CHAPTER IX

DEVOlUTION OF REVENUE: GRANTS-IN-AID

Introduction

Grants-in-aid, as a fiscal instrument for enlarging the financial resources of smaller units of government is becoming increasingly common in all parts of the world, more particularly under a federal set-up of government. In a federal system with its complex economic relationships, it has not been found possible to maintain the theoretical conditions that each unit of government should raise adequate resources for the administration and performance of functions assigned to it. There arises, as already noticed, a disequilibrium and lack of balance between the financial capacity and financial needs of the regional governments. This imbalance results from various factors, e.g., area, climate, topography, natural resources, size of population, productive capacity and levels of income and expenditure. There may also arise differences among the units in the average rate of economic growth. This difference among the economies of the units gives rise to fiscal inequalities. These inequalities operate in different ways: capacity to raise revenue, capacity to provide services to the people. The scheme of federal finance seeks to provide for the disparities among the regions so that the less-developed areas are helped by transfer of finances to them, to come to a comparable level with the more advanced regions, otherwise there develops jealousies and tensions in the body politic. Therefore, in every federation, it has come to be recognised that a process should continuously be working so as to enable each unit to provide comparable social services, at a comparable tax incidence vis-a-vis the other unit. 1

'Tax sharing' and 'grants-in-aid' are the two most common techniques which are adopted for the transferring of funds, usually from the Centre to the States (Units) for augmenting the resources

of the States, according to their various needs, so as to bridge, as far as possible, the gap between their fiscal capacity and capacity for administration. Such transfer of funds may be statutory or discretionary. 'Tax-sharing' and the 'grants-in-aid' differ, however, in certain basic aspects. The former usually involves a certain percentage of the proceeds of some specified taxes, levied and collected by the Centre to be transferred to the States and as such the quantum of the amount to be transferred depends upon the total yield of such taxes to the Centre. Grants-in-aid involve the payment to the States certain sum of money according to their financial needs. Grants, therefore, depend upon the entire revenue position of the Centre to spare those amounts for being paid to the States. The chances of fluctuations in the amount transferred are, relatively more in the case of tax-sharing than in grants-in-aid. Secondly, looking from the objective of an accelerated rate of economic growth through the process of economic planning, aiming also at reducing regional disparities, the device of grants-in-aid appears to be more suitable than that of tax-sharing. This is because, whereas the proceeds of the shared taxes become the part of general revenues of the States, certain amount of conditions of specificity could always be attached to the grants-in-aid in order to influence the determination of the economic policies of the States. When viewed from the point of autonomy of the States, the technique of tax-sharing stands on a better footing than the device of grants-in-aid.

**Purpose of Grants-in-aid**

Grants-in-aid is an effective instrument for bridging the gap between fiscal capacity and capacity for administration. They constitute an important technique for making inter-governmental financial adjustments in a federal system. Grants have different aspects. These do not constitute a system and indeed they were never intended to make up a system. They are introduced for different purposes under different system of governments. The American Commission on inter-governmental relations gave several explanations for the growth of grants-in-aid in the United States.

2. Ibid.
The Commission observed that the grants were developed as means of supporting minimum standards of services in all State Governments. That they have been used as a stimulating device to encourage the States to launch or expand a particular service. Another reason would be to compensate the States for the incidental financial effects of federal policies. In Australia, from where the idea of 'fiscal-need grants' is borrowed by other federations, the object of such grants has been to strengthen the financial position of the Commonwealth in view of possible contingencies. The basic principle of these grants as expounded in the report of the Commonwealth Grants Commission, 1936 was as follows:

Special grants are justified when a State through financial stress from any cause is unable efficiently to discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.

The Commission sought to assess the sums necessary to bring the claimant States to a basis equivalent to that of the non-claimant States. Thus the purpose of the grants was to bring the standards of social services in the claimant States to a corresponding level in non-claimant States. The Canadian federation presents similar features. There the grounds on which fiscal need grants were sought were 'equality of treatment', which could mean unequal treatment of unequals in order to achieve equality. This idea of 'equality of treatment' was in view when in 1937, the Rowell-Sirois Commission was appointed to examine, inter alia, the financial arrangements for the federation. It was argued by the Provinces before the Commission that 'fiscal needs' "are but a measure of the national interest", that each Province should be enabled to maintain a 'normal' Canadian standard of services, that all citizens were "entitled to the same standard of living as


permits in rich provinces." The Rowell-Sirois Commission in their Report of 1940, designed national adjustment grants "to enable a province to provide adequate services at the average Canadian standard." These grants were obviously modelled closely on the system of 'special grants' operating in Australia under the recommendations of the Commonwealth Grants Commission. The Commission also recommended emergency grants for meeting the short-term requirements of needy Provinces, intended to enable a Province "not only to protect its standards in social services, but also to improve them at the average pace maintained by the Provinces as a whole." The grants, thus, have gone some way towards meeting the demands of the Provinces for an equalization of fiscal standards throughout the Canadian federation. The rationale of grants-in-aid in these federations thus, has been to achieve 'social equalisation' by reducing the regional economic imbalances.

