	367.85	4657.07	+811.77	5468.84	Add 295.94 and 50% of 1031.66
10. Karnataka	4670.09	-28.08	258.73	230.65	115.35	4785.44	+157.45	4942.89	Add 28.08 and 50% of 258.73
11. Kerala	2.29	-363.43	720.77	357.34	178.70	180.99	+723.82	904.81	Add 363.43 and 50% of 720.77
12. Madhya Pradesh	1227.98	-462.26	150.81	-311.45	-	1227.98	+537.67	1765.65	Add 462.26 and 50% of 150.81
13. West Bengal	1581.77	-296.12	917.44	621.32	310.65	1892.42	+754.84	2647.26	Add 296.12 and 50% 917.44
Category V									
14. Rajasthan	-486.49	-296.87	-395.16	-692.03	-	-486.49	+99.29	-367.19	Add 296.87 and 50% of (-395.16)

Table 3
Alternative Schemes for changing Plan Deficits

(Rs. Crores)

	States	Post devo-lution Non-Plan surplus or deficit 1/	Non-Plan deficit grant	Plan revenue grant (Gadgil)	Initial resources for revenue Plan financing	Minimum Plan revenue expendi-tures	Initial surplus or deficit	Alternative I 2/			Alternative II 3/		
								Plan deficit grant	Final surplus or deficit	Excise shares	Plan deficit grant	Total assis-tance for Plan	Final surplus or deficit
	(1)	(2)	(3)	(4)	(5) (2+3+4)	(6)	(7) (5-6)	(8)	(9) (7+8)	(10)	(11)	(12) (10+11)	(13) (7+12)
1.	Andhra Pradesh	5468.84		947.00	6415.84	3345.20	3070.64	-	3070.64	462.82	-	462.82	3533.46
2.	Gujarat	3957.94		435.00	4392.94	1779.20	2613.74	-	2613.74	205.69	-	205.69	2819.43
3.	Haryana	2505.06		218.00	2723.06	944.40	1878.66	-	1878.66	71.24	-	71.24	1949.90
4.	Karnataka	4942.89		476.00	5418.89	2206.40	3212.49	-	3212.49	265.16	-	265.16	3477.65
5.	Kerala	904.81		486.00	1390.81	1312.00	78.81	-	78.81	199.27	-	199.27	276.08
6.	Maharashtra	11525.06		753.00	12278.06	3555.60	8722.46	-	8722.46	334.80	-	334.80	9057.26
7.	Punjab	1400.45		258.00	1658.45	926.00	732.45	-	732.45	87.85	-	87.85	820.30
8.	Tamil Nadu	4296.04		648.00	4944.04	2454.00	2490.04	-	2490.04	411.93	-	411.93	2901.97
9.	West Bengal	2647.26		634.00	3281.26	3264.00	17.26	-	17.26	426.40	-	426.40	443.66
		37648.35		4855.00	42503.35	19686.80	22816.55		22816.55	2465.16	-	2465.16	25281.71

Table 3(Cont..)

	States	Post devolution Non-Plan surplus or deficit	Non-Plan deficit grant	Plan revenue grant (Gadgil)	Initial resources for revenue Plan financing	Minimum Plan revenue expenditures	Initial surplus or deficit	Plan deficit grant	Final surplus or deficit	Excise shares	Plan deficit grant	Total assistance for Plan	Final surplus or deficit
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
					(2+3+4)		(5-6)		(7+8)			(10+11)	(7+12)
10.	Bihar	2575.15		1267.00	3842.15	5045.60	-1203.45	986.40	-217.05	712.44	-	712.44	-491.01
11.	Madhya Pradesh	1765.15		942.00	2707.65	3528.80	-821.65	673.05	-148.60	466.57	19.53	486.10	-335.55
12.	Orissa	-505.88	505.88	493.00	493.00	1602.00	-1109.00	908.99	-200.01	346.04	310.46	656.50	-452.50
13.	Rajasthan	-387.19	387.19	552.00	552.00	2472.80	-1920.80	1574.38	-346.42	356.76	780.31	1137.07	-783.73
14.	Uttar Pradesh	-269.37	269.37	1891.00	1891.00	7664.00	-5773.00	4731.83	-1041.17	1009.74	2407.75	3417.49	-2355.51
		3177.86	1162.44	5145.00	9485.30	20313.20	40827.90	8874.65	-1953.25	2891.55	3518.05	6409.60	-4418.30
Total for all 14 states		40826.2	11162.44	10000.00	51988.65	40000.00	11988.65	8874.65	20863.30	5356.71	3518.05	8874.76 4/	20863.41

1/ Based on Col. (9) of Table 2.

2/ Vide para 12 of the note.

3/ Vide para 13 of the note and the Annexure.

4/ Differs slightly from total in Col. (8) due to rounding off.

Report of the Ninth Finance Commission : Some Conceptual and Methodological Comments

M. Govinda Rao

Introduction

The Report of the Ninth Finance Commission is significant for a number of reasons. First, the Presidential order detailing the terms of reference makes a marked departure from the past, particularly by suggesting, "the Commission shall adopt a normative approach in assessing the receipts and expenditures on the revenue accounts of the States and the Centre......". Assessing total receipts and expenditures on the revenue account instead of limiting the scope only to the non-Plan side unlike in the past and the adoption of a `normative' approach in place of the `gap-filling' approach are the two significant departures suggested in the terms of reference. Second, at a time when acute fiscal imbalances are found in both Central and State budgets, the recommendations of the Commission, through their incentive effects could have important implications for the emerging fiscal trends. Third, with the terms of reference indicating a shift from `budgetary needs' to `fiscal needs' as a basis of transfer, the operationalisation of the concept could have important inter-State allocation and equity implications. Finally, the recommendations of the Commission, coming as they are on the eve of the Eighth Five Year Plan, determine the

availability of resources and thereby affect the Plan size of the Centre as well as individual States.

It is true that the Finance Commissions cannot (and perhaps should not) make their recommendations purely on economic considerations; their recommendations, in fact, represent a compromise solution to the points of view of the Centre and the individual States and are based on the amalgam of economic, political, legal and historical considerations. Nevertheless, it would be useful to analyse the recommendations from an economist's perspective.

Intergovernmental transfers, in general, are meant to offset fiscal disadvantages of the States. It is very well recognised in all federations that the sub-Central levels of government face greater fiscal disadvantages than the Central government. This is the problem of vertical fiscal imbalance. At the same time, the residents in the States with lower revenue bases and/or higher cost disabilities face higher fiscal disadvantage as they have to bear a higher tax burden to provide a given normative level of public services than their counterparts in the States with higher revenue capacity and/or lower cost disabilities. This horizontal imbalance can be measured by the gap between expenditure needs and revenue capacities of the States. This measure takes into account both the sources of inequity: the lower revenue capacity and higher unit costs. As the Finance Commissions determine a major proportion of general purpose current transfers from the Centre to the States, their recommendations would have to be evaluated from the point of view of resolving vertical and horizontal imbalances. The Ninth Finance Commission, in addition, was entrusted with "........the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment". This is extremely important in view of the prevailing acute fiscal imbalances and the volume of investment for the Plan hinges crucially on the effectiveness of the strategy adopted by the Commission to phase out revenue deficits.

Transfers to Offset Fiscal Disadvantages of the States

If the intergovernmental transfers are meant to offset the fiscal disadvantages of the States both in the vertical and in the horizontal sense as mentioned above, it is important to analyse how these are conceptualised and measured. This paper attempts to examine some of the conceptual and methodological issues relevant to the framework the Ninth Finance Commission has adopted and to identify areas requiring further improvements. The paper mainly deals with the issues relating to the methodology of assessment which forms the basis of determining tax devolution and grants- in-aid under Article 275. The matters relating to additional excise duties in lieu of sales tax, grants in lieu of tax on railway passenger fares, the States' indebtedness to the Centre and financing of relief expenditure by the States affected by natural calamities, though important, are not analysed here.

a. Offsetting vertical fiscal imbalance:

An important question often asked about Finance Commission transfers is whether the vertical fiscal imbalance has been adequately offset. As a percentage of Central revenues, there is no significant change in the transfers. In fact, at about 22.7 per cent, it is estimated at the same level as in the Seventh Plan period. Perhaps at a time when the Centre itself is facing a yawning gap in its revenue account, larger transfers were unfeasible. In any case, what proportion of Central revenues should be transferred to the States has been a matter of judgement and one can argue for greater or lesser transfers depending on one's own persuasion. Besides, Finance Commission transfers form only a part of the total transfers and the issue of vertical imbalance has to be resolved by the transfer system taken as a whole. Yet, those who have been critical of the proliferation of Centrally sponsored schemes would be certainly disappointed that the Commission implicitly provided for the continuation of the schemes by allowing a 10 per cent annual increase in the growth of grants for Centrally sponsored schemes while estimating the overall revenue deficit

for the period of the award (para 7.17 p.30). Also, as will be argued later in the paper, the strategy of phasing out revenue deficits by understating the expenditure growth in the projections is likely to work discriminatingly against the States.

b. Offsetting fiscal disadvantages among the States:

The two most important points of criticism levelled against the Finance Commission transfers in the past were :

(i) restricting the Finance Commissions to assess only the non-Plan requirements either through Presidential guidelines or on account of the self-imposed limitations by the Finance Commissions themselves have resulted in the artificial compartmentalisation of Plan and non-Plan sides of the budgets of the States rendering the achievement of the objectives of federal transfers difficult (Gulati, 1987, Chelliah, 1983).[1]

(ii) The gap-filling approach adopted by the Commissions not only tended to act as disincentives on the States' fiscal performance, but also did not enable the resource-poor States to raise the standards of public services to some normative levels. The response of the recent Commissions, particularly since the Seventh Commission, to these criticisms were, first, to raise the States' share of divisible taxes to substantially high levels so that very few States were left with deficits after tax devolution; second, to introduce greater weight to general economic backwardness in tax devolution; and third, to provide for upgradation in the levels of selected public services in the States where prevailing levels were below the average. These in turn, apart from the disincentives on revenue and expenditure decisions have led to three important consequences; namely, (i) increased role of tax devolution resulted in the linking of transfers to general economic backwardness rather than fiscal disadvantages of the States as such. In the event, the assessments made by the Finance Commissions had little relevance to the amount of funds received in the case of a majority of the States. (ii) Inspite of the apparently large weight assigned to the backwardness factor, the explicit and implicit

weights assigned to population were predominant. (Datta, 1979)[2]. Consequently, the recommendations of the Commissions left significantly varying per capita non-Plan surpluses across the States, thereby contributing to the widening inter-State inequalities in the levels of development [Bagchi, 1988].

(iii) Attempts to raise the standards of specified services in the deficient States to some normative levels were neither properly designed to achieve the objective nor did they take into account the cost factors beyond the control of the States [Rao, 1990].

The important point to note is that the Finance Commissions in the past could not design transfers to offset fiscal disadvantages of the States. This is mainly due to the difficulties involved in the measurement of parameters representing States' fiscal disadvantages, namely, expenditure needs and revenue capacities. Noting the reasons for not developing the norms by the Finance Commissions, Lakdawala [1984] states, "owing to inherent difficulties of the task, the absence of a permanent secretariat and the short time in which each Finance Commission has to submit the report, except in the case of return on capital lent or invested, no worthwhile work has been done".

Given that not much work in evolving norms, particularly on the expenditure side, is available even in academic literature, two courses were open to the Ninth Finance Commission. First, it could have decided on the total amount of transfers to the States and could have distributed it among them on the basis of some general economic indicators, disregarding the relative fiscal imbalances of the States altogether[3]. The logic behind such a scheme is the contention that Finance Commission transfers are not meant to fill any gap but merely supplement States' revenues on the basis of some indicators of economic backwardness. Also, this scheme would have been simpler and less controversial as the fiscal performances of either the individual States or that of the Centre would not be called into question. However, such a

scheme would not satisfy the basic objective of offsetting fiscal disadvantages of the States nor would it meet the requirements specified in the Presidential order of providing "adequate incentives for resource mobilisation and financial discipline as well as closer linking of revenue-raising and expenditure decisions", and, " keeping in view not only balancing of the receipts and expenditure on revenue account of both the States and the Centre, but also generating surpluses for capital investment". The alternative approach which the Ninth Finance Commission has chosen necessitates the measurement of the fiscal disadvantages of the States as represented by need-revenue gaps and make transfers based thereon. The Commission thus had to break new ground in estimating fiscal capacities and needs of the States.

Concepts like 'fiscal capacities' and 'fiscal needs' however, are difficult to measure and, therefore, some complexities in the methodology of measuring these fiscal parameters are unavoidable. Besides, accuracy in the measurement of these concepts is conditioned by the availability of relevant and reliable data on the determinants of tax revenues and expenditures of the States. Although the methodologies of measuring these parameters may not be transparent, the logic of employing them is quite clear, namely, every State should be enabled to provide a certain normatively determined level of services, subject to the requirement that the residents of the State pay the average tax-price for these services. Nevertheless, the methodology employed by the Commission should be taken only as the starting point. A lot of empirical research on this subject is needed and with improved availability of data and more refinements in the method of estimation, the approach holds promise for the future Commissions.

c. Treatment of special category States:

From this perspective, continuation of the trend approach in respect of the special category States and the State of Goa must be considered as an important shortcoming. It must be noted that the share of these States forms almost 15 per cent

of the total transfers made by the Finance Commission. In fact, in respect of these States, the normative approach has an overwhelming significance. Given that the revenue collections in these States are very low, the emphasis on tax effort to provide incentive for expanding the tax bases in the years to come assumes great significance. It is equally important to enable these States to provide certain normative levels of public services. Further, as the unit costs of providing public services in these States are higher due to both higher input costs and inadequate opportunity to reap scale economies arising from sparsity of population, less subjective methods would have to be evolved to assess their expenditure needs required to provide the normative levels of services. However, difficulties in measuring the fiscal disadvantages in these States are formidable because reliable data on many of the important variables are not available. Besides, extreme heterogeneity even amongst these States has been a major factor inhibiting the evolution of a less objectionable method. The special category States themselves, in their joint memorandum to the Ninth Finance Commission have suggested certain norms for important sectors. Perhaps the future Commissions may find such an approach useful to evolve a suitable methodology. A lot of work in this area, however, is needed.

Methodological Issues

There are some other important areas where conceptual and methodological improvements are necessary. Although the Commission has made an attempt at measuring fiscal disadvantages of the States in terms of 'Need-capacity' gaps, the transfers given to the States are not exactly related to these gaps. Table 1 presents per capita 'Need-Capacity' gaps of the individual States and the per capita transfers received. It may be seen that the transfers do not exactly correspond to the gaps of the States. While in the case of Uttar Pradesh, the transfer formed only 78.17 per cent of the gap, in the case of Maharashtra it was over 3 times the surplus the State had before tax devolution. The scatter diagram shows clearly that the design of the transfers has not exactly corresponded to the

States' fiscal disadvantages. Of course, the correlation coefficient between the transfer and the Need-capacity gap is high and significant, 0.76 in the case of non-Plan transfers and 0.81 for total transfers. Also, the States with higher gaps seem to have gained from the recommendations of the Ninth Commission in comparision with the Eighth Commission's award[4] (vide Table 2). Besides, as will be demonstrated later, even from the point of view of generating surpluses in the non-Plan accounts, the result does not seem to be very satisfactory. This is partly due to the constraints posed by history, namely, the difficulty of reducing the role of tax devolution, but mainly on account of the methodology adopted to determine Plan revenue expenditure and various adjustments made before giving the Plan deficit grants.

a. Determining Plan revenue expenditures - compartmentalised approach

An important shortcoming of the Report appears to be the compartmentalised method of estimating non-Plan and Plan revenue expenditures. Having developed a methodology to estimate non-Plan revenue expenditure needs of the States, it should have been possible for the Commission to estimate their total revenue expenditures without making a distinction between Plan and non-Plan. This would have merely involved some minor conceptual and methodological changes. It may be recalled that the Commission defined non-Plan expenditure needs to mean the justifiable cost of providing 'average' levels in the case of general services and 'actual' levels in the case of social and economic services. Improvement in the levels of social and economic services was to be attempted in the Plan side. In the estimation, therefore, non-Plan expenditures on economic and social services were regressed on quantity and cost variables within and beyond States' control. By substituting average values of quantity and cost variables, the justifiable cost of providing existing levels of social and economic services were estimated.

