Chapter VIII.

Criteria Governing Grants-in-Aid in India.

Basis for Unconditional (non-Plan) Grants.

The basic principles governing the distribution of Grants-in-aid recommended by all the Finance Commissions set up so far are broadly the same.(1) Strictly speaking, they have continued to follow the basis of distribution of federal financial assistance devised by Sir Otto Niemeyer who "proceeded from the premise that each Province should be so equipped as to be able to enjoy a reasonable prospect of maintaining financial equilibrium, and, in particular, that the chronic state of deficit into which some of the Provinces had fallen should be brought to an end, consistently with the condition of not jeopardising the solvency of the Centre".(2) After examining the budgetary position of different Provinces, Sir Niemeyer determined the extent of financial assistance required by them in order to enable them to close their estimated budgetary deficits and he recommended unconditional grants as residuary assistance after allocating all other forms of financial assistance. While estimating the 'overall fiscal need' of a Province, he took note of 'differences in administrative needs' which, Sir Niemeyer thought, could not be 'obliterated' by Central assistance on a basis common to all the Provinces. He treated grants-in-aid "as a form of residuary assistance for certain Provinces after taking into account the sharing of taxes and adjustment of debt", and to him, "any scheme of devolution, which sought to help the financially

weaker Provinces, involved subsidisation at the expense of the financially stronger Provinces". True it is that since the Niemeyer Award, the perspective has changed as a result of independence and the "new conception of close financial collaboration" between the Union and the States "on the basis of a national plan of economic development". It was no longer merely a question of "higher or lower standards of administration" in a restricted sense. The transition from a police state to a welfare state "brought about fundamental changes" in the scope of governmental functions and "resulted in widening the content of fiscal need". Nevertheless, the "basic overall approach" of Niemeyer "still remains valid" - the States and the Union have to "balance their budgets within their available resources and the needs of the States", which cannot be met by devolution of shares of taxes "have to be covered by grants-in-aid".(3)

This basic approach to the distribution of unconditional grants provided by Niemeyer has been accepted and adopted by all the previous Finance Commissions. All the Finance Commissions examined the previous budgetary position of all the States on their revenue accounts, obtained from their forecasts of receipts and expenditures for a period of five years to come or now the period to be covered by the next Five Year Plan, reduced these budgetary forecasts to comparable estimates by eliminating unusual and non-recurring items of receipts and expenditures and worked budgetary position of each State. After so determining the future

financial needs of the States, they first distributed the net proceeds from shared taxes (i.e., a share in the yield from income tax, a share in the yield from Union excise duties, and the entire yield from additional Union excise duties and estate duty), partly on the basis of origin of collection and partly on the basis of population. The budgetary deficits of any State still left unfilled were covered by recommending varying amounts of unconditional grants to such States.(4)

The Fifth Finance Commission (1969) was of the view that the problem of transfer of resources from the Centre to the States is "to strike a dynamic balance between the competing claims of the two layers of Government" and "to allocate the available resources between them" in such a manner that the needs of the country's welfare and development as a whole are served. While the States must be given enough funds to enable them to develop their human and material resources, transference should not also weaken the capacity of the Centre for meeting the compulsive requirements of national defence, emergency and overall needs of planned economic development.(5) The First Finance Commission attempted to evolve certain objective criteria for determining the quantum of grants for each State. But they did not go beyond listing a few guiding principles to this direction. These are budgetary needs, tax effort, economy in expenditure, standard of social services, special obligations and finally, broad purposes of national importance.(6) The Second Finance Commission considered these principles as "unexceptionable".(7) Subsequent Finance Commissions too have complied with these

principles in general, but have differed with regard to the factor on which the degree of importance has to be placed, and, in the case of later Commissions, the 'Terms of References' have provided for the framework within which recommendations under Article 275 have to be made.(8) The Third Finance Commission had recommended that the "total amount of grants-in-aid should be of an order which would enable the States, along with any surplus out of the devolution, to cover 75 percent of the revenue component of their plans".(9) This Commission was in favour of enlarging the functions of the Finance Commission so as to cover the entire scheme of assistance in its totality,(10) and it favoured an integrated view of Union-State finances in the context of developmental planning which required that no artificial distinction between plan and non-plan grants should be made.(11) However, the Union Government did not accept these views on the ground that under its terms of references, the Commission was not asked to consider the States' financial requirements for implementing their Plans as it was entirely assigned to the Planning Commission.(12) In short, the Third Finance Commission broadly accepted the budgetary gaps estimated by the States and thus endorsed the residuary budgetary gap basis enunciated by Niemeyer and certain broad criteria suggested by the First Finance Commission.(13)