The framers of the Indian Constitution, having been influenced by the role of the Central grants, as played in other federations, included adequate provisions for the purpose. The principles on which the grants are to be made, are formulated by the Finance Commission. The approach of the successive Finance Commissions in this respect has been based on the objective of inter-State equalisation. They have kept two main purposes in their mind while recommending grant-in-aid to the States, namely, to augment the States' own limited resources so as to help them meet their expanding need for expenditure as far that can be done from surpluses of the Union and secondly to assist adequately the States with comparatively less capacity to raise resources, so as to avoid large disparities between them. The Commissions have been guided by two main considerations, that of covering the fiscal gaps to enable the States to maintain

6. Id. at 125.
7. Report, Book II, 44.
the levels of existing services and to narrow down the disparities in the availability of various administrative and social services between the developed and the under-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.8

As far the relative role of the grants-in-aid in the scheme of financial assistance by the federal government, there is no clear lead in the experience of classical federations of United States, Australia and Canada. There being no single system of universal applicability in regard to this sector of federal financial relations. Each country appears to have found for itself the system or combination of systems that best fits the facts of its political, economic and administrative conditions. Yet, the most important factor that has influenced the policy in the field of these grants, is the development of particular services and activities, which are felt to be of national concern, to attain certain minimum standards. That is true also about the developing federation of India.

Types of Grants

Broadly, the grants-in-aid from the Centre to the States may fall into either of the two categories, viz., (a) general or unconditional grants and (b) specific purpose or conditional grants. The former type of grants cover the transfer of funds in order to assist the States financially for an efficient performance of their assigned functions. The grant so made becomes a part of the general revenues of the States receiving them and can be utilized for any purpose considered appropriate by the respective States. Such grants are, therefore, called unconditional as no conditions are attached by the Centre while making the grants.

Specific purpose or conditional grants, on the other hand, are made for the performance of certain specified functions and the amounts so transferred are applied only on those functions or programmes. Besides this condition, other conditions may also

8. See infra.
be attached to such grants by the Centre. Sometimes the grants may be made with an understanding that only a proportion of the total cost of the specified scheme-project would be put up by the grant giving authority, i.e., the Central or Federal Government, provided the other proportion is met by the grant-receiving State. Such specific grants are known as 'matching grants'. Such grants are given for a definite programme and the Central Government meets a definite proportion of the cost of that programme. Thus, by this device a part of the responsibility is left in the hands of the State Government concerned. The matching grant exercises a double stimulus to action. The grant itself provides funds to the State that is to administer the spending. At the same time, the State that receives the grant is encouraged to furnish financial support for a service that it would presumably have otherwise left unperformed. The Central Government uses this type of grant when it desires to exercise control and direction over the schemes, though pertaining to the State field. The philosophy underlying such grants is that though the activities concerned are best administered at the State level, but federal government should try to promote their expansion and improve the quality of these services by participating financially in these projects. Thus the federal government is able to initiate common policies of development and coordinate the divergent state policies with a view to ensuring overall sound development of services. According to Dr. B.N. Ganguli, "the supreme advantage of conditional grants is that it enables the federal government to control expenditure with a view to activising the development of certain social services or raising the standard of existing services or otherwise ensuring, as far as possible, uniformity in the standard of public services provided by the states." In the

9. In Canada, such grants are known as "shared-cost programmes".
10. Usually, the cost is shared by both levels of government on 50:50 basis, though in a number of cases, variation in the proportion is also made.
words of Musgrave, "the objective is to give an incentive by way of matching grants to all States to raise their tax and service level." 13

The matching grants have been greatly in vogue in United States, Canada, Australia and India and they have contributed largely towards social and economic development and are regarded a vehicle for bringing about new country-wide social and economic advancement. In a developing economy, like India, suffering from the lack of resources, the principle of 'incentive' underlying such grants needs to be given more importance so as to encourage the States to make more resource mobilizing efforts. The First Finance Commission rightly emphasized that the extent of self-help of a State should determine the eligibility, as well as, the amount of help from the Centre. 14

The system of matching grants, however, suffers from some drawbacks. Such a system distorts the budgets of the State Governments and undermines their autonomy. The State Governments are tempted by offers of such grants and devote their own resources to the centrally-framed schemes, and sometimes ill-advised or immature schemes are executed under the temptation. For fear of public criticism the State Governments dare not to reject the scheme on the ground of want of resources. Besides, under pressure to achieve too much, some of the States may take to unsound methods of financing. This will be specially true of backward or underdeveloped States, which left to themselves might not have spent much out of their own resources on assisted schemes and which are now led to spend much more, neglecting their most essential duties of security, etc., which are not assisted. There, thus, develops a tendency to concentrate on services

However, the technique of matching grants occupies an important place in federal financing and it should be so utilized that conditional and unconditional grants supplement each other depending upon resources of the Central and State Governments and the requirements of moderating regional inequalities in the level of welfare.