If the Commission could estimate the justifiable cost of providing existing levels in the case of social and economic services, surely it should have been possible to estimate the justifiable cost of providing the normative standards of these services also. Besides, it must be mentioned here that the Commission has adopted the regression methodology only in respect of services having revenue expenditures forming a predominant proportion of total expenditures, and the linkage between revenue and capital expenditures is weak. Therefore, the existing levels of these services would be represented better by total revenue expenditures rather than non-Plan revenue expenditures.

However, unlike in the case of administrative services, the levels of social and economic services even in the most developed States may have to be augmented further. Although relative to less developed States the levels of these services provided may be higher, these may still be judged low in absolute terms and hence should be raised further. In any case, in the case of the States with above average levels of these services, it may be necessary to reckon expenditures required to provide at least the existing levels of service. However, in the case of States with below average levels, the expenditure needs for providing the 'average' levels should have been reckoned. If indeed, the amount of transfers required forò thhswaa nîoÿ available with the Centre according to the judgement of the Commission, the benchmark or normative level of services itself could have been changed from 'average' to any other feasible level. This would have done away with the artificial distinction between Plan and non-Plan expenditures.

Instead, the Commission has preferred to estimate non-Plan and Plan revenue expenditures separately by making a number of arbitrary adjustments. First, shares of major States are obtained by reckoning per capita Plan expenditures as inversely related to per capita non-Plan expenditures on economic and social services. But in doing so, upper and lower limits are placed at Rs 325 and Rs 425 per capita respectively. It is not clear why the Commission has chosen these values and not any other.

Second, in determining the finances available with the States to meet minimum levels of Plan revenue expenditures, no explanation is given for taking only 40 per cent of the post-devolution surpluses available with the States. A further adjustment is made when Plan deficit grants are recommended to equal only 50 per cent of the Plan revenue deficit (the amount of minimum levels of Plan revenue expenditure in excess of 40 per cent of non-Plan surplus and the assumed Gadgil formula assistance).

Besides, there is a basic contradiction implicit in the methodology. An important reason for employing the regression method to determine expenditure needs is to adjust for an important source of inequity, namely, differences in the unit cost of providing public services among the States. By determining the relative shares of the States in Plan revenue expenditures as inversely proportional to their non-Plan revenue expenditures (with lower and upper limits specified), cost differences among the States are simply assumed away. Thus, while the non-Plan revenue expenditures allow for cost differences beyond the control of the States, the Plan revenue expenditures do not! Such contradictions could have been easily avoided if different methodologies were not employed to determine non-Plan and Plan revenue expenditures.

Sometimes, questions are asked about the suitability of taking 'average' rates of taxes and levels of public services in determining States' taxable capacities and expenditure needs. It is suggested that neither the Centre nor any of the States can be presumed to have exploited their taxable capacities fully. Similarly, the general impression that prevails is that there is overspending at both the Central and individual States' levels. While this may be true in the absolute sense, operationalisation of such a concept involves several subjective judgements to be made. In any case, what is important is to reckon tax revenues of the States at a uniform level of tax effort and assess expenditures of the States necessary to provide a specified level of public services.

What has been the overall effect of the methodology of assessment on equalising the standards of social and economic services? Table 3 presents annual average per capita normative expenditures, both Plan and non-Plan, estimated for the period 1990-5 by the Commission. The revenue expenditure (Plan and non-Plan) assumed by the Commission varies from Rs 305 per capita in Bihar to Rs 512.73 in Gujarat. Thus the differences in estimated per capita expenditure on social and economic services vary from 78 per cent of the average in Bihar to 131.5 per cent of the average in Gujarat. Although Plan revenue expenditure as determined by the Commission has an equalising impact on per capita expenditures as seen in the reduction in the coefficient of variation from 0.23 in the case of non-Plan expenditures to 0.15 in the case of total revenue expenditures, the extent of differences in per capita expenditure even as envisaged by the Commission itself is substantial.

From the point of view of equalising the levels of services across the States, however, what is relevant is the equalisation in the amount of per capita resources available for the Plan. The amount of available resources for the Plan consequent to the recommendations of the Finance Commission is given by the estimated per capita non-Plan surpluses in individual States. This is estimated by adding the Plan deficit grants to the post-devolution surpluses in each of the States. The per capita non-Plan surpluses arising from the recommendation of the Commission thus estimated ranges from Rs 27.06 to Rs 300.34 (Table 4). In other words, by the Commission's own reckoning, the resources available for the Plan in the State with the highest surplus is over 11 times that of the State with the lowest surplus. While this order of difference is much lower than what had resulted from the recommendations of the past Commissions, the difference is still substantial and certainly not conducive to balanced regional development of the country.

b. Adjustments in normative estimates

Some comments on the adjustments carried out by the Commission in the normatively determined non-Plan deficits

also are in order. It may be recalled that as the conventional estimates were found to yield higher deficits or lower surpluses for 10 out of the 14 major States as compared to the normative estimates, the Commission "as a matter of abundant caution and as a measure of concession to the States" averaged the budget position arising from the two sets of estimates (para 3.82 p.14). Some observations on this adjustment may be made. First, the Commission should have provided a detailed methodology of making conventional estimates like in the past. This is essential because even in respect of some of the States where the normative estimates for 1986-7 were found to be higher than actuals by a significant margin, the conventional estimates of expenditures for 1990-5 were found to be still higher than the normative estimates. For example, in the case of Andhra Pradesh, Bihar, Haryana, Karnataka and Tamil Nadu the normative estimates were found to be higher than the actual in 1986-7 (Table 13.5.2 of the Report p. 125). The difference was as high as Rs. 70 crore in the case of Bihar, Rs 45 crore in the case of Karnataka and Rs. 85 crore in the case of Tamil Nadu. When the growth rate as per the Finance Commission assumption is applied, the difference for the award period would be substantial. Yet it is surprising that the conventional estimates were found to be even higher than these normative estimates. Second, clearly the adjustments made had no beneficial effect on the four poor States of Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh where the normative estimates were higher than the conventional estimates. Similarly the States of Maharashtra, Gujarat, Haryana and Karnataka did not gain as they had no deficits in either non-Plan or Plan account after tax devolution. Only the States of Andhra Pradesh, Bihar, Kerala, Punjab, Tamil Nadu and West Bengal actually gained from these adjustments. Surely, in the case of some States, these adjustments had contradictory effects to the adjustments made in terms of the phased application of the normative approach.[5]

c. **Provision for parity in pay scales:**

What could be the reasons for such differences between the normative and conventional estimates? It may be noted that both in the case of tax revenues and non-Plan revenue expenditures, all-States aggregate figures in the year of estimation approximately equal the actual. Yet on the expenditure side, the normative estimates for 1990-5 were lower than the conventional estimates by Rs. 5213 crore. This can be possible only if any one or more of the following reasons hold: (i) the growth rate applied to the normative figures of 1986-7 to reach base year (1989-90) figures was an underestimate; (ii) the conventional figures were overestimates; and (iii) the provision made for salary revision was inadequate. It appears that the rate of growth (13 per cent) taken is only marginally lower than the trend rate of growth and as the salary revision portion is added separately, this does not appear to be an underestimate. As far as conventional estimates are concerned, we have pointed out some anomalies in the previous paragraph. In any case as the detailed methodology is not spelt out anywhere in the report, it is difficult to offer any comments. On the methodology of working out the provision for salary revison, surely, some comments are necessary.

The methodology detailed in Annexure III.17 indicates that the differences between emoluments of specified categories of employees in the Central and individual State governments were not multiplied with the total number of State government employees in the category, but only with 20 per cent of the number of employees if the percentage difference in salaries is less than ten, or twice the percentage difference in salaries if it is more than 10 subject to the maximum of 100 per cent of the employees. The reason for thus limiting the benefits to only a fraction of employees is given as, "all the employees in a specific emoluments range are not expected to get the full benefit of the difference". The argument is that, as the States have been revising their pay scales more frequently than the Centre, due to the 'weightage and fixàtion' benefits given at every revision, even if the pay scales in the States are lower than

the Central scales, total emoluments for a particular category of employees could be higher. However, the important issue is, once it is stated that the Finance Commission has agreed in principle to pay parity, do the States have any other option? If not, can the States deny the benefit of `weightage' and `fixation' to some employees when their scales are lower than the comparable Central government employees even though their total emoluments are higher? On what empirical basis was the benefit of revision limited to employees equivalent to twice the percentage difference in the emoluments subject to a minimum of 20 per cent and maximum of 100 per cent? These issues are not explained adequately in the Report.

The Commission has not given the estimated expenditures reckoned to bring about pay parity in any detail. This can, however, be worked out from the normative estimates. The aggregate expenditure estimates given in Appendix 5 include provision for pay parity, whereas the disaggregated estimates do not. But these estimates have been adjusted to conform to normative expenditures. The provision for pay revision estimated according to the methodology detailed in Annexure III.17 can be obtained by making pro-rata adjustments to the above estimates. These estimates are given in Table 5.

Implications of Phasing out Revenue Deficits

One of the major objectives the Finance Commission took upon itself is the phasing out of revenue deficits of the Central and State governments in the course of the Commission's award. In the final analysis, according to the Commission's own reckoning, there will be revenue deficit of Rs. 10,766 crore in the Centre and the States taken together. This is certainly an important achievement, considering the existing scenario.

The main method through which the Finance Commission has sought to phase out the revenue deficit is by assuming very low rates of growth of expenditures. Taking seven per cent growth rate in the non-Plan expenditures of the

Centre and the States even when inflation is only five per cent could be realised only if they apply emergency brakes. As far as the States are concerned, the overdraft regulation scheme does not allow the States to have significant overall deficits. Therefore, quite a large part of the adjustment may not come through raising more revenues or cutting down expenditures, but by continuing the diversion of capital receipts to finance revenue expenditures. In the case of the Centre, there are no constraints even on the overall availability of funds and hence it can easily finance revenue expenditures by borrowing from the Reserve Bank of India. Even the budget for 1990-1 for the Centre envisages a revenue deficit of Rs. 13,032 crore which is higher than the target set by the Finance Commission (Rs. 8,501 crore) by over 53 per cent. The short point is that neither in the case of the Centre nor in the case of the States, is the ceiling on revenue deficits set by the Finance Commission likely to be effective. Nor has the Finance Commission provided any fool-proof mechanism to limit the Centre and the States to the prescribed ceilings. Further, while the States have to operate within the overall availability of resources, both revenue and capital, due to the existence of the overdraft regulation scheme, the Centre has no such limitation. Therefore, the methodology adopted to phase out the deficits would only have the effect of 'barking' on the Centre, whereas on the States, it would 'bite'[6].

Summary and Conclusions

To sum up, the Ninth Finance Commission has broken new ground in some respects. In particular, the attempt at linking transfers to offset fiscal disadvantages of the States is noteworthy. Whether it has indeed succeeded in measuring fiscal disadvantages has to be seen, but the method employed by the Commission seems to hold promise. However, the Commission certainly has missed an opportunity to make an integrated assessment of the revenue accounts of the States. The continued adherence to the compartmentalised approach to assessing Plan and non-Plan sides of States' budgets is clearly a setback. A more integrated approach was possible with the same level

of transfers and without impinging on the role of the Planning Commission. Such an integrated approach to assessment is necessary to design transfers to offset fiscal disadvantages of the States and to pave the way for balanced regional development. Also, as there exists no effective mechanism, it is doubtful whether the States and the Centre will adhere to the Plan of phasing out revenue deficits. In any case, while non-adherence on the part of the States would largely reduce their investments, non-adherence on the part of the Centre would hurt the economy as a whole.

Notes

1. Chelliah [1983 p.19] for example states, " there is nothing in the Constitution to restrict the purview of the Finance Commission to non-Plan revenue account. It would, in fact, be desirable for an independent quasi-judicial body like the Finance Commission to make an over-all assessment of the financial situation of each State and then make recommendations on the basis of well-defined principles related to federal transfers and equalisation".

2. According to the Report of the Ninth Finance Commission, [India, 1990, p.6) effective weight assigned to population according to the Eighth Commission's recommendation works out to 83 per cent on the average although the direct weight assigned to this factor was only 25 per cent."

3. In fact, V.K.R.V. Rao (1973) had suggested such a scheme a number of years ago. Also, the memorandum submitted by the Government of Gujarat to the Ninth Finance Commission argues for adopting such an approach.

4. Strictly, it is necessary to compute the need-capacity gap for the period of the Eighth

Commission's award for the purpose of comparison. Besides, the actual percentages of transfers were different from the estimated percentages in the Report of the Eighth Commission as (i) three new States came into existence, (ii) net interest liability grants are not included in these computations, and (iii) the amount of shareable taxes actually realised was different from what was estimated by the Commission.

5. In fact, the Commission applied the normative approach in a phased manner. For instance, the normative levels of tax revenue were to be reached in 1994-5 beginning from the trend estimates in 1989-90. Similarly, in the case of expenditures, the norms were applied in a phased manner starting from 50 per cent in 1989-90 to reach full normative levels in 1994-5.

6. Guhan (1989) made a similar observation on the First Report of the Commission.

Table 1
Estimated Need-Capacity Gaps and Per Capita Transfers

(Rs.)

States	Estimated Annual Average per capita Need capacity gap (1990-5)		Per Capita Transfer (1990-5)		Per cent of transfer to need-capacity gap
	Non-Plan (1)^y	Total (2)^y	Non-Plan (1)^y	Total (2)^y	Total
1. Andhra Pradesh	60.50	149.02	174.01	183.04	122.83
2. Bihar	159.09	272.22	216.78	247.59	90.95
3. Gujarat	(-)26.97	58.21	162.53	162.53	279.21
4. Haryana	(-)163.38	62.97	134.49	134.49	213.58
5. Karnataka	(-)30.60	64.64	171.42	171.02	264.57
6. Kerala	190.26	275.84	190.42	217.33	78.79
7. Madhya Pradesh	161.11	268.24	198.40	230.21	85.72
8. Maharashtra	(-)143.04	(-)50.38	157.30	157.30	(-)312.25
9. Orissa	298.24	397.94	298.24	332.75	83.62
10. Punjab	11.42	103.55	150.77	156.13	150.77
11. Rajasthan	22.43	129.37	221.18	262.84	203.17
12. Tamil Nadu	59.71	197.30	209.56	211.09	106.99
13. Uttar Pradesh	201.80	310.52	201.78	242.72	78.17
14. West Bengal	138.79	235.69	185.92	215.42	91.40

Y = Mid year population estimates of Registrar General for the years from 1990 to 1995 were taken to compute per capita estimates.