The Fourth Finance Commission had maintained unhesitatingly that the "principles laid down by the previous Commissions are still valid and we agree with them except to the extent that we do not recommend the inclusion of plan

grants and special purpose grants in grants-in-aid".[14] The reason behind this sentiment was that this Commission thought that the "Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard" and, therefore, "it would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure".[15] This Commission recommended unconditional grants for ten States for a period of five years from 1966-67.[16]

The Fifth Finance Commission thought that "the emphasis must shift significantly from budgetary needs to broad fiscal needs" and it accordingly "tried to apply the principles laid down by the previous Commissions more extensively".[17] This Commission examined in detail the revenues raised by the States, their capacity to raise more revenues within the ambit of the constitutional allocation of revenue-sources, economy in various fields of expenditure, the efficiency of their public utility and commercial undertakings and their debt charges, and then, after allocating the tax-shares, it found that eight States were having budgetary surplus over the period covered by its recommendations.[18] Therefore, it recommended unconditional grants for the remaining deficit States.[19]

The Sixth Finance Commission too, followed the way covered by the previous Commissions for recommending grants-in-aid under Article 275, although this Commission improved to an extent so as to aim at equalizing certain essential administrative and social services among the States.[20] At the

outset, it distributed the tax-shares more or less on the same basis as did the previous Commissions with some modifications. After distributing the tax shares, it estimated the budgetary positions of the States. Then it made adjustments on the expenditure side by allowing for increasing the per capita revenue expenditure of each State on general administration, law and order, elementary education, medical and public health, welfare of scheduled castes and tribes and other backward classes, to all States' average per capita expenditure by 1978-79. Besides, it allowed for some increase in relief expenditure, expenditure on maintenance of capital assets and interest charges on existing debt. On the revenue side of the States' budgetary positions, the Commission adjusted for some reasonable reduction of tax arrears, earning reasonable rates of return from State Governments' undertakings such as electricity generation and supply, road transport and irrigation works. After that, it took into account the final budgetary positions of the States.(21) In its opinion, 14 states would be in budgetary deficits during the period covered by its recommendations and, accordingly, it recommended varying amounts of unconditional grants for those States.(22) Although "tax-sharing as such between the Centre and the States underwent some change in the hands of the Sixth Finance Commission, the major change effected by the Commission with respect to tax-sharing was an indirect one, namely, to reduce the relative role of tax transfers in the overall scheme of statutory transfers. The ratio of tax transfers to grants under the Commission's award for 1974-79

works out to be roughly 3:1 as against the corresponding ratio of almost 6:1 during the preceding five years, 1969-74".[23]

The Seventh Finance Commission (1978) considered that some of the principles governing grants-in-aid adopted by the First Finance Commission "were more in the nature of guidelines for the internal work in Commissions in the matter of reassessment of the revenue forecasts of the States" and "some related to areas which have since then become clearly established as being within the purview of the Planning Commission".[24] It is of the opinion that the "later Finance Commissions also had serious difficulties in the application of some of these principles", as for example, "measurement of the effects of economy and efficiency in expenditure, or assessment of the comparative tax efforts of the States".[25] In the present circumstances, this Commission prefers the following principles as relevant and appropriate for governing grants-in-aid under Article 275 :

(a) Grants-in-aid may, in the first place, be given to States to enable them to cover fiscal gaps, if any are left after devolution of taxes and duties, so as to enable them to maintain the levels of existing services and built their revenue forecasts. In this connection, consideration should be given to the tax effort made by the individual states in relation to targets for the Plan, to economy in expenditure consistent with efficiency, and to prudent management

of public sector enterprises.