There is another kind of specific grants known as 'Block Grants'. Such grants are made for specific but a broad purpose without any further details. These provide certain amount of freedom to the receiving States in the utilization of the funds on any item within the specified field.

In the context of economic planning, the specific grants have been categorised as development grants or plan grants. Such grants may be made both in the form of matching grants and block grants. The general grants or the unconditional grants in distinction to the specific grants are called non-plan grants.

There is yet another type of grants known as 'compensatory grants', which are given to the States to compensate them for the loss of revenue arising out of transfer of some sources of revenue from the States to the Centre or to compensate them for the loss resulting from any changes made in the basis of tax-sharing. Such grants are unconditional or general in nature.

We have thus noticed that 'general grants' are usually given to secure an equitable allocation of resources of the Constituent units so as to assist them financially for an efficient performance of their assigned functions. Whereas, the 'specific purpose grants' are made in most of the federations, to serve three
important purposes. Firstly, these are made to enable the units to put up the additional financial burden arising out of undertaking some additional obligations, statutory or voluntary. Secondly, they are made with a specific purpose of advancing certain economic and social services in the constituent units which without the financial help of the Centre, they may be unable to undertake. In India, these objectives are sought to be achieved through Plan grants. Thirdly, specific grants may also be given to help the relatively underdeveloped units to enable them to improve their administrative, economic and social services, so as to bring them at par with those of the relatively developed units. This purpose is also kept in view by the grant-making authority while making general grants-in-aid.

Grants-in-aid in India

The system of grants in India has had a fairly long history. Prior to 1919, grants to Provinces were a marked feature of financial system operating in India. The Provinces had no revenues of their own and were sustained entirely by grants made by the Centre. The system was rationalised in the scheme of 'Provincial Financial Settlements' which was further developed under the reforms of 1919 when enlarged grants to the Provinces were provided by the Devolution Rules enacted under the Government of India Act 1919. The first statutory provision for grants was, however, made under Section 142 of the Government of India Act 1935, under which grants-in-aid were given to the Provinces in need of assistance. These grants were prescribed on the basis of the Niemeyer Report, 1936.

Sir Otto Niemeyer recommended the provision of annual Central grants to the Provinces of Assam, North-West Frontier Province, Orissa and Sind, for the purpose of setting their finances on 'an even keel'. Under his award, too much emphasis was put on the need of securing budgetary equilibrium in the Provinces. He took an integrated view of the finances of the Centre and the Provinces and recognised that any scheme of

17. See Supra Chapter III.
devolution which sought to help the financially weaker Provinces, involved subsidisation at the expense of financially stronger Provinces. He also marked the differences in the fiscal capacity and fiscal needs of the Provinces and recommended a certain measure of corrective in the form of debt-adjustment and unconditional grants-in-aid either fixed or tapering. Sir Otto treated grants-in-aid as a form of residuary assistance for certain Provinces after taking into account the sharing of taxes and the adjustment of debts. This scheme continued till 1947 when the system became out of tune with the expanding needs of the States.18

Beside these unconditional grants, special purpose and sometimes conditional grants were also made by the Centre from time to time by using its own power under Section 150 of the Government of India Act 1935. For example, in 1942 the Centre made a three-year grant to Bengal, as its contribution towards relief and rehabilitation, on account of a famine of unprecedented magnitude, which affected the Province. After 1943, when the problem of food shortage became very acute because of war-time expenditure, the Food Grants Policy Committee recommended grants, which were paid under the 'Grow-More-Food Campaign', for the extension of irrigation facilities, land clearance and improvement. The underlying objective was to produce the maximum quantity of foodgrains at minimum cost, irrespective of regional consideration.19 After partition in 1947, Central grants were given to the Provinces of West Bengal and East Punjab for the purpose of helping them in meeting their financial difficulties.