Table 2

Relative Shares of States in Transfers Recommended by the Eighth and the Ninth Finance Commission

(Per cent)

Major States	As per 8th Commission Report (1984-9)	Shares in 1988-9 (B.E)	As per 9th Commission First Report	As per 9th Commission Second Report
1. Andhra Pradesh	7.34	7.18	6.60	6.83
2. Bihar	10.70	10.52	10.65	10.54
3. Gujarat	3.77	3.49	3.19	3.50
4. Haryana	1.11	1.03	1.21	1.13
5. Karnataka	4.38	4.19	4.22	3.83
6. Kerala	3.27	3.16	3.01	3.25
7. Madhya Pradesh	7.50	7.33	6.98	7.40
8. Maharashtra	6.68	6.27	6.71	5.85
9. Orissa	4.84	4.99	4.53	5.21
10. Punjab	1.64	1.54	2.04	1.58
11. Rajasthan	4.25	4.31	4.77	6.15
12. Tamil Nadu	6.25	6.09	6.38	5.85
13. Uttar Pradesh	15.47	15.19	15.83	16.46
14. West Bengal	8.74	8.71	6.99	6.89
Other States				
1. Arunachal Pradesh	-	0.89	1.11	0.79
2. Assam	4.07	4.29	4.12	3.73
3. Goa	-	0.44	0.34	0.48
4. Himachal Pradesh	1.96	1.76	1.86	1.75
5. Jammu & Kashmir	2.84	3.02	3.48	3.17
6. Manipur	1.19	1.09	1.09	1.02
7. Meghalaya	0.97	0.89	0.82	0.78
8. Mizoram	-	0.89	1.25	0.96
9. Nagaland	1.34	1.73	1.25	1.17
10. Sikkim	0.27	0.24	0.23	0.24
11. Tripura	1.42	1.28	1.34	1.32
Total	100.00	100.00	100.00	100.00

Table 3

Per Capita Normative Expenditure on Social and Economic Services 1990-5

States	Per capita Annual Average Revenue Expenditure on Economic and Social Services			Index of Per Capita Expenditure		
	Non-Plan	Plan	Total	Non-Plan	Plan	Total
Andhra Pradesh	274.23	112.78	387.01	98.19	101.99	99.26
Bihar	181.27	123.78	305.05	64.90	111.93	78.24
Gujarat	418.26	94.47	512.73	149.75	85.43	131.51
Haryana	292.07	110.74	402.81	104.57	100.14	103.31
Karnataka	334.84	105.19	440.03	119.88	95.13	112.86
Kerala	387.70	94.94	482.64	138.81	83.14	123.79
Madhya Pradesh	235.62	117.70	353.32	84.35	106.44	90.62
Maharashtra	355.15	102.62	457.77	127.15	92.80	117.41
Orissa	278.00	110.05	388.05	99.55	99.52	99.53
Punjab	353.25	102.74	455.99	126.44	92.91	116.95
Rajasthan	242.33	116.41	358.74	86.76	105.27	92.04
Tamil Nadu	368.79	95.23	464.02	132.04	86.12	119.01
Uttar Pradesh	191.50	119.05	310.55	68.56	107.66	79.65
West Bengal	310.00	107.89	417.89	110.99	97.57	107.18
All Major States	279.31	110.58	389.89	100.00	100.00	100.00
Standard Deviation	69.75	0.08	60.90	24.97	8.51	15.62
Coefficient of Variation	0.23	0.08	0.15	0.23	0.09	0.15

Table 4

Non-Plan Surplus of Major States During 1990-5 according to the Recommendation of the Finance Commission

Major States	Non-Plan Surplus After Tax Dev-olution (Rs.crore)	Plan Deficit Grants (Rs.crore)	Total Non-Plan Surplus (Rs.crore)	Per capita Annual Average Non-Plan Surpluses (Rs)
Andhra Pradesh	4289.22	341.25	4630.47	122.54
Bihar	2575.15	1374.27	3949.42	88.55
Gujarat	3957.94	-	3957.94	189.49
Haryana	2505.06	-	2505.06	297.47
Karnataka	4670.79	-	4670.79	201.62
Kerala	2.29	412.54	414.83	27.06
Madhya Pradesh	1227.98	1047.81	2275.79	69.10
Maharashtra	11525.56	-	11525.56	300.34
Orissa	-	554.50	554.50	34.51
Punjab	1400.45	53.91	1454.36	144.73
Rajasthan	-	960.40	960.40	41.65
Tamil Nadu	4296.04	43.79	4339.83	151.37
Uttar Pradesh	-	2886.50	2886.50	40.94
West Bengal	1581.77	998.65	2580.42	76.63
All Major States	38032.25	8673.62	46705.87	108.49

Table 5

Additional Expenditure Reckoned on Account of Parity in Pay Scales with the Central Pay Scales in 1989-90

(Rs. lakh)

State		Additional Expenditures as per Annexure III.17	Additional Expendi- adjusted to half normative estimates	Additional Expendi- adjusted to full normative estimates
1.	Andhra Praadesh	1084.14	1082.41	1085.87
2.	Bihar	10763.30	10430.18	11096.42
3.	Gujarat	-	-	-
4.	Haryana	-	-	-
5.	Karnataka	126.02	·123.12	128.92
6.	Kerala	8341.46	8734.34	7948.58
7.	Madhya Pradesh	1239.78	1237.30	1242.26
8.	Maharashtra	-	-	-
9.	Orissa	6536.01	6241.89	6830.13
10.	Punjab	-	-	-
11.	Rajasthan	3998.29	3806.57	4190
12.	Tamil Nadu	26380.36	25488.36	27272.02
13.	Uttar Pradesh	56707.29	54166.80	59247.77
14.	West Bengal	6874.96	7107.33	6642.59

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Enforcing Fiscal Discipline : An Evaluation of the Second Report of the Ninth Finance Commission

Renuka Vishwanathan

The prevailing economic and fiscal environment even more than its own terms of reference, has compelled the Ninth Finance Commission to formulate its recommendations with the aim of making every rupee count. No earlier Commission has been so constrained by the paucity of finances while framing its suggestions for distributing some component of Central revenues among the different States. Even administrators and academics, despite initial misgivings about the Commission's terms of reference, unhappily acknowledged that there were only deficits to share[1]. This realisation has had an effect on the Ninth Commission's recommendations in two ways:

i. It has led to a search for surpluses and revenue cushions available with the different governments which could be redistributed for optimum benefit.

ii. It has also focussed the Commission's attention on the unpleasant but unavoidable task of promoting prudent husbanding of financial resources.

Predictably, the Commission's Second Report, even more than the First, opens with a sombre presentation of the "steadily deteriorating fiscal scenario" of the '80s and draws pointed attention both to the dissavings on government account (as seen in the growing revenue deficits) as well as the costs of the rapidly increasing public debt. Like the Finance

Minister's budget speech for 1990-1, it minces no words while deploring the consequences of the unrestrained rise in public expenditure accompanied by stagnating revenues from State enterprises which have seriously undermined the country's long term economic and developmental interests. The three-fold objective of the Commission comprises two which are clearly meant to enforce fiscal discipline - the phasing out of revenue deficits by the end of the mandate period (1990-5) and the promotion of efficiency and fiscal restraint. Whether the recommendations will substantially contribute to these stated objectives is a different matter altogether. The Commission has itself indicated the manner in which it expects its approach to impose a degree of discipline on the budgetary operations of the State and Central governments[2]. These remarks will be taken into account while passing judgement on the Commission's recommendations.

The Search for Surpluses

The earlier perception that the Centre had access to a fiscal cornucopia which could be indefinitely tapped by the States has become outdated. The Ninth Commission's predecessors could have safely increased the States' share in taxes from 55 per cent to 85 per cent for income taxes and 20 per cent to 45 per cent for Central excises; the Ninth Commission has been left with very limited leeway in the matter. Both governmental levels were clamouring for more and both were running revenue deficits. In its search for available allocable resources, the Commission had before it just two difficult alternatives (both of which it has adopted to a limited extent).

- A close look at Central revenues to enforce economy and force out surpluses.
- A quest for funds, if available, with certain State governments that could be diverted to other more needy ones.

a. Disciplining the Centre

The Central government has never had to subject its fiscal decisions to Finance Commission scrutiny till the days of the Seventh Commission, although the terms of reference from the days of the Fifth Commission itself had provided for considering the Centre's resources and demands on account of expenditure on civil administration, defence, border security, debt servicing and other committed expenditure or liabilities before determining transfers to States. The argument that Finance Commissions do not subject Central finances to the same degree of scrutiny as State finances may not be totally valid; certainly, the Seventh and Eighth Commissions applied broadly similar considerations to both exercises. The approach of these Commissions did not also lack sophistication,[3] there were even occasional sorties into the normative methodology (especially with regard to dividend income and the major Central subsidies), even if the general tendency was to proceed on past trends. Nevertheless, the analyses were only of peripheral significance as determination of the quantum of transfers to States was an independent exercise not limited by the availability of sufficient Central surpluses after the reassessment of the Central forecast. The Eighth Finance Commission, for example, identified an overall surplus of Rs 96,319 crore by putting up the Finance Ministry's assumptions of Rs 65,912 crore. The fund requirements for State transfers were fixed at around Rs. 42,000 crore including both the revenue and capital accounts (net interest and committed liability grants were to be subsequently calculated by the government on the lines indicated by the Commission). But the Commission did not even point out anywhere that fortunately State transfers were well within the identified Central surpluses - the need for establishing such a link was not felt at that stage.

On the other hand, the Ninth Finance Commission in its First and Second Reports has clearly admitted that the level of transfers to States can be finalised only if adequate funds can be spared for the purpose by the Centre. In the First Report, the non-Plan revenue surplus implied in the Finance Ministry's es-

timates of Rs. 9,757 crore for 1989-90 had to be raised to Rs. 16,868 crore after reassessment by the Ninth Commission to accommodate the recommended devolution levels of Rs 13,660 crore of tax shares and grants.

The Second Report is even clearer regarding the connection between transfers and Central surpluses. If the Central government's forecasts for 1990-5 had been taken at face value its non-Plan revenue surplus before transfers would only have been around Rs 46,394 crore, which would in no way have covered the recommended devolution levels (Rs 1,06,602 crore). The Central government would have had to borrow even for paying out statutory Article 275 grants. As the Ninth Commission has noted, the total non-Plan revenue surplus available in 1984-5 would have been less than the States' share of the mandatorily divisible income tax receipts at current levels. Hence, a serious reassessment was clearly in order to release additional Central funds for State governments. The Ninth Commission has by its efforts identified revenue surpluses before transfers of Rs 1,49,271 crore to be placed at the service of State governments. It did this by listing a set of nine guidelines for reassessment of the Central forecast. Setting up the Centre as the role model for States, the Commission has proceeded more on practical rather than censorious lines. The trend approach is relegated to the sidelines, norms come to the forefront and what is feasible is given prominence. For example, realistic projections of growth rates have been assumed for divisible taxes, mainly in the interests of deficit States, so as not to inflate their likely revenues from these sources, leading to a reduction in their deficits and the grants available against the deficits.

While making Plan grants too, the requirements of States have been identified but not fully catered to, evidently because of the inadequacy of resources. The Ninth Finance Commission has taken pains to indicate that if the assumptions made by it materialise, Rs. 94,200 crore of budgetary support to the Central Plan at 1989-90 prices should be available during 1990-5. Thus the conflicting demands on available revenues are sought to be reconciled, leaving each party partially satisfied.

A comparison of the Commission's approach to the States and the Centre is in order. All the same we must not forget that such comparisons are relevant only up to a point. Central tax revenues are not totally comparable with apparently similar State tax heads. Nor can inter-country comparisons be made given the wide divergence in internal conditions, productive structures and developmental levels. With this caveat we may look at the Finance Commission's methodology in reassessing Central and State forecasts.

In the case of tax revenues, the modified representative tax system adopted to estimate the taxable capacities of individual States does not affect the overall quantum of transfers to States. The growth rates adopted for 1990-5 are slightly ahead of the sum of the assumed annual growth rates of SDP (6 per cent) and prices (5 per cent) at 11.5 per cent but this level is to be reached only by stages at the close of the mandate period. As against this, Central tax proceeds have been presumed to grow at 12.8 per cent annually. This is, no doubt, less than the long-term trend of 14.64 per cent between 1974 and 1990 (BEs) but it is certainly ahead of the Central forecast of 10 per cent. The justification is that Income tax and Central Excise proceeds are being projected with an eye to avoiding under-estimation of State deficits and reduction of their grants-in-aid. Since State shares are on a percentage basis, higher actual growth rates will in any case benefit them.

In the case of non-tax revenues, a uniform rate of 12 per cent has been applied to both Central and State interest receipts and this has also been adopted for calculating interest payments.

As for dividends, rates of return from Central public sector undertakings have been projected at 6 per cent and on other investments including industrial schemes at 5 per cent. This is more stringent than the 5 per cent maximum annual return assumed on State commercial enterprises and cooperatives, for a 3 per cent return alone has been applied to State financial institutions and none at all to promotional units, while milk supply schemes are only expected to break even by

1994-5. Other State non-tax revenues are not, however, strictly comparable to Central heads and different modulations of the normative approach have been applied to the different items, looking to the specific requirements of each.

On the non-Plan revenue expenditure side, the two exercises are even less comparable. Central forecasts have been watered down ignoring higher trend levels with a view to containing deficits. Only a 9.5 per cent growth rate has been allowed for the Centre's overall non-Plan revenue expenditure. A 10 per cent increase for defence and 8 per cent for the different subsidies argues a rather conservative approach. The States have received more meticulous treatment with a minute examination of their major expenditure heads. Provisions have been made on the basis of exogenous norms which are quite likely to be difficult to achieve, going by past experience. The Eighth Finance Commission's methodology has been generally accepted and occasional modifications introduced where required. Phasing has also been done gradually to enable States to eventually attain the desirable levels by the close of the forecast period. There does not seem to be much evidence however, that different standards have been applied to the Centre and the States.

It would be facile to conclude nevertheless, that the Ninth Finance Commission's recommendations by themselves will have a salutory effect on Central imprudence. Of course a higher level of transfers to State imposed on an already deficit budget could induce the Central government to be more careful about generating the required level of surplus funds but given the Centre's powers to print money and resort to deficit financing, the Finance Commission's interventions either by censure or by higher transfer recommendations for State can never be the major factor in compelling it to limit wasteful expenditure. The constraints must come, as they seem to have done at last, from the macro-economic realities of inflation and the debt burden. Eventually, the most effective check on Central extravagance can only be through the statutory audit of the C&AG and the intervention of elected representatives in Parliament.

Recognising this truth, the Commission has suggested that as a check against unlimited drawal on RBI credit a convention should be established to limit deficit financing to a pre-determined figure laid down in consultation with the Governor, RBI. This would be in the interest of States too, as deficit financing and the consequential inflation can adversely affect State expenditure requirements. There are echoes here of the Gramm-Rudman clause in US budget-making, since both the methods are attempts to fix secular limits to the financial powers of the Government and Parliament. Like the Gramm-Rudman clause, however, this attempt is unlikely to succeed. Eventually, the Commission has been forced to dole out advice to both governmental levels regarding prudent fiscal policy. The inescapable conclusion is that the Commission's recommendations can only have a marginal effect on Central government fiscal behaviour and in any case this body is not the appropriate vehicle to undertake such a task.