(b) Grants-in-aid may be made as correctives intended to narrow, as far as possible, disparities in the availability of various administrative and social services between the developed and less developed States, the object being that every citizen, irrespective of the State boundaries within which he lives, is provided with certain basic national minimum standards of such services. While the long term objective may be to provide to each citizen these services at the levels obtaining in the most advanced state, due regard should be had to the feasibility of upgrading these standards in the shorter term.

(c) Grants-in-aid may also be given to individual States to enable them to meet special burdens on their finances because of their peculiar circumstances or matters of national concern.(26)

The Seventh Commission has "projected expenditure requirements on the revenue account in such a manner as to induce States to improve efficiency and to regulate expenditure carefully". It has taken 'prohibition' as a national policy and has recommended grants from the Centre to the States to cover losses of excise revenue. It has also recommended that the "net interest liability devolving on the States" in each year for the period covered by its Report "on account of their fresh borrowings and

lendings" should be "made good by grants to be calculated and paid by the Central Government".(27) In its view, "the role of a Finance Commission should not be negative, of filling in the revenue gaps only, but positive in that its scheme of devolution gives a better start for developmental outlay".(28) It suggested that the Finance Commissions should "deal with more of the transfers now being effected by the Centre at its discretion".(29) Under the substantive portion of Article 275, following its predecessors, this Commission recommend varying amounts of grants for eight States during the period covered by its recommendations.(30)

The above review of the basis of grants (unconditional) determined by different Finance Commissions under Article 275 of the Constitution shows clearly that the main principle of statutory grants-in-aid in India has been the relative non-plan revenue needs of the States concerned. The States' revenue expenditure are estimated on a comparable basis. Their revenue receipts are assessed on the basis of levels of taxation existing in a particular period. The gap between their revenue expenditures and receipts, thus assessed, is sought to be filled up by grants-in-aid (of statutory and unconditional nature) on the basis of recommendations made by the Finance Commissions. Any surplus after the tax-shares disqualified a State for grants-in-aid.(31)

Though there is nothing in the Constitution to exclude 'capital grants' from the purview of the Finance Commission, in practice, the recommendations of the Finance Commission relate to revenue expenditure (for non-plan purposes)

only.[32] The Chairman of the Fourth Finance Commission had observed that "there is nothing in the Constitution to prevent the Finance Commission to take into consideration both Capital and Revenue requirements of the States in formulating a scheme of devolution and in recommending grants under Article 275 of the Constitution".[33]

A reputed author has found the "seemingly simple approach" adopted by various Finance Commissions in providing grants under Article 275, suffering from "certain inherent defects".[34] First of all, the residuary assistance approach devised by Sir Otto Niemeyer was not based on a study of diverse needs and resources of the then Provincial Governments or disparities in their tax burden and service standards. Thus Sir Niemeyer only relied on certain broad impressions and confined himself to filling in financial gaps. The Finance Commissions in India have "overestimated the usefulness of this outmoded approach" and have "failed to develop" either an alternative approach "consistent with the socio-political objectives of the country" or adopt the usual approach of relative horizontal federal fiscal equalization through allocating the unconditional grants on fiscal need basis. Second, the budgetary gaps of different States estimated by the Finance Commissions for recommending grants-in-aid under Article 275 on the basis of the forecasts of revenue receipts and expenditures supplied by the States may not be free from "hidden unrealities" which are not noticed by the Finance Commission within a short period of time at its disposal.

Third, the Finance Commissions "appear to be very much concerned with the balancing of future budgets of the States by filling as far as possible their expected budgetary deficits" by unconditional grants. But the Finance Commissions "have no actual control" over the nature of the budgets of the States because the Finance Commissions 'disappear' as soon as they submit their reports. So long as they guarantee to fill the future budgetary deficits of the State Governments, there is no incentive nor a compulsion for the States to balance their budgets.(35)

The same author suggests that the States should be encouraged and also 'compelled' to follow "a cautious financial policy" and only when they cannot make both ends meet in spite of such policy, financial assistance should be provided "partly as an encouragement for their past prudent policies and partly to enable them to meet their peoples' expectations at least to a minimum extent". He further suggests that the Finance Commission should adopt "fiscal need" approach for recommending unconditional grants to the States. The Finance Commission should, at the outset, review the financial position of the Union Government to form an idea about the "quantum of revenue surpluses" which the Union Government "might be able to spare" for the States. Then the Commission should ask for the forecasts of revenue receipts and expenditures of all the States, scrutinise it and adjust it so as to make the forecasts comparable. Afterwards the Commission should estimate "adjusted fiscal need" of each State "excluding the devolution of federal revenues". Thereafter, tax-shares to all States should be