The Constitution of India, originally, contained a system of grants under Articles 273, 275, 278 and 282. The grants under Article 273 being compensatory in nature, were paid to four jute-growing States of Assam, Bihar, Orissa and West Bengal, in lieu of

18. Ibid.
their share in the net proceeds of export duty on jute and jute products. These have become obsolete with effect from 1960 as provided in Clause (2) of the Article itself. Article 278, which originally dealt with 'revenue-gap grants' for a transitional period mostly to Part-B States, was repealed by the Constitution (Seventh Amendment) Act in 1956 on the reorganisation of the States. Article 282 permits the Union or a State to make grants for any public purpose notwithstanding the fact that the purpose is not one with respect to which the Parliament or the State Legislature, as the case may be, may make laws. These grants fall in the category of 'miscellaneous financial provisions'. These have grown enormously in the context of the Five Year Plans and are made under the plan proposals on the recommendations of the Planning Commission and are, thus, outside the purview of the Finance Commission. These grants are known as non-statutory grants or Plan grants.

Article 275 remains the only mechanism for the transference of financial assistance under the head of 'revenue grants' from the Centre to the States, so far as the Finance Commission is concerned. It provides for both 'general or unconditional' grants to such States 'as the Parliament may determine to be in need of assistance' and 'specific block grants' to a State in the form of capital or recurring sums as provided in the first proviso to Clause (1) of this Article. The second proviso to this Clause says of the block grants-in-aid to be paid to the State of Assam for the purpose of raising the level of administration of certain areas of that State. The grants under these provisos have been in the form of financial assistance to the States for the welfare of scheduled tribes and the development of scheduled areas and also for the backward classes. The provision requires the schemes, under which these

20. The Clause provided: "The sums so prescribed shall continue to be charged on the Consolidated Fund of India so long as any export duty on jute or jute products continues to be levied by the Government of India or until the expiration of ten years from the commencement of this Constitution, whichever is earlier."

21. See Provisos to Clause (1) of Article 275.
Grants are made, to be approved by the Government of India. The grants under Article 275 have been confined to revenue budgets of the States only, though, these may be provided for both their revenue and capital budget requirements. Further such grants have been made for meeting mostly, though not entirely, the non-Plan budgetary gaps of the States.

Article 275 lays down no criteria or purpose for judging whether a State is qualified to get the grants. However, it requires the Parliament to determine the States in need of this assistance. The quantum of grants made under this provision and the principles on which it is based, are determined, under Article 280, by the Finance Commission, who make recommendations to the President in this respect. This Article occupies the most important place among all the provisions relating to grants-in-aid and is described by a learned author to make the Union 'the mother of grants'.

Grants-in-aid Under Article 275

The grants-in-aid are indicated when a State cannot raise enough resources by an 'adequate' tax-effort coupled with receipts from shared Central taxes, to provide an adequate standard of public services. The intention behind the constitutional provision thus appears to be that 'the financial transfers should be so organised as to give to each State according to its fiscal needs'. The fiscal need of a State is essentially related, on the one hand, to the range and level of fiscal activity of a State Government and, on the other, to the availability of its own resources. Accordingly, the authority, responsible for determining financial assistance to States must be able to have a close scrutiny of the existing position of the States finances on the one hand, and a judgement as to the appropriate scale of fiscal operations of State Governments on the other. Discrimination in the matter of making grants would not be unconstitutional, for, grants under this provision, to financially weaker States in need of assistance, cannot but be

discriminatory in nature. Obviously, the issues involved here are of fundamental importance as they touch upon the basic philosophy of fiscal federalism. Though, the centralising power of federal grants impinges on the autonomy of the units in a federation, yet "the units cannot be allowed to continue in a state of disease, squalor, ignorance or even bad roads", and, therefore, not only the affected units but also the whole nation must bear the cost of such destitution since all are members of the same Union. The basic importance of the approach of the Finance Commission in recommending these grants is clearly brought out by all these considerations. The Fourth Finance Commission, in this context, observed that a State might apparently have a comfortable budgetary position simply because of low level of its public expenditure. On the other hand, a State may slip into budgetary deficits due to inadequate resource mobilisation or extravagance in expenditure. Therefore budgetary needs of different States as well as the amounts of grants assistance recommended, will be different if worked out to achieve the inter-State economic equalisation than those calculated in the absence of any such objective. The first important task before the Finance Commission, therefore, is to define the objectives to be achieved through such assistance. The scope of the work of the Commission, in this respect, is circumscribed by the following considerations:

1. Grants under Article 275 are grants-in-aid of the revenues of the States, hence they are unconditional grants.

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24. Dr. Diwan, 111, quoting J.N. Sharma, Union and the States, 92.
25. The Government of India also makes discretionary grants-in-aid for specific purposes under Article 282. But here we are concerned with the grants-in-aid made on the recommendations of the Finance Commission.
(ii) Grants may be given only to States which are in need of them;

(iii) Different sums may be given to different States.