One matter in which the Second Report of the Ninth Finance Commission has lagged behind the First is the case of Centrally sponsored schemes. Where the First Report rightly deplored the uncontrolled expansion of such schemes, the Second Report has been strangely silent. The issue is a ticklish one as can be seen from the dilemma already facing the reconstituted Planning Commission. No government at the Centre would like to cede its power to substantially influence policies and programmes in the State sector, especially when State responsibilities extend primarily to social sectors which have considerable electoral significance. By paring down Central requirements in this area, the Commission could have usefully identified additional funds for transfer to States.

b. Managing the States

The second avenue for squeezing out resources for reallocation to needy governments is the budgetary surpluses of some States before and after devolution. The fragmented approach to devolution in the Indian Constitution, following the Government of India Act of 1935, makes it difficult to pool

transferable funds and allocate them on a composite set of criteria. While Article 270 governs the transfer of income tax receipts, Article 272 determines what should happen to excise revenues. Income tax receipts must compulsorily be transferred to States while the Parliament can decide whether Excise proceeds should be so distributed or not - theoretically one could forsee a contingency in which they were wholly retained by the Central government, though in actual practice this has become almost impossible, since convention has sanctified the distribution of Central Excises also.

There are procedural complications too. State shares of Income tax proceeds are a compulsory charge on Central revenue; in the budget, they are netted out on the receipts side out of gross collections and do not accrue to the Consolidated Fund. Excise revenues, on the other hand, enter the Consolidated Fund and are then paid out to States according to the shares determined by Act of Parliament through a budgetary outflow on the expenditure side.

Above all, Article 270 - 2 enjoins that Income tax proceeds shall be assigned only to the States within which the tax is leviable. Sikkim, for example, could not claim a share of the tax revenues till Central income tax was actually introduced in the State very recently.

The need to take a holistic view of available resources to finance identified requirements has been put forward from time to time[4]. The Sarkaria Commission, which looked at one possible variant (Para 10.6.03 - Chapter X Financial Relations) did not favour the idea from the Constitutional point of view on the ground that all Central revenues should not form part of the divisible pool since Customs Duties, for example, are subject to violent fluctuations in response to external conditions and are not suitable for sharing. The Sarkaria Commission has also cited the views of the Sarkaria Committee in the matter and has not recommended giving States a fixed share in total Union tax revenues in order to avoid putting the Centre at a disadvantage and taking note of its "onerous responsibilities". Yet there

is a great deal to be said in favour of the idea as it would give States a predictable income and prevent the growing Central disinterest in and manipulation of Central Income Tax and excise revenues, attendant on the existing arrangements. Without ostensibly doing so, the Finance Commission will have no choice but to move towards treating all existing divisible heads and grants as one pool to be shared with States[5]. This has been the trend for some time despite the misgivings of surplus States who have been protesting, with some justification, their right to dispose of budget surpluses available after devolution, especially where, as in the case of Maharashtra, there are pockets of backwardness within the State. Nonetheless, this is one of the very few areas which can be tapped to cater to the additional requirements of the poorer States, given that the surpluses of the Central government have been shown to be finite and could even become nonexistent.

Without violently disturbing Constitutional equations, however, it may not be possible to substantially draw on these amounts. A frontal attack could even raise a storm of protest from the surplus States. Hence, the Finance Commissions have generally tackled the issue by a circuitous route, each improving on its predecessor.

The movement towards using tax shares also for equalisation purposes started with the Eighth Finance Commission. After setting aside the normal 10 per cent of Income tax proceeds for distribution on the basis of contribution, 25 per cent of the remaining amount alone was allotted for distribution on the basis of population, as against 80 to 90 per cent under previous Commissions. On the other hand, 25 per cent weightage was given to the inverse of per capita income and 50 per cent to the distance factor. The Ninth Commission in its First Report reduced the weightage of the inverse of per capita income to 12.5 per cent and introduced the proportion of persons below the poverty line as the indicator of backwardness to be applied for distributing the remaining 12.5 per cent. Faced with severe criticism on this account, the Second Report has replaced this criterion by a composite index of backwardness comprising

the population of Scheduled castes and Scheduled tribes and the number of agricultural labourers in the State.

In the case of Central Excises, the Eighth Commission had given weightages of 25 per cent, 25 per cent and 50 per cent respectively to population, the inverse of per capita income and the distance factor for distributing 40 per cent of the revenues. For a further 5 per cent, the ratio of the deficit of a deficit State to the total deficits of all States was taken as the criterion. The First Report of the Ninth Commission broke up the 25 per cent divisible on the inverse of per capita income equally between the income adjusted total population (IATP) and the poverty ratio. The Second Report, however, has made two changes. The weightage attached to the distance factor has come down to 33.5per cent of 45 per cent, while the deficit factor has been given 16.5 per cent weightage (16.5 per cent of 45 per cent - that is 7.5 per cent of the total Central excise proceeds against 5 per cent earlier). Besides, the poverty ratio has been replaced by the index of backwardness. There is a distinction between the criteria that reflect the backwardness of a State and those that reveal only budgetary inadequacy. (Even a developed State could have a deficit budget - a fact that is clear when we look at some special category States). The deficit factor is an indicator of the latter kind. It is noteworthy that the weightages of both these kinds of indicators have been steadily on the increase so that today only 32.5 per cent of divisible Income tax and 25 per cent of Central excise receipts are distributed on the basis of factors which are not aimed at equalising the spending capacities of the States.

On the revenue grants side, a considerable amount of manipulation has gone into reworking allocations. The Second Report has really attempted to break free of the gap-filling approach[6]. The non-Plan expenditures on social and economic services required to maintain standards achieved at the close of the Sixth Plan at a normative cost in 1994-5 have been placed against estimated per capita Plan revenue expenditures required to be made so that all States are enabled to improve their service levels, with the lower level States moving faster than

the others. The ratios of the difference of per capita expenditure from the highest level have been calculated and the total requirements of States worked out for the entire population on this basis. The relative shares of each State in the total Plan revenue resources available have been then worked out and applied to the likely available resource level. Likely Gadgil formula assistance for these States has been estimated and pro-rata alloted to the States on the basis of the previous allocation pattern. 40 per cent of the non-Plan revenue surpluses has also been adjusted to arrive at the ultimate deficits. Only 50 per cent of these deficits have eventually been provided as grants-in-aid.

Some queries/comments can be made at this point.

- The distinction between Plan and non-Plan expenditure has been removed as far as the revenue account is concerned. Despite the Finance Commission's expectations, however, the possibility always exists that the grants recommended by it could be taken into account while determining the likely Gadgil formula assistance for State governments. If the assistance grows faster than the 10 per cent assumed by the Finance Commission, this will provide additional funds for States. At any rate, the minimum assistance levels proposed by the Commission will have to be provided.

- Only 40 per cent of the surpluses of States have been adjusted to calculate grants-in-aid. This is a via media adopted in view of the fact that the grants-in-aid cover both the Plan and non-Plan accounts.

- The equalisation method adopted steers a path between the sometimes conflicting objectives of maintaining standards of economic and social services already achieved and providing funds

for bringing up the standards in the poorer States - at least States which had spent heavily on these sectors in earlier years have not been penalised for being pioneers.

- The overall manipulation gives the impression that the intention was somehow to stay within the existing levels of Central transfers to States, which is a professed objective of the Commission.

The cumulative effect of the working of Finance Commissions since the Eighth Commission has been the steady reduction in the shares of the richest States in Central transfers for the benefit of the low income States (Table I). The shares of high income States in tax devolution have fallen from 14.2 per cent (Eighth Commission) to 13.8 per cent (the Second Report of the Ninth Commission). Maharashtra has lost at least 4 percentage points in the process. In respect of all revenue transfers also, (excluding calamity grants) their shares have come down from 13.1 per cent to 11.8 per cent with Maharashtra again suffering the most (a decline of 1.3 percentage points). Middle income States have suffered the same fate - a fall from 30.8 per cent to 29.2 per cent in the case of tax shares and 30 per cent to 26.8 per cent for all transfers. West Bengal has lost heavily (0.8 per cent in tax shares and 1.6 per cent in all transfers) while Andhra Pradesh and Karnataka have suffered some damage. In fact, middle income States have lost more than high income States in terms of percentage points.

The beneficiaries have been not only low income States but also special category ones. The low income States have increased their shares of tax devolution from 35.3 per cent to 44.4 per cent - an improvement of 9.1 per cent - and in all transfers by a smaller extent (42.9 per cent to 45.8 per cent). Rajasthan has been the major beneficiary (1 percentage point in tax shares and 1.6 percentage points in all transfers). As for special category States, in all transfers their shares have gone up from 14 per cent to 16 per cent. This has happened even when the overall percentage of tax devolution to States has remained constant,

that is to say, the new special category States which were formerly Union Territories have cut into the States' shares after they have changed status.

Instilling Fiscal Discipline

The Second Report of the Ninth Commission has been generously peppered with ominous allusions to prudence, tax effort, discipline, etc. The "confines of available resources" have been reluctantly recognised to be an inflexible constraint on the Finance Commission generosity. Without saying so directly, the Commission appears to have accepted the undeniable fact that its predecessors had not paid sufficient attention to encouraging fiscal restraint, despite professions to the contrary. This is in line with the growing evidence that the methodology adopted by the Commissions is likely to have encouraged the States to be positively imprudent - to rush into hasty decision making, committing to undertake infructuous and unproductive expenditure on the eve of expected Commission cut-off dates (for example, for salary fixation) and project requirements that were palpably false and unrealistic[7] (which they were subsequently compelled to implement). The atmosphere engendered was naturally one of fiscal licence coupled with the confidence that the Centre would eventually pick up the tab. The most pernicious consequence was however the positive disincentive to economising States who cut their coats according to the cloth. With the normative approach, however, State forecasts are becoming redundant, to be called for only to satisfy the convention that the States have been heard before the award is finalised. It is, therefore, useful to examine the Second Report from this specific viewpoint and determine to what extent the Commission has lived up to its own objectives of promoting fiscal discipline and discouraging excesses.

We have already looked at the role of the Finance Commission in curbing Central extravagance. Here we shall only study the effects on the behaviour of State governments. Fortunately, the Commission has itself asked and answered

this question in its concluding observations. It feels that the normative approach for determination of Central transfers would make it difficult for States to increase expenditure without mobilising additional resources. Besides, non-Plan capital gaps have not been fully closed, compelling States to be cautious in incurring additional debt especially to finance revenue expenditure. For the rest, there are homilies which apply equally to the Centre and the States - linking performance with accessibility to funds, zero-based budgeting and shedding peripheral activities, limiting employment in the government sector, streamlining and reducing budgetary support to public sector undertakings by adopting the interest subsidy route for market financing of core projects instead of budgetary outflows and restructuring public enterprises.

We readily concede that the shift to the normative approach is a positive incentive to efficient performance despite the drawbacks associated with the "average" approach on the tax revenue side[8]. The Finance Commission's observations regarding the non-Plan capital gap are relevant but difficult to achieve in the present context where the borrowing scenario is largely influenced by external factors and decisions rarely made as part of conscious self-directed policy. Market borrowing levels are fixed by the Planning Commission on a formula basis after the overall States' share is laid down after negotiations with the Finance Ministry. 70 per cent of Plan assistance which is distributed under the Gadgil formula after the shares of special category States and the overall States' share are determined through consultation, consists of loans to States. A few Central loans outside the Central assistance are linked to specific projects, with the really major component, in recent years, being the large gap filling amounts transferred to Punjab. As for Centrally sponsored schemes, the loan component of each (where there is such a component) is on a schemewise basis, determined Ministry by Ministry, through the Planning mechanism. All this is to say that the borrowing figures can be influenced to a very limited extent only by the

unilateral action of a single State; the only area of conscious management relates to State performance on the recovery of loans extended to favoured sectors and public sector undertakings but this is a relatively small component of the whole.

This apart, on the non-Plan revenue account alone, there does not appear to have been any positive encouragement to better fiscal management on the part of States. We had earlier concluded that the Finance Commission's role in inducing such behaviour is limited in the case of the Central government; for State governments, however, deprived of access to deficit financing, the 5 yearly exercises could have a much larger budgetary impact for good as well as for evil. But the Commission has not examined various available indicators of State willingness to effectively manage its own finances.

One of these could be the own revenues of States as a percentage of their domestic products (Table 2). More than even high income States, the middle income States seem to have made considerable efforts to improve their resource mobilisation and some have reached percentages above 14 per cent (Tamil Nadu, Kerala, Karnataka and Andhra Pradesh). Only 2 of the 4 high income States (Haryana and Maharashtra) have attained these levels. Certain low income States also have made efforts to tap a greater share of internal resources relative to SDP over time (Bihar and Orissa, for example), but others like UP and Rajasthan have stagnated along with one middle income State - West Bengal. Non-recognition of these efforts in any way goes against the Commission's objective of encouraging States which had made valiant efforts to increase internal revenues.

We could look at the growth of own revenues - tax and non-tax as well as the major State taxes in the recent past. Since earlier Commissions had laid down targets in these areas, comparisons of actual achievements against these targets would have been valid. As this issue has been fully treated in an earlier paper I will not spend much time on it here[9]. (Table 3 and 4 provide the data). There are sharp variations especially with regard to non-tax revenues which are worth examining.

The comparatively low levels of overall growth in own revenues in States like Punjab (both tax and non-tax revenue), West Bengal and U.P. (especially non-tax revenue) and Tamil Nadu (during the Seventh Plan alone) call for analysis and corrective action. On the major taxes, comments have already been made in the earlier paper and figures alone are being presented here. (Motor vehicles tax has not been considered as results are likely to be distorted due to the shift to one-time tax in several States). On the receipts side, even more specific indicators could have been taken up - the cost of collection of major tax revenues, for example. As for non-tax revenues, only the rates of return and the performance of the State electricity and transport undertakings have been looked at thoroughly by the Ninth Finance Commission, as is the normal practice.

The expenditure side is also liable to a closer study with a view to focusing on slack administrative practices. The costs of delivery of the major services are a relevant variable and the overall picture would emerged when the non Plan budgetary balances become clear. We could then ask whether a State has a non-Plan revenue deficit or surplus in the final analysis (Table 5). Haryana and Madhya Pradesh are the only States that have generated revenue surpluses throughout the '80s. Bihar, Tamil Nadu and Karnataka have run deficits in only 2 of the 10 years whereas West Bengal has been in deficit in 9 out of 10 years, Kerala in 7 and U.P., Maharashtra and Rajasthan in 5 years.

None of these possible indices of prudent fiscal behaviour have been mentioned, so that one is disposed to enquire whether the Commission itself has linked "performance with accessibility to funds", as it has so sagely counselled the States and Central governments.

An area that has been practically left untouched by the normative approach relates to assistance given to special category States. While the same criteria have been applied to them in determining the tax shares as are applicable to other States, more or less actual levels of receipts and expenditure have been adopted in fixing grants-in-aid. The overall share of these States

in Finance Commission recommended transfers has gone up as we have indicated earlier. The most anomalous thing however is the special attention paid to these States, even where their per capita SDP is far above the all - States average - Goa in fact has the highest SDP of all States, while Sikkim and Nagaland are also fairly well off. The justification that these States require special treatment because of their size and strategic location will not hold water for all time, without some accompanying attempt to enforce financial discipline. On all fronts, these States are today in a position to indiscriminately put up expenditure, without a thought to the resource availability so much so that their share of all Central transfers has spiralled steadily upwards from 12.5 per cent in 1979-80 to 22 per cent in the 1986-7 budget estimates. This has been seriously hampering efforts to prod the States into gradually becoming more self reliant and provoking other States too into demanding special status for one reason or another[10] (Punjab had already defacto achieved this objective, despite its higher per capita SDP).

In the light of the developments in fiscal federalism reflected in the Ninth Commission's reports, it might be useful to speculate on the likely directions of State policy in future.