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recommended. Then the "gross revenue deficits" of the States may be worked out which may also be termed as "gross fiscal needs" of the States over a quinquennium - covered by the recommendations of the Finance Commission. In the next stage of estimating the "net fiscal needs" of the States, the Finance Commission should "assess the revenue efforts (tax as well as non-tax efforts) made by the States during the period of the "immediately preceding Five Year Plan". This is necessary to ensure that the States have exploited their sources of revenue fully in relation to their fiscal capacity. For this, the said author thinks, it is better to take "the additional revenue efforts" promised by each State and approved by the Planning Commission during the period of the immediately preceding Five Year Plan as a "standard required effort". If a state has failed to achieve the promised target of making its additional revenue efforts, "the extent of shortfall" should be "deducted on an annual average basis" from the "annual gross revenue deficit of that State". After that, the Finance Commission should make adjustments to the gross revenue deficits of the States from the expenditure side too. For this purpose, the Finance Commissions should determine a "standard level" of revenue expenditures of certain states "on certain essential public and social services" and then it should 'bring the levels of such expenditures' of other States to this "standard level". The Sixth Finance Commission, in fact, made a beginning for such a scheme. This Commission made 'adjustments' in the estimated expenditure of the States "for equalizing the per capita expenditure of all

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States" on essential public and social services like general administration, law and order, elementary education, medical and public health facilities and welfare of scheduled castes and tribes and other backward classes by 1978-79. To this same author, it is convenient to use "the method of Commonwealth Grants Commission" (of Australia) in this regard, that is, to use the "average of three or four richer States (in terms of per capita income) level of public and social services". It is better to try to equalize per capita revenue expenditure on general administration, police, justice, education, medical and public health, water supply and road communications - in a word, on items which fall within the purview of the Finance Commission and thus conflict with the Planning Commission in this field may be avoided. And thus, after estimating the standard level of per capita expenditure on those services, the Finance Commission "should find out the differences between the actual per capita expenditure and the standard per capita expenditure on each of those items." If the "standard per capita expenditure is equal to the actual per capita expenditure", no adjustment need be made to the "gross annual revenue deficit". If it is greater than the "actual per capita expenditure", the difference may be "converted into absolute amount by multiplying it by the respective States' population and be deducted from the average annual gross revenue deficit of that state". If it is less than the "actual per capita expenditure", the difference should be "converted into absolute amount and be added to

the annual gross revenue deficit" of the concerned State.(36)

After making all these adjustments to the gross revenue deficits of the States, it is feasible for the Finance Commission to arrive at the "final net revenue deficit of each State for each of the five years or the period covered by its recommendations" and this, according to the author, is the "true fiscal need of each State" which will have to be filled up by unconditional grants under Article 275.(37)

This is an important outlook no doubt towards the basis of grants under Article 275 and also method of its dispensation by the Finance Commission since this approach takes into account past revenue efforts, economy measures and future social needs of each state to bring its level to the level of the standard States. The Finance Commissions in future should try to reduce both vertical as well as horizontal federal fiscal imbalances. It has been pointed out that under existing arrangements, the Commissions have only tried to reduce vertical imbalance by recommending more and more amount of financial devolution from the Union to the States as a whole.(38) If federal financial devolutions (including grants-in-aid) are made on the basis of "net fiscal need" of each State mentioned earlier, horizontal imbalances may also be reduced in the Indian federal system.(39)

It has already been mentioned that while unconditional grants are provided in India by Centre to the units on the recommendations of

Basis for Conditional Grants.

the statutory Finance Commissions, conditional grants have come to be provided by the Union Government on the recommendations of a non-statutory Planning Commission under Article 282 of the Constitution of India. These grants have assumed discretionary character and are generally given for developmental purposes.(40)