(iv) Grants are revenue grants, hence they exclude capital grants which are granted under Article 282. So to say, the grants under Article 275 are called non-Plan grants.

(v) Provisos to Clause (1) of Article 275 exclude the jurisdiction of the Finance Commission with respect to specific block grants to be made for specified purposes.

**Principles for governing grants-in-aid.**

Article 280(3) enjoins the Finance Commission to determine the principles which should govern the grants-in-aid of the revenue of the States. This requires the Commission to determine the States that would be in need of grant assistance for the quinquennium under reference and the quantum of such assistance in each case. It is the most difficult task that the Commission is required to accomplish as it involves a judgement on the fiscal management of the States. In doing so, the First Finance Commission enunciated various principles which should govern their recommendations regarding grants-in-aid to the States. The Commission recognised first that since the basic purpose of these grants was to recommend adequate resources for those States which did not get enough by way of tax-devolution, their budgetary needs should serve as a major criterion for these grants. For this purpose, the States' budgets would have to be converted to a standard and comparable form by excluding unusual and abnormal items. To the extent the budgets of the States showed deficits, grants assistance may be provided to fill these gaps. Secondly, the Commission maintained that equalising the levels of social services in the States was another important objective of grants-in-aid. Thirdly, another consideration might be to assist the States in undertaking a public activity which it was in the
national interest to promote. Fourthly, the Commission considered that if some States were under a special burden or obligation of national concern, they should be suitably assisted.\textsuperscript{28} Above all, the Commission stated that the 'tax-effort' and 'economy in expenditure' effected by the States should also be taken into account while determining the eligibility of a State for grant of assistance, otherwise, "if the amount of grants-in-aid were to be merely in proportion to the financial plight of a State, a direct premium might be placed on impecunious policies and a penalty imposed on financial prudence."\textsuperscript{29} Finally, as a part of their general approach, the Commission acknowledged that lessening the inter-State inequalities should be the basic objective before them while determining the grants-in-aid. They hoped that in due course with greater data, it would be possible to apply the principles more precisely.\textsuperscript{30}

The principles stated above by the First Commission were found unexceptionable by the subsequent Commissions. Although they endorsed their agreement to these principles, yet found it difficult or unnecessary to fully apply the tests in working out the scheme of grants-in-aid. In the following paragraphs a detailed account of the actual working of these principles by the successive Finance Commissions is given.

\textbf{Tax-effort}

In every scheme of financial devolution, the importance of tax-effort of the recipient State is commonly acknowledged. This means that the extent of self-help a State is willing to undertake, i.e., how far the State is exploiting its own taxable capacity, should determine its eligibility for Central assistance. If the grants assistance is allowed uncritically the receiving State may develop a habit of depending upon Central assistance instead of

\begin{itemize}
\item \textsuperscript{28} Here the First Commission had in view the financial burden cast upon some of the States, namely, Punjab, Assam and West Bengal, by the partition of the country.
\item \textsuperscript{29} \textit{Report}, First Finance Commission, 97, 1952.
\item \textsuperscript{30} \textit{Id.} at 98.
\end{itemize}
efficiently tapping its own resources. This can lead to disastrous results particularly in a developing country. The First Finance Commission realising this possibility remarked:

A State which is prepared to raise the maximum amount of revenue through taxation is better entitled to Central assistance than a State which does not itself act sufficiently in the same direction. In respect of a State in the latter class, there is no guarantee that the benefit of external assistance will, in fact, accrue to the weaker sections of the community for whom it would be intended. Assistance to such a State may have the effect of postponing action by the State to increase its own taxation.

The First Commission applied the principle in the determination of the States in need of assistance as well as the amounts of grants. The Commission, however, did not publish the basis of their recommendations. It is not known exactly as to how they applied the principle in their scheme of grants-in-aid. They also did not properly define the criterion. It may be because of the non-availability of the information regarding the finances of the States. They could only compare the per capita tax revenues of various States. States for which the First Commission recommended grants-in-aid included those with higher as well as lower than average per capita tax revenue. This shows that the First Commission hardly made use of the criterion of 'tax-effort'.

The same was the case with the Second Finance Commission. The Commission upheld the principle of tax-effort as unexceptionable and explained:

31. Id. at 96.
32. Grants were recommended for seven States, of which Assam, Orissa and Punjab had lower than average per capita tax revenue. No grants were made for Hyderabad, Madhya Bharat, Pepsu and Rajasthan even though their per capita tax revenue was higher than the average. Report, 107 and Table 6(a) at 174-75, 1952.
In our assessment of tax effort we have assumed that if a State raised additional revenue which it has promised for Plan, it will have done its part.