The growing shortages in Central funds available for disbursement to States as a whole may compel high and middle income States to shift their strategy from merely supporting demands for an increase in the level of transfers to one of the defence of their existing shares. They may pay greater attention to influencing Commission deliberations with a view to reducing (or at least preventing the extension of) the scope of equalising criteria in the distribution of tax shares. Opposing both greater allocations to special category States as well as expansion of the applicability of the budget deficit criterion are likely to yield dividends for these States. Various permutations and combinations of different criteria of backwardness are also likely to be suggested by them depending on the mix that would favour each. The curtailment of Central statutory funding might finally force middle income States to give up hopes of ever becoming eligible for statutory grants.

As for Plan transfers, much will depend on the outcome of the present controversy relating to Centrally sponsored schemes. If the ultimate fallout is a reduction in the quantum and importance of such schemes the middle and high income States will attain greater flexibility in making expenditure and resource- raising decisions. They will then indeed move towards greater autonomy in decision-making and explore inter-State and multi-State mechanisms to evolve useful common policy initiatives. This would be generally beneficial, as experience has shown that workable innovative programmes like those relating to nutrition or employment, have invariably had their genesis in the State sector and were only subsequently picked up and developed as nationwide schemes. Financial autarchy could make States more inclined to assert themselves politically and federalise party and governmental structures.

The behaviour of low income States will continue to be governed by their dependence on Central largesse. As the Ninth Commission has not fully met even their identified requirements, they would have to set their houses in order, to indent upon available resources and manage domestic finances. The stiffer resistance they are likely to face from the other two groups of non- special category States to general expansion of equalisation criteria in distributing tax shares will lead them also to discover permutations and combinations that will specifically benefit each State. Hopefully, they will set about improving internal resource generation and claim credit for this in future Finance Commission deliberations.

It is thus hoped that all States will be thrown more on their own resources and concentrate on developing methodologies to effectively manage domestic finances, without looking to the Centre alone for succour. If this happens, however, it will hardly be due to Finance Commission methodology - it will only be the natural outcome of the resource constraints of the Central government.

One likely fallout of the reduced fund availability

for distribution to States will be a diminution in the dependence of all States on Finance Commission transfers. As these transfers are in any case governed by certain general principles, States will tend to concentrate more on the complex political processes behind the sharing of non-statutory funds like general purpose Plan assistance or amounts earmarked for Centrally sponsored schemes. This is also not a bad thing, as federalism implies active political interaction, over and above the supposedly objective award of an independent group of experts.

Notes

1. See, for example, "Issues Before the Ninth Finance Commission: On Closing Pandora's Box", by S. Guhan, paper presented at the Seminar on "Issues Before the Ninth Finance Commission" organised by the NIPFP, New Delhi, 1988.

2. Paras 10.8 to 10.14 - Chapter X "Concluding Observations" of the 2nd Report of the Ninth Finance Commission.

3. The Eighth Commission, for example, looked at trends in the growth of the major Central Taxes, assumptions made by the Seventh Finance Commission and the Sixth Plan as well as price and income elasticities worked out by an NIPFP study in addition to CBDT forecasts.

4. One of the earliest to suggest this was K.V.S. Sastri in "Federal - State Fiscal Relations in India" O.U.P. 1966.

5. There is a clear indication of such an approach in the Ninth Finance Commission's Second Report, where it has admitted its intention of staying within the existing overall limits of Central transfers.

6. Even the First Report, despite normative

calculations of receipts and expenditure, only recommended grants to close the newly-established revenue gaps.

7. An interesting sidelight of the Second Report of the Ninth Commission is the manner in which the Centre, threatened by the prospect of a closer scrutiny of its resources, has resorted to the same techniques as States and projected growth levels of receipts and expenditure which represent perhaps the worst scenario before it - an eventuality that it was likely to avoid any advance corrective measures.

8. See "Financial Management in States: Role of Finance Commission" J.L. Bajaj and Renuka Viswanathan, Economic and Political Weekly, 7th October, 1989.

9. J.L. Bajaj and Renuka Viswanathan - op.cit.

10. The tirade of a Kerala politician some time back on the issue, which attracted considerably adverse publicity may be remembered.

Table 1

(Per cent)

	Shares in Tax Shares			Shares in Grants		
	Eighth Commi-sion Report	Ninth Commi-ssion Report I	Ninth Commi-ssion Report II	Eighth Commi-ssion Report	Ninth Commi-ssion Report I	Ninth Commis Report II
High Income						
Gujarat	4	3.6	3.9	3.7	3.1	3.3
Haryana	1.2	1.2	1.3	1.1	1.2	1.1
Maharashtra	7.3	7.3	6.9	6.7	6.8	5.9
Punjab	1.7	1.6	1.7	1.6	2	1.5
TOTAL	14.2	13 .7	13.8	13.1	13.1	11.8
Middle Income						
Andhra Pradesh	7.7	7.2	7.5	7.3	6.5	6.7
Karnataka	4.8	4.8	4.5	4.4	4.2	3.9
Kerala	3.5	3.4	3.3	3.3	3	3.2
Tamil Nadu	6.9	7.1	6.8	6.3	6.4	5.9
West Bengal	7.9	7.2	7.1	8.7	7	7.1
TOTAL	30.8	29.7	29.2	30	27.1	26.8
Low Income						
Bihar	11.2	11.6	11	10.7	10.7	10.7
Madhya Pradesh	7.8	7.7	7.4	7.6	7.1	7.4
Orissa	4.4	4.3	4.9	4.8	4.4	5.2
Rajasthan	4.3	4.9	5.3	4.3	4.8	5.9
Uttar Pradesh	16.6	17.4	15.8	15.5	15.8	16.6
TOTAL	35.3	45.9	44.4	42.9	42.8	45.8
Grand Total	**80.3**	**88.3**	**87.40**	**86.0**	**83.0**	**84.4**

Table 2

Own Revenue/SDP

(Percentage)

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87
High Income								
Gujarat	10.4	10.8	10.3	11.4	10.8	11.5	12.6	13.6
Haryana	12.76	11.74	12.7	12.76	12.95	13.4	13.8	14.6
Maharashtra	11.31	11.22	12.06	13.1	12.82	13	13.7	14.7
Punjab	9.8	10.13	10.55	10.9	10.73	9.9	10.3	10.7
Middle Income								
Andhra Pradesh	11.22	11.17	10.74	11.15	11.36	13	14.2	14.2
Karnataka	11.96	12.7	13.08	14.18	13.81	14.3	15.5	14.7
Kerala	13.38	12.55	16.49	13.12	12.15	13.2	14.7	14.6
Tamil Nadu	9.98	13.66	12.35	14.37	14.24	13.6	14.1	14.3
West Bengal	7.45	7.53	7.94	7.66	7.21	7.4	8.1	7.9
Low Income								
Bihar	6.27	5.76	6.31	6.37	6.62	7	8.5	8.4
Madhya Pradesh	12.86	10.61	12.2	12.33	11.58	11.5	11.5	12.5
Orissa	7.71	8.6	7.25	7.72	6.8	7.4	7.4	8.4
Rajasthan	10.67	10.37	9.76	10.75	9.58	10.5	11.2	10.9
Uttar Pradesh	7.97	6.36	7.66	7.57	7.18	7.2	7.4	7.6

Table 3

Compound Growth Rates

(Per cent)

	Tax		Non-tax		Own Revenues	
	6th Plan	7th Plan	6th Plan	7th Plan	6th Plan	7th Plan
High Income						
Gujarat	16.9	14	16.82	12.8	16.88	12.3
Haryana	15.49	17.9	13.92	15	14.93	16.8
Maharashtra	14.92	17	16.57	9.7	15.4	14
Punjab	12.88	13.2	9.62	6.5	12.1	11.8
Middle Income						
Andhra Pradesh	18.95	16.7	13.76	13.2	17.57	15.2
Karnataka	17.57	16.5	14.31	8.6	16.61	14
Kerala	16.41	15.7	1.8	4.9	12.84	12.7
Tamil Nadu	21.68	9.9	12.22	3.5	20.02	8
West Bengal	14.9	14.8	4.47	3.5	12.84	13.3
Low Income						
Bihar	14.72	17	29.99	25.2	19.83	20.7
Madhya Pradesh	17.37	17.6	9.42	14.5	14.1	16.3
Orissa	15.23	20.9	14.59	14.5	15.01	18.8
Rajasthan	17.59	15.2	13.87	7.6	16.15	12.3
Uttar Pradesh	15.19	14.5	8.14	10.7	13.15	12.7

Table 4

Compound Growth Rates

(Per cent)

	Stamps		Excise		Sales Tax	
	6th Plan	7th Plan	6th Plan	7th Plan	6th Plan	7th Plan
High Income						
Gujarat	11.2	8.43	7.56	10.74	16.06	14.43
Haryana	16.11	15.38	21.26	18.84	15.35	16.75
Maharashtra	15.89	17.34	19.2	14.53	14.86	14.1
Punjab	5.4	9.92	15.49	8.76	15.22	12.63
Middle Income						
Andhra Pradesh	13.4	13.5	20.01	9.82	22.64	14.64
Karnataka	16.14	16.91	19.59	13.54	19.39	15.63
Kerala	13.36	12.12	10.46	16.61	18.2	13.55
Tamil Nadu	15.77	15.15	107.76	-	20.45	11.55
West Bengal	14.29	10.54	12.01	12.87	13.82	14.85
Low Income						
Bihar	15.07	6.42	63.03	15.06	15.54	13.06
Madhya Pradesh	16.49	13.45	17.67	13.86	18.15	16.73
Orissa	14.69	10.81	19.09	10.88	13.86	19.31
Rajasthan	14.67	18.06	30.05	17.66	15.6	14.78
Uttar Pradesh	13.07	10.07	20.75	25.77	15.84	11.71

Table V

Non—Plan Revenue Surplus/Deficit

(Rs. Crore)

	1979-80	1980-81	1981-82	1982-83	1983-84 RE	1984-85 BE	1985-86	1986-87	1987-88	1988-89
High Income										
Gujarat	92.3	121.73	120.31	66.26	139.03	68.26	-69.91	-309.52	-411.8	-353.68
Haryana	84.32	59.22	50.53	44.76	85.85	29.58	106.12	162.82	43.6	97.6
Maharashtra	195.41	121.02	147.37	210.12	70.77	-212.0	-316.65	-0.55	-84.1	-243.41
Punjab	77.49	18.13	62.63	102.48	59.27	-9.35	7.34	90.41	-333.03	-239.22
Middle Income										
Andhra Pradesh	121.29	103.41	97.91	132.57	-88.58	-169.03	-7.31	38.63	51.45	120.31
Karnataka	80.65	58.65	164.29	141.89	72.91	143.62	-84.74	79.39	25.1	-184.55
Kerala	57.93	-27.22	95.98	26.78	-58.2	-13.67	-74.17	-152.24	-153.15	-139.14
Tamil Nadu	95.3	127.7	81.61	01.94	51.71	17.18	188.57	103.61	-304.5	-217.56
West Bengal	-13.71	-23.51	-87.81	-242.44	-206.17	-371.94	82.89	-187.31	-133.8	-104.99
Low Income										
Bihar	230.51	59.55	-94.65	-37.7	72.14	106.712	97.67	354.4	190	424.63
Madhya Pradesh	167.08	117.78	229. 26	187.77	176.28	79.13	70.42	35.77	66.79	48.91
Orissa	18.68	80.81	27.98	-22.98	0.36	-74.03	-60.09	-19.74	-21.23	60.77
Rajasthan	18.01	65.3	34.23	54.54	44.64	-75.86	-2.16	-60.17	-291.66	-191.81
Uttar Pradesh	245.06	182.64	353.43	192.37	-105.74	-147.31	74.61	-177.51	-206.3	-559.97

Second Report of the Ninth Finance Commission: Manipulated Normative Approach

G. Thimmaiah

Background

The Ninth Finance Commission, whose constitution and terms of reference had created unprecedented public debate and controversy, has failed to do justice to the normative approach. The majority report of the Commission which has been accepted by the Government of India claims to have adopted the normative approach and this claim seems to have persuaded the Union Finance Ministry to accept the majority recommendations. But closer examination of the normative approach actually used by the Ninth Finance Commission (NFC) exposes the distortions which have been deliberately introduced in the name of effecting modifications to give sufficient time for the State governments to adjust to the normative approach.

The earlier Commissions were accused of having used the colonial approach which has come to be called the 'gap filling' approach, which is familiar to the scholars of Indian federal finance. This 'gap filling' approach was feared to have led to huge financial transfers from the Union to the States thus causing mounting revenue account deficit of the Union government. Therefore, the Ninth Finance Commission was asked to adopt a normative approach for assessing the revenue receipts and revenue expenditures of the State governments. In the First Report, the Ninth Finance Commission could not attempt such an approach for want of time and required data. Even so, the Commission attempted to estimate the tax revenue potential

by using the regression approach. This method came to be criticised as unreasonable. In the Second Report the Ninth Finance Commission has claimed to have adopted the normative approach to assess both tax revenue receipts and non-Plan revenue expenditures. While the Ninth Finance Commission has made an attempt to do that, in the final results its approach ceases to be a normative approach. It has only manipulated the 'gap filling' approach by using some elements of the normative approach to benefit some States at the cost of others.

In what follows an attempt will be made to show the estimation of pre-devolution non-Plan revenue account budgetary positions of the States by the Ninth Finance Commission. The focus of this paper will be mainly confined to the methodology used by the Ninth Finance Commission to reassess the revenue receipts and non-Plan revenue expenditures by using the so-called normative approach.

It was possible for the Ninth Finance Commission to do away with the 'gap filling' exercise by properly estimating both non-Plan revenue expenditure and more importantly, Plan revenue expenditure so as to ensure a minimum level of essential public services in all the States without increasing the level of federal fiscal transfers. The Ninth Finance Commission could have pooled all tax shares which are indicated in the Constitution and distributed the total divisible pool among the States so as to raise the levels of revenue expenditures of the State governments. The Ninth Finance Commission has not attempted such a comprehensive normative approach. It has only tried to re-assess the revenue potential of the State governments by using some norms and also non-Plan revenue expenditures of the State governments again by using discriminatory norms. The resultant net budgetary position of the States has come to be filled by the devolution of tax shares which are again determined independently of the normative approach. Therefore, the normative approach has been applied only to the extent of reassessing the revenue receipts and non-Plan revenue expenditures of the State governments. Even the revenue component of the Plan expenditure has not been assessed

by using any norms. More about this later. The ultimate result of this kind of haphazard manipulation is that those States which used to receive less per capita transfers under the earlier methodology have come to receive more. These happen to be the States which attracted the special attention of the Commission in the First Report for substantial shortfall in their revenue efforts. Suddenly they have become high tax effort States in the Second Report within a period of 12 months. These very States which criticised the methodology of the Commission used in the First Report have become silent admirers after receiving a bonanza in the Second Report not withstanding the fact that the methodology used in the Second Report is worse than that used in the First Report. This transformation has been made possible through the manipulation of the calculations as will be shown below.

In the literature on fiscal federalism, the net fiscal needs approach has been developed to reduce inter-State disparities in the levels and quality of certain essential public services. This objective is expected to be achieved by determining the nature and extent of federal assistance to the State governments to reduce the disparities. In this net fiscal needs approach the most important objective is to equalise the normative level of essential public services across the States.