Grants are provided by the Union Government in India under Art.282 to assist and encourage or stimulate the States' interest and activity in the field of economic development and these (conditional) grants are initiated and sponsored from above by the Centre to enable the State Governments to undertake developmental schemes which have been given priority in the Five-Year Plans.(41) In the financial relations between the Centre and the States in India Article 282 "has come to play a most significant part" and it is interesting to note that 'discretionary' grants under this Article "are given in the non-plan sector also".(42) Authors, therefore, aptly argue that in India, at present, "states receive three kinds of grants: statutory, non-statutory non-plan, and non-statutory Plan grants".(43) Statutory grants under the substantive portion of Article 275(1) of the Constitution are 'unconditional' and its purpose is to enable the States to meet their "revenue deficits" in order to avoid "large disparities in the standards of social services" and to provide for "special responsibilities of national interest which may be onerous to them". The "revenue deficits" are

Non-Plan Non-Statutory Grants Under Art.282.

ascertained by the Finance Commission in the light of forecasts of the States' non-plan revenue and their "expenditure on non-Plan items and committed expenditure on previous Plan schemes on revenue account". While non-statutory grants "are given by the Central Government" to enable the States to meet unforeseen expenditure and for Plan purposes. Both types of non-statutory grants are governed by Article 282.(44) The A.R.C. Study Team on Centre-State Relationships has recognised that though Article 282 "should not normally be used for giving non-plan grants" and though the "financial requirements of the States on the non-plan side should be met by assured grants under Article 275", yet "substantial non-plan grants" have been forming a significant percentage of "the total of all types of grants (statutory and non-statutory) passed from Centre to States".(45)

Statutory transfer of funds from the Centre to different States and the Criteria governing such transfers are well known. But substantial amount of funds are transferred behind the back of both the Finance and Planning Commissions "which are not yet subjected to Public scrutiny" and "one does not even know clearly what constitutes such transfers". The criteria of such grants are almost unknown.(46) These discretionary non-statutory, non-plan grants will be dealt with in detail in Chapter IX of the present study while considering the role of Article 282.

Plan grants, under the first three Five-Year Plans, were provided to the States on the basis of their

financial needs in relation to their plan outlays. The need of each State for plan grants was generally considered on the basis of its population, area, the extent of development already reached, development projects undertaken etc. Broadly speaking, plan grants were provided to each State to fill the gap between the States' plan outlay approved by the Planning Commission and the States own financial resources available for Plan purposes.(47) The distribution of assistance, however, "did not follow any clear-cut principle".(48) It appears that in the initial years of Planning, there were many complications in regard to the enumeration of schemes and determination of quantum of assistance, and also there was confusion and delay in regard to the disbursement of the grants to the States but constant pressure from the State Governments for introduction of certain "objective criteria" instead of "simple uniform percentage" resulted in the placing of the question before the National Development Council.(49)

Plan Grants Under Art.282.

The views of the States were discussed by the NDC in August, 1966, but "no agreement could be reached" in the NDC "which asked the Planning Commission to evolve a set of principles in the light of the discussions in the Council". The Planning Commission, therefore, subsequently "drew up some guidelines for determining the amount of Central assistance for the Fourth Plan", which, however, "was eventually postponed for three years". The Central assistance

for 1966-67 and 1967-68 was made on an 'ad hoc basis'. But some States did not get their share. In the assistance for 1968-69, these States "got a part of their share on account of the previous two years". When the preparation of the Fourth Plan was taken in hand afresh, "the Planning Commission felt that it would be proper to re-examine the principles underlying the distribution of Central assistance to States". Accordingly, the State Governments were asked "to give their views" on this matter. Each State "gave a principle which would suit it most". The more populous of the States wanted 'population' as the basis for a major portion of the assistance while the less populous ones were 'opposed' to it. The question was placed before a "Committee of Chief Ministers" of the NDC. After meeting in two stages in July and September, 1968, the Committee came to a decision which formed the "basis of allocation of Central assistance" for the Fourth Plan.(60) The outcome of this Committee is known as the "Gadgil Formula".(61) In the opinion of M.J.K.Thavaraj, "with the emergence of non-Congress Governments in some States after the general election of 1967, the problems of Central assistance for plan schemes attracted serious attention. Parties belonging to different persuations assumed office at the State level. They began to challenge Central dominance and control in resource allocation ...... when parties with different ideologies, approaches and priorities occupy the different layers of federal polity, any attempt on the part of the Centre to impose its will over the States by attaching politically motivated conditions to (discretionary) grants would be

untenable and intolerable. The heat that was generated around this issue, therefore, prompted the National Development Council to set up a Committee to evolve an equitable formula of plan assistance acceptable to all the States".(52)