Thus stating, the Second Commission felt that it was difficult to determine whether the principle had been satisfied or not. The Commission found it difficult to decide whether a State was taxing its people adequately in relation to their income and taxable capacity. They, therefore, could not spell out as to how they treated the States which failed to fulfil their tax obligations for the Plan. This failure on the part of the Finance Commission, in the opinion of a critic, amounts to "abdication of this responsibility to an ad hoc political body created by Parliament." The Third Finance Commission did not apply the principle of 'tax-effort' as they felt that the comparative determination of the 'tax-effort' of States had to be related to their tax-potentials and that would require special study. The Commission based their recommendations on the past actuals and the forecasts settled by the Planning Commission. The Fourth Commission agreed with the principles formulated by the First Finance Commission but remained silent on this particular issue of 'tax-effort' as a criterion for grant assistance. In their assessment of the States' needs, the Commission took into account only non-plan revenue expenditure and revenue receipts expected on the basis of the then existing level of taxes and did not examine the extent of additional tax-effort as they felt that it was related to the financing of States' Plan expenditure.

Such lack on the part of the successive Finance Commissions, to give due consideration to the principle of 'tax-effort' of the States was marked seriously by the Study Team of the Administrative Reforms Commission. The Team observed:

There is limited time at the disposal of the Commission and, because of this limitation, quantitative issues tend to squeeze out qualitative ones in the Commission's examination of budgetary needs. The States find indirect (and unintended) encouragement for the belief that, no matter how poor their tax-efforts and how high their levels of expenditure, the non-plan revenue gaps will be made good by the Finance Commission.

This observation appears to have been taken note of by the Fifth Finance Commission as it was made before the Commission submitted their report in 1969. The Fifth Commission kept in mind the principle that the efforts made by the States to raise resources in relation to their tax-potentials should be taken into account while assessing their budgetary needs. The Commission made a broad comparison of each State's total tax revenue at the existing levels of taxation with that of other States on a per capita basis. For the purpose, the Commission made use of the average State incomes for the three years 1962-63 to 1964-65 as furnished by the Central Statistical Organisation. Owing to the different circumstances of each State and different policies of the State Governments and the lack of satisfactory data regarding the basis of different State taxes, the Commission depended upon a broad comparison of the incidence of total State taxes in the context of the tax potential of each State as indicated by its level of per capita income. The Commission considered certain other factors in order to compare the 'tax-efforts' of each State. However, it is not known how exactly the factor of tax-effort was taken into account. The Commission did not publish the basis of their calculations. An examination of the relevant data, claimed to have been used by the Commission also, does not suggest that tax-effort figured prominently in their scheme of grant assistance. Rather, resource flow by way of grants, was more to States with lower tax-effort

37. Ibid.
ranking in so far and such States had relatively lesser fiscal capacity.\textsuperscript{38} The Sixth Finance Commission made a departure from the conventional ridden approach of the earlier Commissions. They propounded their own scheme for the grants-in-aid on the basic postulate of reducing regional disparities. Although the Commission referred to 'tax-effort' as a special aspect of fiscal management but gave up the principle on the practical consideration that "the application of a formula based on relative tax-effort, however designed, would place at a disadvantage some of the States faced with big gaps on non-Plan revenue accounts."\textsuperscript{39} To leave such gaps uncovered on the ground of their poor tax-performance, however defensible on theoretical considerations, would in their opinion "jeopardise maintenance of essential administrative and social services for want of adequate resources".\textsuperscript{40} However, the Commission recognized the importance of the principle of 'tax-effort' and observed: "The course we have adopted would not merely reward the States for their fiscal prudence but also bring about, over a period of time, a greater measure of equality in levels of scales of pay and other allowances among the States". The Seventh Finance Commission while formulating new principles for grants-in-aid accepted the importance of 'tax-effort' and has taken it into account while making their recommendations.\textsuperscript{41} But it is not known as to how the Commission calculated the tax-effort of each State.

\textbf{Economy in Expenditure}

Economy in public expenditure, sound financial management and efficient allocation of its own resources by a State are as important as 'tax-effort' to be considered for assessing its financial need, specially in view of the general scarcity of investible resources in India. The grants-in-aid should be so

\textsuperscript{38} D.K. Nanjundappa, "Tax-effort and Resource Transfer under Fiscal Federalism in India", 175, VIII Karnataka University Journal (Social Sciences), 1972.


\textsuperscript{40} \textit{Ibid}.

designed as to avoid any suggestion that the Central Government has taken upon itself the responsibility of helping the States to balance their budgets whatever the causes of deficits may be. 

Otherwise the grants may produce disincentive effects on the States in utilising their own resources to the fullest possible extent.