The normative approach which was suggested to the Ninth Finance Commission in the terms of reference and which has been adopted by it has treated the objective of equalisation of essential public services as a secondary objective. Primacy is given to the objective of reducing the revenue deficit by the year 1994-5. The Ninth Finance Commission was no doubt disturbed by the growing revenue deficits of both the Union and State governments, and the terms of reference indirectly indicated that the package of recommendations of the Finance Commission should try to reduce the revenue deficit of the Union government. In order to achieve this objective, the Commission has tried to use the net fiscal needs approach to assess financial needs of the State governments in the name of normative approach. But the results of the normative approach

would not have served the purpose of phasing out the revenue deficit of the Union government. Therefore, the estimated budgetary position of the State governments has been further modified so as to make the Union and the State governments balance their revenue account budgets by 1994-5. This is the underlying objective, and equalisation of essential public services has been treated as secondary. Consequently, the normative approach used has come to be distorted in the name of ensuring financial discipline. In other words, the Ninth Finance Commission has so modified the normative results relating to the reassessment of the tax revenue receipts and non-Plan revenue expenditures as to make those States, which have not been raising or tapping their own sources of revenue as also some States which are spending regularly on the so called social and economic services, receive a bonanza along with those States whose expenditure levels are low and revenue capacity is also limited. Since the objective is to phase out the revenue deficit, the Finance Commission has tried to relegate the very purpose of the net fiscal needs approach, which was supposed to be formulated for the purpose of raising the levels of certain essential public services, to the background. Even if the Commission wanted to phase out the revenue account deficits of both the Union and the State governments, there was no need to distort the results obtained from the statistical exercises relating to estimation of tax potential and normative levels of non-Plan revenue expenditure. The final results relating to the reassessed non-Plan net budgetary positions of the States create justifiable doubt about the objectivity involved in detailed calculations done by the Commission. Let us understand how the Commission has gone about it.

Estimation of Revenue Receipts

On the revenue side, the Commission has estimated the potential tax revenue receipts by using a modified representative tax system approach. Non-tax revenue receipts have been assessed by using the norms which were applied by the earlier Commissions. The State governments, by and large, have come

to accept these norms used for assessing non-tax revenue receipts. However, the past Commissions used to apply historical growth rates for estimating the growth of tax revenue receipts. This has been changed and a modified representative tax system approach has been used. But even here the Commission has not applied the results obtained from such a normative approach. It has made further adjustments to serve the objective of the Commission's recommendations, namely, to phase out the revenue deficit of the State governments by 1994-5.

First the potential of some seven major taxes of 14 State governments like Sales tax, State excise, Entertainment tax, Stamp duties and Registration fees is estimated by using a modified representative tax system approach. The resultant coefficients are treated as average tax rates, and they are applied to respective tax bases to arrive at the potential tax revenue up to the year 1986-7 for which actuals were available. Then these normative estimates are projected from 1986-87 to 1989-90 by using historical growth rates. Then for the subsequent period i.e., 1990-1 to 1994-5, States' tax revenue receipts "have been projected at the rate of 6 per cent and allowing for a price rise of 5 per cent per annum. The rate of increase in the yield of different taxes has been derived from the above projection of aggregate tax revenues, using their respective growth rates in the past which were *pro rata* adjusted". (p.7) After doing this questionable exercise, the Commission has estimated a trend level of the tax revenue of all the States upto 1989-90, then worked out the rate of growth of tax revenue required during the period to reach the normative levels by 1994-5. Further, in regard to the State excise duty, the Commission has adjusted only 30 per cent of the estimated revenue that would have accrued to Gujarat and Tamil Nadu on the assumption that prohibition had not been in force.

First of all the Ninth Finance Commission has failed to collect the required data and estimate the revenue potential by using the representative tax system approach. This failure has made the Commission carry out arbitrary modifications to suit

the available data. Second, even these not so reliable estimates are made only upto 1986-7 on the ground that the actual revenue receipts were available only upto that year. Then these normative estimates are projected by using historical growth rates upto 1989-90. This amounts to combining the trend growth method and the normative estimates. Furthermore, the Commission has used an arbitrarily determined rate of 11.5 per cent growth rate for all the States' tax revenues for projecting the tax revenue receipts from 1989-90 to 1984-5 and derived individual tax revenues from this aggregate growth rate by applying the *pro rata* method. Why the Commission has used 11.5 per cent and not any other growth rate can be explained by the objective which the Commission wanted to promote. The Commission wanted to reduce the revenue deficits of the State governments by 1994-5. For this purpose, after estimating the probable volume of federal transfers, the Commission worked back to determine the extent of own revenue receipts which the State governments should raise. Probably, these exercises gave 11.5 per cent growth rate and definitely it is not a normative growth rate. After doing all these distorted normative exercises, the Commission wanted to give benefit of doubt to the State governments. In order to provide adequate time for those States which were found to be under-taxing to adjust to this distorted normative approach, the Commission has applied, instead of normative estimates, the trend level estimates for 1989-90 and then worked out the "rate of growth of tax revenues required during the period to reach the normative levels by 1994-5. In other words, the normative approach to the assessment of tax revenues has been moderated." (p.7) This is the explanation given on page 7. But on page 78 it is indicated that the Commission has compared normative estimates for the period 1990-5 with conventional trend growth estimates relating to both tax revenue and non-Plan revenue expenditures and made adjustment to the extent of 50 per cent of the net improvement. But this is not clearly stated in Chapter 3 which is devoted to an explanation of the methodology of the Commission. This means the Commission has not really used the normative estimates as estimated by using the representa-

tive tax system approach. There is enough circumstantial evidence to prove that the Commission prepared the Report in haste without examining the worksheets prepared by the assistants in the Commission's secretariat. As a matter of fact there was hardly anybody in the Commission who had time to examine them except the Member Secretary.

Even in the case of State excise revenue, the First Report adjusted 50 per cent of the probable yield from State excise in the case of Gujarat and Tamil Nadu. This adjustment has been reduced to 30 per cent in the Second Report. But the normative approach should make full adjustment of the estimated revenue, not an arbitrary fraction of it. There is no argument mentioned in para 3.4 in page 7 as to why the Commission reduced the adjustment from the 50 per cent made in the First Report to the 30 per cent in the Second Report. Even this arbitrary reduction has not prevented a member from Gujarat from appending his dissenting note. In all fairness to him, he has not mentioned this issue at all in his minute of dissent.

As far as the non-tax revenues are concerned, by and large, the norms used by the earlier Commissions have been followed and we do not find any fault with these norms. They have also been, by and large, accepted by the State governments as reasonable.

Estimation of Non-Plan Revenue Expenditure

On the non-Plan revenue expenditure side, the Commission has used for the first time a normative approach to determine the normative level of non-Plan revenue expenditure of only general services, which includes interest payments, expenditure on maintenance, emolument of State government employees, pension and retirement benefits, elections and other services. Interest payments by and large are predetermined, and this expenditure for the years from 1990-1 to 1994-5 is projected at the rate of 12 per cent per annum. Expenditure on the maintenance of capital assets has been determined on the assumption that the States will reach the

normative level by 1994-5 i.e., graduated increase in the level of maintenance expenditure. In the case of non-Plan revenue expenditure relating to revision of pay scales of State government employees, the Commission has taken into account only basic pay scales. The Commission has compared the basic pay scales of Central and State government employees by making them comparable and estimated the additional expenditure required by each State to achieve pay parity. This is done upto 1986-7 only. After 1986-7 the non-Plan revenue expenditure has been projected upto 1989-90 by using average historical growth rates of all States adjusted partially for periodic revision of pay scales. The Commission has added additional expenditure as a result of revision of pay scales after 1986-7. The extent of adjustment is based on the standard number of employees at justifiable cost. For the period from 1990-1 to 1994-5 the Commission used a 7 per cent growth rate to project non-Plan revenue expenditure with a view to phasing out the revenue account deficit of the State governments. Thus the normative approach is used only to arrive at the level of expenditure upto 1986-7. Afterwards these levels are projected to match the revenue receipts.

Thus the Commission has estimated first the normative level of expenditure on general services and further adjusted that for standard justifiable cost. However, in the case of non-Plan revenue expenditure on social and economic services, the Commission has taken existing levels of services as given and adjusted them for the justifiable cost of providing the existing actual level of services. This exercise is done upto 1986-7. From 1986-7 the Commission has projected the non-Plan revenue expenditure on these services by using historical growth rates. In other words, the Commission has estimated the normative level of expenditure on general services and actual level of expenditure at justifiable cost on social and economic services for 1986-7 and this normative expenditure has been projected at the rate of 13 per cent per annum upto 1989-90, as against the actual historical growth rate of 14.5 per cent. Then projecting these expenditure levels from 1989-90 upto 1994-5, the Commission has used the growth rate of 7 per cent consisting of 4 per

cent inflation rate and 3 per cent real growth rate. According to the Commission's finding, the elasticity of non-Plan revenue expenditure to changes in 1 per cent price level is .75 per cent. Since they have assumed a 5 per cent rate of growth of price level, growth of non-Plan revenue expenditure on account of inflation would be about 4 per cent. The remaining 3 per cent is provided on the ground that it is slightly higher than the growth rate of population. The Commission has further phased out the movement towards normative levels of expenditure such that each State reaches the normative level by 1994-5. This has been done by reducing the estimated difference between the actual and the normative estimates for 1989-90 by 50 per cent. With the resultant figures as the base year estimates, the targeted full normative expenditures are to be attained in 1994-5. Details about this part of the confusing exercise are not made known.

Thus it can be observed that the Ninth Finance Commission has not really adopted an objective normative approach. Its main objective was to reduce the non-Plan revenue deficits of the State governments by 1994-5. In order to achieve this objective, the Commission has done all sorts of permutations and combinations of growth rates for different States such that the projected post-devolution non-Plan revenue budget for these States would show no deficit by 1994-5. There is absolutely no normative approach in this exercise. It is not even the earlier 'gap filling' approach. It is a hybrid of both.

It is true that enormous efforts were put into the estimation of tax potential and the normative levels of non-Plan revenue expenditure. But these exercises were not used to estimate the revenue deficits for the period 1990-1 to 1994-5. These levels of normative expenditures were compared with actual levels and they were modified in such a way as to achieve one sole objective of reducing the revenue deficits by 1994-5. In effect the normative estimates are used only as base year figures upto 1986-7. There is no normative approach in the projected estimates and what the Commission has done is worse than the trend growth method which the earlier Finance Commissions used to adopt in the 'gap filling' approach.

This is evident from Table 1 which shows the percentage of deviation from the normative expenditure under general services, social services and economic services. It also shows percentage of excess or shortfall in the tax efforts of major States. Under the normative approach those State governments which spend more than the average or normative level and raise less than the potential revenue should experience a deficit budget before devolution. Those States which spend less than the normative level and fully tap their revenue should experience surplus on the revenue account before devolution. And those states which spend more than the normative level of non-Plan revenue expenditure and raise more than potential normative tax revenue should experience either balanced budget or surplus budget, depending upon the relative percentage of higher level of expenditure and tax efforts. Such logical results are not found in the Commission's exercise. It may be observed that Andhra Pradesh, Gujarat and Kerala have experienced higher percentage of non-Plan revenue expenditure and tax efforts than the normative levels. But only Gujarat has experienced pre-devolution non-Plan revenue budget surplus. Further the percentage level of higher tax effort is more than the percentage level of higher non-Plan revenue expenditure in the case of Andhra Pradesh. Logically, therefore, Andhra Pradesh should have experienced pre-devolution non-Plan revenue budget surplus. But according to the Ninth Finance Commission's estimation, Andhra Pradesh has experienced pre-devolution non-Plan revenue budget deficit. Again in the case of Gujarat the percentage level of higher non-Plan revenue expenditure is more than the percentage level of higher tax effort and hence it should have experienced pre-devolution non- Plan revenue budget deficit. But the Ninth Finance Commission's reassessed pre-devolution non-Plan revenue account budgetary position of Gujarat shows surplus. What is more, Haryana, Karnataka and Maharashtra whose percentage levels of non-Plan revenue expenditure and tax efforts fall short of normative levels have experienced pre-devolution non-Plan revenue account budgetary surplus. We can justify the net budgetary position of Haryana as the percentage shortfall in its tax effort is more than the percentage shortfall

in the level of non-Plan revenue expenditure. But in the case of Karnataka and Maharashtra the percentage shortfall in non-Plan revenue expenditure is more than the percentage shortfall in the tax effort. Even then both these States face the stigma of pre-devolution non-Plan revenue account budgetary surplus in the judgement of the Ninth Finance Commission. How could these inconsistent results emerge? They cannot be explained away in terms of correspondingly opposite variations in non-tax revenue efforts. These awkward results have emerged because of the arbitrary manipulation of the calculations to benefit some States. This would mean that those States which have been spending above the normative level notably Punjab, Kerala and West Bengal have got away with a bonanza and those States which are not tapping their revenue potential like West Bengal, have been rewarded with substantial non-Plan budgetary deficit. Manipulation of calculations to favour or to punish states by the staff of the Finance Commissions' secretariat is no longer gossip but is boldly mentioned in private conversations. It is better to find out the truth in the interest of the States. The arbitrary way in which the First Report was prepared invited criticism. But the Second Report has silenced some States though it is worse than the First Report. The States which cannot be considered economically backward like Kerala and West Bengal get much higher per capita transfers than the States whose actual levels of expenditure are far below the normative level and the revenue efforts are just marginally inadequate. In other words, the normative approach has not prevented those States which have been spending excessively on non-Plan revenue account to get away with more financial transfers. This used to happen under the 'gap filling' approach because of the trend growth method used for projecting the future level of non-Plan revenue expenditure and tax revenue receipts. In the Second Report virtually the same results have been obtained by manipulating normatively estimated tax efforts and non-Plan expenditure levels. The rates of growth used for projections from 1986-7 onwards have been chosen arbitrarily and adjusted and readjusted so as to favour these States. Three States which have received a bonanza through these adjustments and readjustments are Andhra

Pradesh, Kerala and West Bengal. One State which has been penalised arbitrarily is Karnataka.

This becomes further evident if we compare the pre-devolution non-Plan net budgetary positions of major States as reassessed by the Ninth Finance Commission in its First and Second Reports. These are presented in Table 2. It may be observed that there is no consistency in the reassessed pre-devolution net budgetary positions of Gujarat, Karnataka, Maharashtra and Punjab. Gujarat which experienced Rs. 13.72 crore pre-devolution surplus in 1989-90 experiences Rs. 44.22 crore pre-devolution deficit in 1990-1. Karnataka which experienced Rs. 302.11 crore surplus in 1989-90 experiences Rs. 19.21 crore surplus in 1990-1. Punjab which experienced Rs. 128.58 crore surplus in 1989-90 experiences Rs. 204.50 crore deficit in 1990-1.

What is noteworthy is that Kerala's pre-devolution net budgetary deficit of Rs. 314.57 crore in 1989-90 increased to Rs. 590.42 crore in 1990-1, a little less than 100 per cent increase. Maharashtra's hefty pre-devolution surplus of Rs. 1304.54 crore in 1989-90 more than halves to Rs. 597.73 crore in 1990-91. West Bengal's Rs. 653.16 crore pre-devolution deficit becomes as much as Rs. 1076.42 crore deficit in 1990-1. How could such inconsistent and in some cases obnoxious results emerge from a normative approach ? It appears that the Ninth Finance Commission has used State - specific normative approaches and not one objective normative approach.