Under this 'Gadgil Formula', it was decided that "after providing for the requirements of the States of Assam, Nagaland and Jammu and Kashmir, the Central assistance to the remaining States for the Fourth Plan be distributed to the extent of 60 per cent on the basis of their population, 10 per cent on their per capita income if below the national average, and 10 per cent on the basis of tax effort in relation to per capita income, and that another 10 per cent be allotted in proportion to the commitments in respect of major continuing irrigation and power projects. The remaining 10 per cent, it was decided, should be distributed among the States so as to assist them in tackling certain special problems, like those relating to metropolitan areas, floods, chronically drought-affected areas and tribal areas".(53)

Since then, this formula has been the guiding principle for providing plan grants, and the Union Government in consultation with the Planning Commission decides the total amount of financial assistance which it can provide annually over five years. It also decides the proportions of block grants and loans in this total assistance and then the share of each State is calculated in terms of those criteria. Detailed sectoral planning and execution of individual schemes and projects have been left to the State Governments.(54)

On February 25, 1979, after a meeting of the National Development Council at New Delhi, the States accepted the then Prime Minister Morarji Desai's "award" regarding distribution of certain Plan grants.(55) Mr.Desai's award, "given and accepted when the States were unable to agree on any of the alternatives before them", is that the "Gadgil formula will be applied for the remaining four years of the Plan regarding the Rs.4,300 crores due to them under the Seventh Finance Commission recommendations".(56)

"For the Rs.2,000 crores that have become available as a result of dropping some Centrally-sponsored schemes,(57) the formula to be adopted will take into account the poverty level of the States by multiplying the population by the inverse of the per capita income".(58)

This arrangements, known as the "Income-adjusted-to-total-population" formula, would, therefore, go along with the Gadgil Formula and would benefit "five States - Bihar by Rs.76 crores, Madhya Pradesh by Rs. 8 crores, Orissa by Rs.23 crores, Tamil Nadu by Rs.19 crores, U.P. by Rs.82 crores and West Bengal by Rs.2 crores - compared to the amounts that would become available to them if the Gadgil formula had been applied to the Rs.2,000 crores also".(59)

However, the Planning Commission retains some 'discretion' in the manner in which the Gadgil and "Income-Adjusted-To-Total-Population" formulae were scheduled to be implemented. The annual Plans of the States for 1979-80 had

been finalized on the basis of the Gadgil formula in respect of the amount due to them, as if the Centrally-sponsored schemes had not been dropped. It was decided that "marginal changes" would be made to "take into account the Desai award which will continue to be applied until 1982-83".(60)

The Rs. 2,000 crores would, "under the IATP formula, be divided as follows, among the 14 States to which the Gadgil formula applies: Andhra Pradesh Rs.161 crores, Bihar Rs.300 crores, Guzrat Rs. 81 crores, Haryana Rs.25 crores, Karnataka Rs. 96 crores, Kerala Rs.77 crores, Madhya Pradesh Rs.184 crores, Maharashtra Rs.123 crores, Orissa Rs.86 crores, Punjab Rs.29 crores, Rajasthan Rs. 103 crores, Tamil Nadu Rs. 150 crores, U.P. Rs. 424 crores and West Bengal Rs. 147 crores".(61)

Anyway, one thing seems to become clear from the study of the criteria governing Plan grants under Article 282, that the basis for such grants in India has not yet been statutorily assured, and although some sort of objective criteria may be discernible in this respect since the Fourth Five-Year Plan, an element of discretion still lies with the Planning Commission - a central agency. Central Ministries too may easily play vital parts in this respect. This, no doubt, attracts serious attention especially in view of the large quantum of Plan grants which have been distributed by the Planning Commission during different Plan periods.(62) And, therefore, Article 282 appears to be imbued with enormous potentialities to mould the balance of power in the Indian federal system.

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