The First Finance Commission formulating the principle emphasised that it was not the purpose of any system of grants-in-aid to diminish the responsibility of the State Governments to balance their own budgets. If the amount of grants-in-aid were to be merely in proportion to the financial plight of a State, the Commission observed, "a direct premium might be placed on impecunious policies and a penalty imposed on financial prudence." Further, a sound financial management by a State of its budget should not render it ineligible for a grant if it otherwise qualifies for it. The Commission, though, formulated a sound principle but did not appear to have applied it practically while distributing the grants-in-aid. The Second Finance Commission appreciated the principle as unexceptionable, but expressly declared it difficult to be followed, for, the principle required special detailed studies by an independent commission. The Third Commission did no better than their predecessors. All the three Commissions failed to evolve an explicit procedure in respect of making their calculations. They have, admittedly, not been able to apply the criterion. The Third Commission admitted:

The earlier Commissions had rightly stressed the importance of efficiency and economy in administration and the tax efforts of States. But they were unable to assess the relative efficiency and performance due to inadequacy and often unreliability of statistical and other material. We have also been confronted with the same difficulty. With the limited time and organisation at our disposal, we would have been otherwise unable to undertake either of those reviews and give recognition in our scheme of devolution to those States which had made the maximum effort in effecting economy in expenditure and raising resources.

42. Report, First Finance Commission, 97, 1952.
43. Ibid.
All this is a sad commentary on the work of the successive Finance Commissions. The logic itself, of the Third Commission that their inability to apply the accepted criteria stems from the limited time at their disposal is open to question. K.V.S. Sastri argues that it would have been better to have applied some rough and ready criterion for economy than to have given up all attempts to reckon with that item of 'adjustment'. In this respect, the Fourth Commission did some exercise to apply the principle by excluding from their assessment of expenditure, losses in the working of State enterprises and assumed full realisation of current interest due from State corporations, even then there was a possibility that these bodies might not be able to pay the full amount. The terms of reference of the Fifth Commission specifically required them to have regard to the scope for economy consistent with efficiency. The Commission collected information from the States regarding the economy measures undertaken by them. After examining their total expenditure (excluding famine relief, losses on departmental commercial schemes and net burden of interest) on broad considerations in the light of the levels of such expenditure in other States, particularly those with similar per capita income and having similar conditions, the Commission made assessment of the relative needs of the States. The Sixth Commission was enjoined, inter alia, to keep in view the scope for better fiscal management and economy consistent with efficiency which might be effected by the States in their administrative maintenance, development and other expenditure. Fiscal management in the opinion of the Sixth Commission, was a multi-dimensional concept. In the application of this concept to concrete situations, both qualitative and quantitative aspects deserved attention. Further that it would call for a comprehensive and critical survey of the fiscal policies and administration of State Governments over a period of time. This was a task which the Sixth Commission


46. Report, Fourth Finance Commission, 55, 1965. In fact 'economy consistent with efficiency was one of the terms of reference of the Commission.

held to be too difficult to undertake within the limited time at their disposal. However, within the time with them, the Commission held discussions, among others, with the Accountant Generals of the States, which enabled them to form a general judgement on the manner in which the State finances were being managed. The Commission thus, took a general view of the principle of economy in expenditure effected by the States while recommending the grants-in-aid to them. The Seventh Finance Commission while formulating their own principles for grants-in-aid attached importance to the principle of 'economy in expenditure consistent with efficiency,' but it is hardly evidenced from their recommendations that they applied the principle in making them.

The successive Finance Commissions have recognised the importance of economy in States' expenditure and to some extent have tried to enforce the principle by disallowing, for the purpose of their estimates, certain expenditures which the State Governments wished to undertake. But this effort on the part of the Finance Commission appears to have been neutralised by certain avenues of Central assistance other than the Finance Commission. The States can very hopefully depend upon the ad hoc loans from the Centre to finance their overall gaps, which are granted by the latter in its discretion.

**Standard of Social Services**

An important purpose of grants-in-aid is to assure that every citizen of the country, irrespective of the State boundary within which he resides, is provided with certain basic minimum standard of social services. Lower level of social services which it imparts to its residents, reflects the economic backwardness of the region. It also reflects that the resources of the region have not been properly tapped to their full capacity. Usually, however, the States differ significantly in their natural resources, their levels of development and their tax potentials. What is required is that the level of certain basic social

services in the less-developed States should be raised to the standard minimum prevailing in other richly-developed ones. Otherwise, poor standards of their services in one State are likely to have adverse effects on the economic and social activity of not only the people of that State but also of those living in other States. These services contribute to the increased productivity and mobility of human resources. The only way to ensure optimum level of public good produced by the State Governments is, therefore, for the Central Government to give grants to the States to enable them to tap their resources as well, to ensure the minimum standard of these social services to their citizens.