There is another issue involved in the Ninth Finance Commission's normative approach. It was asked to take into account the total revenue expenditure including Plan and non-Plan. The Commission, after a great deal of deliberations, decided to do so in the First Report itself. But because of the shortage of time and the non-availability of Planning Commission's projection of the revenue component of Plan expenditure, the Commission did some exercise to project the non-Plan revenue expenditure for 1989-90. But in the Second Report where it claims to have used the normative approach, the

Commission has not used any norms for projecting the revenue component of the Plan expenditure. No reason has been advanced for not doing it. Even assuming that the Planning Commission had not yet decided the total volume of Plan outlay and also the revenue component of the Plan outlay, the Ninth Finance Commission could have used the same methodology which it has used for estimating the non-Plan revenue expenditure on social and economic services. For reasons not clearly stated, the Commission has used a different and again obnoxiously arbitrary method.

The Commission has explained on page 27 that it "had to attempt determination of this item (i.e. revenue component of Plan expenditure), of need based on available data, past trends and our normative approach". The Commission has taken Rs.6,500 crore out of Rs. 7,200 crore of Plan outlay of 14 States in 1989-90 as the base and projected it at 7 per cent per annum upto 1994-5, thereby arriving at a total amount of Rs.40000 crore as revenue component of Plan expenditure for the period 1990-1 to 1994-5. This amount is distributed among 14 major States by using a formula. The Commission has explained this formula on page 133 in the following way:

> "In order to determine the shares of the different States, their per capita Plan revenue expenditures are estimated to range from a minimum of Rs. 325 for the State with the highest per capita expenditure (Gujarat), to a maximum of Rs. 425 for the State with the lowest per capita expenditure (Bihar). The difference in per capita non-Plan expenditure on social and economic services in 1994-5 between each State and the State with the highest per capita expenditures was first worked out. These differences were expressed as a ratio of the maximum difference obtained and then multiplied by hundred. The values obtained represent the additional amount of per capita expenditure required to supplement the minimum amount specified, i.e., Rs. 325."

This is only the first part of the exercise. The second part has been explained by the Commission on page 28 in the following way:

> "We assume that Gadgil formula assistance (total for all the 14 States) will grow at least at 10 per cent per annum from the 1989-90 base of Rs.1,450 crore. We have calculated that on that basis, these States can be expected to get Rs.10,000 crore grant under Gadgil formula (excluding ad hoc items like portion of additionality for externally aided schemes, hill area programmes etc.) in the Eighth Plan Period. We have divided that amount among the 14 States in the same ratio as the Gadgil formula ratio as applied to Seventh Plan allocation, (excluding the weight of 10 per cent given to special problems). We have taken the amounts so arrived at as approximate receipts available for the States' revenue Plan. To that we have added 40 per cent of the non-Plan revenue surplus of each of the States having such surpluses. The total of these two amounts, (only the Gadgil formula amount for deficit States), is set off against the minimum revenue Plan expenditure share of each State in the total Plan revenue expenditure of Rs.4,000 cores. The difference between the two shares is each State's deficit in the Plan revenue account. Fifty per cent of that deficit will, in our scheme, be given as grants under Article 275."

The rationale of this estimate of the revenue component of Plan expenditure has not been explained by the Commission. There were three methods open to the Ninth Finance Commission to estimate the revenue component of Plan expenditure. First, the Commission could have adopted the same arbitrary method used in the name of the normative approach for projecting the non-Plan revenue expenditure. Alternatively, the Commission could have taken the average percentage of the revenue component of Plan expenditure of all the States during the Seventh Plan Period as the base and projected it by using a

trend growth rate. (In fact the Commission has taken the revenue Plan expenditure of special category States for 1989-90 as the base and has projected it at 7 per cent per annum to arrive at the revenue component of the Plan expenditure for these States for the period 1990-1 to 1994-5). Third, the Commission could have requested the Planning Commission to do some exercise for the sake of the Finance Commission as otherwise there was no justification of having a member of the Planning Commission to serve as an ex-officio member of the Finance Commission. Probably, the Commission felt that all these alternatives would not fit into the objective of phasing out the revenue deficit or probably the Commission invented a method which has favoured some States and punished many other States.

What is surprising is that the Union Finance Ministry has accepted these estimates and the projections without understanding the implications. The whole exercise of estimating the revenue potential by using the modified representative tax system approach and estimating the levels of normative non-Plan revenue expenditure by using regression co-efficients has gone waste, because it has not been properly used for reassessing the non-Plan revenue budgetary positions of the State Governments. Probably, if the Commission had followed merely the 'gap filling' approach that would have made our understanding easy and the results would have been less arbitrary than what they are now.

Concluding Remarks

In this paper, I have confined my evaluation of the Second Report of the Ninth Finance Commission to the way the Commission has reassessed the pre-devolution non-Plan revenue budgets of the States by applying the much publicized normative approach. I have shown that the Commission has not used the normative approach objectively. I have highlighted the arbitrary adjustments introduced to arrive at the net budgetary positions of the States. I have also argued that in effect the Ninth Finance Commission has used a hybrid approach combining some elements of the normative approach

and of the earlier 'gap filling' approach. Adoption of such a hybrid approach has given rise to possible doubts of manipulation and therefore, the State governments should demand publication of all the calculations made by the Ninth Finance Commission for scrutiny by scholars in this country. The National Front government which has been more responsive to such openness in government should ask a group of experts to examine all the detailed calculations. Meanwhile, the recommendations which have been accepted by the new government should be made applicable to only 1990-1 as suggested by Justice Qureshi in his minute of dissent. Immediate action should be initiated to appoint a new Finance Commission consisting of men of unquestionable integrity. It would be safer to make it a standing Commission to make annual recommendations so that any deficiency in the recommendations can be rectified immediately in the following year.

I do not want to comment on the criteria of tax devolution and the other recommendations of the Commission. They are all a continuation of the earlier criteria with some minor modifications with a view to reducing the excessive weightage given to 'distance' and the 'inverse' of per capita income criteria. But reduction of the share in the Union excise duties from 40 per cent to 37.5 per cent for post-devolution surplus States is unjustifiable. Even the narration of the process of this reduction is confusing.

The non-Congress-I State governments' fears relating to extension of the additional Union excise duty arrangement to other commodities and creation of National Insurance Fund for financing relief expenditure have been allayed as the Ninth Finance Commission has recommended more rational alternatives. They are all welcome. But the most disappointing part of the recommendations of this Finance Commission is that it has used a mixture of all possible methods which confuse virtually everybody and this really exposes the incompetence if not nepotism of the Commission.

Table 1

Percentage Deviation of Actual Non-Plan Revenue Expenditure and Tax Revenue from Normative Level and the Net Non-Plan Budgetary Position of Major States

Major States	General services	Social services	Economic services	Total non-Plan revenue expenditure	Tax effort (1989-90)	Net non-Plan revenue budget position with devolution (Rs crore)
Andhra Pradesh	-1.14	-1.25	+3.96	+1.57	+7.89	-2286.25
Bihar	-27.02	-6.20	+26.89	-6.33	-9.49	-7095.38
Gujarat	+3.85	+2.59	+8.87	+15.31	+0.84	+568.26
Haryana	-2.28	-1.75	+0.59	-3.44	-4.46	+1374.00
Karnataka	-8.39	-4.00	-2.07	-14.46	-3.63	+708.77
Kerala	+0.29	+10.84	+17.02	+28.15	+3.96	-2916.81
Madhya Pradesh	+1.20	+3.68	-19.21	-14.33	-2.02	-5306.50
Maharashtra	+28.16	+8.11	-42.02	-5.75	-0.27	+5489.20
Orissa	+3.68	-24.35	+14.91	-5.76	-5.71	-4792.29
Punjab	+21.21	+13.49	-12.27	+22.88	-5.81	-114.77
Rajasthan	-14.66	-5.28	-18.81	-38.75	+13.17	-5100.22
Tamil Nadu	-2.92	-12.52	+7.16	-8.28	-7.09	-1712.12
Uttar Pradesh	-15.84	-6.65	-4.11	-26.60	+18.32	-14225.14
West Bengal	+0.63	+7.80	+10.35	+18.77	-10.80	-4678.98

Note: Plus sign indicates percentage higher than the estimated normative level and minus sign indicates percentage lower than the estimated normative level.

Table 2

Estimated Pre-Devoltion Non-Plan Revenue Budgetary Position of Major States as per First and Second Reports of the Ninth Finance Commission

(Rs. crore)

Major State	First Report 1989-90	Second Report				
		1990-91	1991-92	1992-93	1993-94	1994-95
Andhra Pradesh	-592.32	-473.98	-459.81	-446.96	-432.67	-472.83
Bihar	-411.05	-1360.17	-1350.17	-1400.45	-1453.42	-1531.17
Gujarat	+13.72	-44.22	+27.41	+106.03	+203.32	+270.72
Haryana	+128.83	+158.57	+206.87	+256.45	+337.42	+414.75
Karnataka	+302.11	-19.21	+54.37	+137.29	+231.71	+304.61
Kerala	-314.57	-590.43	-605.13	-580.62	-574.19	-566.44
Madhya Pradesh	-630.57	-932.07	-984.59	-1044.31	-111.96	-1233.57
Maharashtra	+1304.54	+597.73	+831.05	+1084.35	+1363.55	+1612.52
Orissa	-566.69	-803.71	-870.46	-945.05	-1028.16	-1144.91
Punjab	+152.58	-204.50	-109.50	-25.91	+64.77	+160.37
Rajasthan	-613.50	-849.67	-921.23	-1002.75	-1095.00	-1231.57
Tamil Nadu	-303.05	-582.49	-477.13	-352.87	-208.88	-91.35
Uttar Pradesh	-1232.78	-2377.83	-2570.42	-2790.64	-3840.95	-3445.38
West Bengal	-653.16	-1076.42	-1014.91	-988.16	-853.26	-746.23

Table 3

Relative Shares of Major States in the Total Devolution of the Finance Commission

State	Share as per Eighth Finance Commission's Report	Share as per First Report of NFC	Share as per Second Report of NFC
	(%)	(%)	(%)
Andhra Pradesh	7.74	6.60	6.83
Assam	4.03	4.12	3.73
Bihar	10.70	10.65	10.54
Gujarat	3.77	3.19	3.50
Haryana	1.11	1.21	1.13
Jammu & Kashmir	2.84	3.48	3.17
Karnataka	4.38	4.22	3.83
Kerala	3.27	3.01	3.25
Madhya Pradesh	7.50	6.69	7.40
Maharashtra	6.68	6.71	5.85
Orissa	4.84	4.53	5.21
Punjab	1.64	2.04	1.58
Rajasthan	4.25	4.77	6.16
Tamil Nadu	6.25	6.38	5.85
Uttar Pradesh	15.47	15.03	16.46
West Bengal	8.74	6.99	6.99

Ninth Finance Commission and the Criteria of Federal Fiscal Transfers

Dr (Mrs) Hemlata Rao

There are mainly two issues in the sphere of federal finance, the first relates to the distribution of resources between the Centre and the States and the second refers to the distribution of resources among the States. We refer to the first as the issue pertaining to vertical fiscal transfers and the second is called "horizontal fiscal transfers".

Regarding the vertical fiscal transfers, the Ninth Finance Commission does not appear to have departed much from the recommendations of its predecessors. The Commission has kept two basic principles in mind while suggesting vertical fiscal transfers. "(a) a fair apportionment of revenue resources between the Centre and the States, given their Constitutional responsibilities and the overall limitation of resources; and (b) the manner of transfer of resources to be such as to preserve fiscal autonomy of the States and to promote fiscal responsibility on the part of both the Centre and the States". Accordingly, the panel felt that 85 per cent of net proceeds of Income tax, and 45 per cent of Union excise duty should go to the States. Regarding additional excise duties, 1.90 per cent of net proceeds are retained by the Centre as attributable to Union Territories and the balance is given to the States. Further Rs 50 crore per annum are being recommended to be transferred to the States as grants- in-lieu of tax on railway passenger fares. Regarding financing of relief expenditure, the panel felt that the prevailing system needed to be replaced by a new system and accordingly, recommended that a calamity relief fund should be

constituted for each State. The Centre should contribute 75 per cent in the form of non-Plan grant and the remaining 25 per cent should come from the States' own resources. Approximately, Rs 604 crore are to be distributed among the States per annum under this provision. A sum of Rs 15,017.18 crore is proposed to be transferred to States in the form of grants-in-aid.

There are several issues which crop up in connection with vertical fiscal transfers such as the definition and scope of the concept of net proceeds of divisible taxes and duties, the question of including surcharge in the divisible pool, expansion of divisible pool by including a share in the ever expanding Corporation tax and a higher percentage share in some of the divisible taxes and duties and so on. This paper does not examine these issues[1]. The question of vertical fiscal transfers can be examined at length separately. This paper focusses on the second major issue in federal finance, namely 'horizontal fiscal transfers'.

The Ninth Finance Commission has several unique features, one of them pertains to the adoption of the normative approach in its horizontal fiscal transfer scheme. It is a welcome feature to make a departure from the traditional 'gap-filling' approach. However, a mere departure does not ensure superiority of the new approach. It is important to examine how objective and scientific is this normative approach, and also to see the nature and extent of fiscal transfers effected through this approach.

Normative Approach

There is a lot of discussion about the 'normative approach' adopted by the Commission. In its terms of reference it was stated "the Commission shall, (a) adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and Centre ......". The Commission has developed a normative approach according to which, "'needs' and 'capacities' of different governments are then taken as basis for determining the volume and pattern of federal

transfers". If we examine the various types of federal fiscal transfers, we find that this normative approach or the earlier 'gap filling' approach is applicable only in the case of distribution of 'grants-in-aid', which as per the present Commission constitutes just 14 per cent of the total federal fiscal transfers through the Finance Commission. This is also used as one of the five criteria of distribution of Union excise duty. Thus, application of the normative approach is limited to about 20 to 23 per cent of total transfers and the bulk of federal fiscal transfers i.e., 77 to 80 per cent of the transfers are not guided by the normative approach. Under these conditions, it is important to see if the Finance Commission wasted its precious time and money in evolving this approach and to analyse whether it was worth devoting so much of time, human resources and money on this, which is applicable only to a small portion of federal fiscal transfers.

Even if we assume that such a criterion is needed though it is applicable to a small fragment of total transfers, it is crucial to examine the method of deciding 'fiscal need' of the States. Many a time, what is a very interesting and exciting exercise to a pure academic researcher may prove disastrous when actually applied. The so called 'modified normative approach' is riddled with unrealistic unscientific assumptions of the 'Representative Tax System' approach which was tried out in the USA[2]. The system was called 'Representative' because in the U.S., all States did not have a uniform pattern of taxes. Therefore, the question of including certain taxes while estimating taxable capacity of different States cropped up. In an effort to make the system representative of current practices in the States, the criterion adopted by them was to include in the system any tax employed by States where more than half the nation's population lived. In the case of taxes on selected business activities which happened to be concentrated in a small number of States this criterion was modified to include any tax in use in enough States to account for more than half the potential tax base. The tax rate assigned to each tax included in the Representative Tax System(R.T.S.), was derived by dividing its aggregated State and local yield in 1960 by the aggregate base for that tax in all the

States. This procedure was equivalent to computing a weighted average of tax bases in each State, whereas the weights used were the aggregate revenues derived from each tax in 1960. For dealing with the problem of tax-base they had taken individual taxes. They selected 15 taxes and worked out the individual tax base for each State. Later on several studies cropped up using this method to measure taxable capacity or tax effort of States. A major shortcoming of this method is non-availability of tax data relating to actual tax bases.

The technical experts attached to the Ninth Finance Commission were aware of the shortcoming of the R.T.S. approach. As the tax system is very complex in the States, it was rightly stated in the Ninth Finance Commission Report that in the case of levy (first point, last point), the number of taxable points (single, double, multi-points) and the nominal rates revised vary from a minimum of six to twenty one in various States. The Commission admits, "In such a situation, obtaining data on the tax bases as also the tax yield from each of the tax rate categories becomes virtually impossible". In the absence of actual tax bases, some aggregation was derived and manageable groups were formed and proxies of tax bases were employed by the Commission. This method introduces strong biases and subjectivity of the `representative tax system approach' which they call the `modified representative tax system' approach. Further, the Ninth Finance Commission adopted different approaches to assess tax yielding capacity of different taxes. Thus, for agricultural taxes, projections are based on actual revenue figures and for other taxes like Sales tax, State excise and so on, they have estimated taxable capacity of the States by employing the model using pooled time series and cross section observations. Unlike in their First Report, they have made separate estimations for separate taxes. Here instead of taking a simple mean tax rate they had taken regression average tax rate. Further their model was a completely restricted one with both intercepts and slope parameters assumed to be common across the States. They have

liberally used proxy and dummy variables to get some results wanted by them. While assessing expenditure needs the Commission has adopted a different approach.

Criteria of Federal Fiscal Transfers Adopted by the Ninth Finance Commission

The total federal fiscal transfers recommended by the Ninth Finance Commission is as large as Rs 106062 crore over a period of five years, as against Rs 38,500 crore recommended by the previous Finance Commission. While States as one unit are getting a good share in the Centrally raised resources, it is important to see how this amount reaches the individual States. While formulating their scheme of distribution *inter se,* the Commission expresses, "the manner of transfer of resources should not tend to weaken fiscal responsibility and should ensure inter-State equity, i.e., the genuine basic needs of all the States should be taken into account along with differences in taxable capacity. Once assistance is granted on such a basis, it would be the responsibility of each government to balance its revenue budget". We have to examine whether the above considerations, viz., basic needs, taxable capacity and so on were incorporated by the Ninth Finance Commission in its scheme of devolution of income tax and Union excise duties.

The much advertised normative approach does not find any place in the scheme of devolution of Income tax. However, it does appear in the devolution process of Union excise duties, when the Commission set aside a portion equivalent to 16.5 per cent of States, share exclusively for distribution among the 21 States which were identified as deficit States according to the normative approach. We shall examine in the following section the criteria adopted by this Commission and examine if they are different from the earlier Finance Commissions' recommendations.

Devolution of Income Tax

The Commission recommended the following criteria:

i. 10 per cent on the basis of contribution; the remaining 90 per cent of the divisible pool of Income tax to be distributed *inter se* in the following manner;

ii. 45 per cent on the basis of distance of per capita income of the States from that of the State with the highest per capita income multiplied by 1971 population;

iii. 22.5 per cent on the basis of population (35 per cent of 90 per cent);

iv. 11.25 per cent on the basis of the composite index of backwardness as compiled by the Commission;

v. 11.25 per cent on the basis of inverse of per capita income multiplied by population of the State in 1971.

Devolution Criteria of Union Excise Duties

The Commission recommended that 45 per cent of the net proceeds of Union excise duties should be distributed among the States in the following manner:

1. 25 per cent on the basis of 1971 population.
2. 12.5 per cent on the basis of IATP i.e., income adjusted total population of 1971.
3. 12.5 per cent on the basis of the index of backwardness.
4. 33.5 per cent on the basis of distance of per capita income of State during the triennium 1982-3 to 1984-5 from that of the State having the highest per capita income, multiplied by 1971 population.
5. The remaining 16.5 per cent to be distributed among

the States with deficits, after taking into account their shares from Income tax, Excise duties etc. Distribution should take place on the basis of the proportion of deficit of each State to the total of all States' deficit worked out by the Finance Commission.

If we examine the above criteria it may be deduced that probably the use of population independently or as a scale factor is taken to denote the 'basic need' of a State and probably income adjusted population or 'distance' criteria are taken to measure taxable capacity. However, the Finance Commission does not say so in the Report, if these criteria do not represent 'basic need' or taxable capacity directly or indirectly, it is obvious that the basic considerations proclaimed by the Finance Commission in their scheme of devolution are totally ignored in their actual devolution scheme and if the Finance Commission assures that the above criteria indicate either 'need' or capacity of the State that would need further critical analysis. Population is generally taken as a measure of need. However, fiscal need of a State cannot be measured by population alone. Fiscal need is related to the functions of the State and all the functions are not directly related to population. Further, a State's need for resources arises due to various types of expenditure programmes which may be quite unconnected the total population. Thus, expenditure on irrigation, power, transport, industries, agriculture and so on does not depend upon the total population but on various other factors. Higher the expenditure on those developmental programmes, higher would be the need for resources. A State's need for resources also arises out of the 'capital assets created', whose maintenance cost puts pressure on the resources of the State. Thus, it is not rational to take 'Population' as the sole indicator of basic need of a State. When we talk of 'need' in the federal fiscal context, we imply States' need for resources. Even for a moment, if we accept population as a 'measure' of need, how logical is it to adopt 20 year old (1971) population figures to assess the fiscal need of the States. This point was brought repeatedly to the notice of the Eighth Finance Commission and

also of the Ninth Finance Commission. It was expressed that in case population was to be taken as a measure of 'need', the Commission should consider the latest available figure. This suggestion was considered important by the members of the Ninth Panel but in their scheme of allocation they did not incorporate it. The plea that the purpose of taking 1971 population is to discourage States to increase their population and to encourage States with better family planning programme implementation, does not appear quite logical. While it may be true at the national level that total increase in population is due to higher rise of birth rate, the same does not hold good at the subnational level where free inter-State migration is a common phenomenon, the States with higher development programmes attract labour along with their dependents from other States. This in-migration causes population to increase rapidly in some States. Further due to better health care and health planning some States have been successful in bringing down infant mortality and increasing longevity and this has resulted in increase in population. Lastly, wherever there is better administration, the law and order situation is good and peace prevails, it helps to increase population. Considering these basic factors, it is unfair to punish better managed and developing States for their developmental efforts. At least the future Finance Commissions should reject any such terms of reference where it is made compulsory to adopt outdated data. In my view if at all for some reason we have to take 'population' we should take the latest figures and not figures as old as 20 to 25 years.

The Ninth Finance Commission also like the earlier Finance Commissions has relied mainly on the population criterion. Though they have listed a few criteria like ITAP or inverse of per capita income multiplied by 1971 population or distance from highest per capita income States multiplied by 1971 population, etc., these are nothing but weighted population criterion. In fact, the weights are too small to make any dent on the criterion of pure population: the coefficients of correlation worked out for these criteria are found to be as high as 0.93. A comparison of different States' percentage share in the divisble

pool of Income tax and Union excise duties as per the present Finance Commission's recommendations with those of earlier Finance Commissions does not reveal a significant departure. It may be seen from Tables 1 and 2 that there is hardly any change either in the percentage share or in the relative share of major States in the divisible pool. Whatever little change is noticed in the case of Union excise duties, it is because of the fifth criterion, i.e., 16.5 per cent devolution to the deficit States.

It is interesting to observe that the Eighth Finance Commission had split the divisible pool of Union excise into two components; first, 40 per cent for all the States, and second, 5 per cent for the deficit States. The Ninth Finance Commission in its First Report followed the same procedure. It was brought to the notice of this Commission through my memorandum and also through my various articles that this is a wrong procedure. In its Second Report, the Finance Commission states, "We are making a departure from this and we propose to distribute the entire amount of 45 per cent as a consolidated amount without dividing it into two components of 40 per cent and 5 per cent".

However, if we critically examine the criterion adopted by the Ninth Finance Commission, we find that 16.5 per cent of 45 per cent of Union excise duties accruable to the States is exclusively kept aside for distribution among the deficit States. This 18.5 per cent works out to be 7.42 per cent of the total share allotted to the States. Thus, out of the 45 per cent share, while 37.58 per cent is distributed among all the States, 7.4 per cent is set aside instead of the earlier 5 per cent for the deficit States. This method violates the Constitutional requirement that in case the Parliament decides to share the Union excise duties with the States, the revenue should be distributed *inter-se* on some uniform basis. Under the present scheme, 21 out of 25 States are considered as deficit States on the basis of the defective 'normative approach' and 4 States are severely discriminated against. Karnataka happens to be one such State being the victim of the defective normative approach and the discrimination in the scheme of devolution of Union excise duties.

Coming to the criterion of 'backwardness', it appears as if the Ninth Finance Commission was under the pressure of completing the assigned task in a hurry. Perhaps due to pressure of time and lack of proper data, the Commission could not really construct a proper composite index of backwardness and had to be satisfied by adopting two indicators viz., relative share of SC/ST population and relative share of agriculture labourers in 1981. These two indicators were combined together and a combined index was estimated which was labelled as the 'composite index of backwardness'.

The use of the 'composite index of backwardness' is rational, but the definition of backwardness and its scope needs proper analysis. 'Backwardness' should represent the expenditure programme need of the States. The indicators chosen by this Commission do not really reflect the total programme need. The State does not spend only on the development of SC/ST population or on the upliftment of agricultural labourers. In fact such indicators are more relevant for social welfare planning and not for the devolution of federal resources. The programme need of the State is better indicated by the relative levels of development of productive sectors, economic infrastructure and social infrastructure. The lower the level of development of those indicators the higher is the need of the State for 'investible resources'.

In the scheme of fiscal devolution, one has to keep in mind the original spirit of 'federalism', the basic objectives of fiscal devolution and Constitutional arrangements. The claims of the States and their necessities should not be ignored. Otherwise, in due course, the very set up of the federal structure will be distorted and will give way to a unitary form of government.

To conclude, it may be said that the Ninth Finance Commission has properly diagnosed the fiscal problems of both the Centre and the States. We must appreciate the efforts made by the Commission to solve these problems through their innovative approaches and criteria of devolution. How-

ever, it is a different matter whether the prescriptions are suitable to the fiscal maladies diagnosed by the experts or not. Even if the prescription is not appropriate, the 'diagnostic' work of the Commission is commendable.

Notes

1. These issues are dealt with in detail by the author in her memorandum submitted to the Ninth Finance Commission.

2. Advisory Commission on Inter State Relations, USA, Chapter III, pp. 31-36.

Table 1

Per Cent Share of States in Income Tax

States	6th Finance Commission	7th Finance Commission	8th Finance Commission	9th Finance Commission First Report	9th Finance Commission Second Report
Andhra Pradesh	7.76(6)	8.021(5)	8.187(5)	7.3444	8.208(3)
Arunachal Pradesh	-	-	-	.066	.073
Assam	2.54(14)	2.521(4)	2.789(13)	2.507	2.631(13)
Bihar	9.61(3)	9.536(3)	12.080(2)	12.314	12.418(2)
Goa	-	-	-	-	.110
Gujarat	5.55(8)	5.957(8)	4.409(11)	4.232	4.550(10)
Haryana	1.77(15)	1.819(15)	1.074(15)	1.048	1.244(15)
H.P.	.60(17)	.595(17)	.555(17)	.505	.595(17)
J&K	.81(16)	.818(16)	.838(15)	.682	.695(16)
Karnataka	5.33(9)	5.440(9)	4.979(8)	4.937	4.928(8)
Kerala	3.92(11)	3.948(11)	3.760(12)	3.553	3.729(12)
M.P.	7.30(7)	7.354(7)	9.378(4)	8.000	8.185(5)
Maharashtra	11.05(2)	10.949(2)	8.392(3)	10.110	8.191(4)

Table 1(Contd.)

States	6th Finance Commission	7th Finance Commission	8th Finance Commission	9th Finance Commission First Report	9th Finance Commission Second Report
Manipur	.18	.188	.220	.181	.171
Meghalaya	.18	.178	.184	.183	.208
Mizoram	-	-	-	.059	.073
Nagaland	.09	.085	.088	.064	.096
Orissa	3.73(12)	3.738(12)	4.202(10)	4.054	4.326(11)
Punjab	2.75(13)	2.713(13)	1.744(16)	1.522	1.706(14)
Rajasthan	4.50(10)	4.362(10)	4.545(9)	4.773	4.836(9)
Sikkim	-	.035	.035	.028	.030
Tamil Nadu	7.94(5)	.258	.269	.269	.303
Tripura	.27	.258	.269	.269	.303
Uttar Pradesh	15.23(1)	15.422(1)	17.907(1)	18.326	16.787(1)
West Bengal	8.89(4)	8.015(6)	7.800(6)	7.539	7.976(7)
Total	100.00	100.00	100.00	100.00	100.00
Union Teritories					
(per cent of total)	1.79	2.19	1.792	1.044	1.437

Note:Figures in parantheses are ranks of the major States.

Table 2

Share of States in Union Excise Duties

States	6th Finance Commission	7th Finance Commission	8th Finance Commission	9th Finance Commission First Report		9th Finance Commission Second Report		
				40 %	5 %	40 %	5 %	45 %
Andhra Pradesh	8.16(4)	7.691	8.587	12.758	7.858	-	7.170(4)	
Arunachal Pradesh	-	-	-	-	-	.070	7.158	.897
Assam	2.71(13)	2.793	2.977	-	2.707	14.233	3.810(11)	
Bihar	11.47(2)	13.021	13.202	-	13.573	-	11.028(2)	
Goa	-	-	-	-	-	.074	1.695	.523
Gujarat	4.57(10)	4.101	3.506	-	3.109	-	3.183(13)	
Haryana	1.53(15)	1.777	1.017	-	1.077	-	1.099(17)	
H.P.	.63(17)	.521	.589	10.340	.549	10.031	1.943(15)	
J&K	.90(16)	.839	.856	15.457	.713	19.499	13.548(12)	
Karnataka	5.45(8)	4.876	5.077	-	5.092	-	4.104(10)	
Kerala	3.86(12)	4.035	3.800	-	3.707	-	3.087(14)	
M.P.	8.15(5)	8.725	8.852	-	8.726	-	7.224(3)	
Maharashtra	8.58(3)	6.632	6.216	-	5.635	-	5.185(9)	
Manipur	.21	.218	.233	6.969	.197	6.787	1.174	
Meghalaya	.19	.200	.194	5.575	.199	4.837	.891	

Table 2 (Contd.)

States	6th Finance Commission	7th Finance Commission	8th Finance Commission	9th Finance Commission First Report		9th Finance Commission Second Report		
				40 %	5 %	40 %	5 %	45 %
Mizoram	-	-	-	-	-	.065	8.199	
Nagaland	.11	.097	.096	8.837	.070	8.108	1.348	
Orissa	4.06(11)	4.662	4.592	9.214	4.454	5.806	5.358(8)	
Punjab	1.87(14)	1.226	1.317	-	1.310	-	1.362(16)	
Rajasthan	5.00(9)	4.813	4.695	1.940	5.097	3.946	5.524(7)	
Sikkim	-	.028	.039	1.659	.032	1.408	.260	
Tamil Nadu	7.43(7)	7.637	7.317	-	7.785	-	6.379(6)	
Tripura	.30	.373	.292	8.200	.295	8.293	1.556	
Uttar Pradesh	17.03(1)	18.290	19.097	-	19.877	-	15.638(1)	
West Bengal	7.79(6)	8.025	7.449	19.081	7.729	-	6.600(5)	
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	
Deficit States	-	-	-	11	-	13	-	

Notes: 1. Figures in brackets are the ranks given to major States.

2. 16.5 per cent of 45 per cent of U.Ex. exclusively for 21 deficit States - R.D. means that out of 45 per cent only 37.58 per cent is for all the States and the remaining 7.42 per cent is reserved for deficit States. This amounts to splitting of divisible pool of U.Ex. into two components.

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