The First Finance Commission realised the importance of these basic services and included 'standard of social services' as one of the principles they recommended for the grants-in-aid to the States under Article 275 of the Constitution. To achieve the objective of equalising standards of basic social services, the Commission observed that if two States whose budgets with other adjustments indicated by them, pointed to the need for an equal amount of assistance, the one with a significantly lower level of social services should qualify for a higher amount of assistance than the other with a relatively high level of social services. Keeping this objective in view, the Commission recommended a special grant for the promotion of primary education, for some States having enrolment in primary classes below the average. The Second Commission recognised that maintenance of certain public services at a minimum national level might justify the giving of special grants-in-aid. But they took a different view in the matter. The Commission felt that this objective could be achieved only by stages and needed more resources. In their opinion, the responsibility for this task did not fall on the Finance

50. Services such as education, public health, agriculture, have substantial external benefits also. Maxwell says that "the State boundaries are 'porous' and the benefits of public good overflow in varying degrees to the neighbouring States" Financing State and Local Governments, 2, Brookings Institute, Washington, 1969.

Commission. Rather, it was the function of the Planning Commission and the National Development Council to make adequate provisions for it. The Second Commission, therefore, accepted the Five Year Plan formulated by the Planning Commission and approved by the National Development Council as ensuring an equitable development in the field of social services. The Third Commission accepted the principle of equalising the standard of social services and recommended a special grant for the development of communication in ten States. The Commission was of the view that this grant for the development of roads would not only mobilise economic resources and develop backward areas, but also lead to the creation of a feeling of oneness in peoples' minds. The Fourth Finance Commission again discontinued the practice on the ground that a special purpose grant made under Article 275 would get merged with the general revenues of the States and consequently it would not be possible for them to ensure that it was utilized for the appointed purpose. Though the subsequent Finance Commission might review the utilization of the grant but that would not in their opinion, be of any practical value. The Fifth Finance Commission, in agreement with the views expressed by their immediate predecessors, did not favour making any special purpose grants and left the responsibility of giving assistance for equalising standards of social services on the Planning Commission. The Sixth Commission, however, revived the scheme. Their terms of reference specifically required the Commission 'to keep in mind the requirements of States which were backward in standards of general administration for upgrading the administration with a view to bringing it to the levels obtaining in the more advanced States'. The Commission approached the whole question from the view-point of reducing the regional disparities as much as possible and this approach was

clearly stated and emphasised by them while they explained "the most significant departure we have made from the approach of the earlier Finance Commissions is in the process we have initiated of enabling the States that are backward in standards of general administration to come up to a certain national minimum." The services the Commission included for the purpose were general administration, justice, jails, police, education, medical, public health, administration of land revenue and welfare of scheduled castes, tribes and other backward classes. The Sixth Commission, however, was fully aware of the outcome of similar attempts made by the First and the Third Commissions and conceded that the special grants made by them were not utilized for the purpose for which they were intended. In the light of this experience, the Sixth Commission proposed to ensure against any diversion of special grants they recommended. The Commission suggested:

The concerned administrative Ministry at the Centre and the Planning Commission should, as part of their scrutiny of the Annual Plans of the States, take special care to verify whether the funds provided by us for primary education... have been utilized on these services. We would suggest that only such expenditure on these services, as in excess of the provisions indicated by us under these heads, should alone be treated as Plan expenditure qualifying for Central assistance.

The terms of reference of the Seventh Commission in this respect were more or less the same as that of the Sixth Commission with a little difference that whereas the Sixth Commission was required to enable States which were backward in standards of general administration to improve it to an all-States average levels, the Seventh Commission was to confine themselves to

57. Id. at 68.
58. Id. at 49.
59. Id. at 68. As the grants were not at all distinguishable from the general grants-in-aid and were accompanied by no administrative supervision of the Centre, it was virtually impossible to keep track of how and where they were spent.
60. Ibid.
providing for upgradation of standards of administration in non-developmental sectors and services. For the purpose, the Commission considered the non-developmental services such as: (a) judicial administration, (b) revenue, district and tribal administration and the secretariat services, (c) police administration, (d) jails and (e) treasury and accounts administration. The Commission recommended that the States which would have a deficit in non-Plan revenue account without devolution of Union taxes and duties should be paid grants-in-aid for the upgradation of the standards of administration of these services. With a view that the funds provided for the purpose were to be actually utilised for those purposes, the Commission suggested that the administrative Ministries at the Centre concerned with the finalisation of plans of action and the release of grants should draw up procedures for monitoring in terms of financial as well as performance indicators based on the criteria adopted by them while making these provisions.

The foregoing analysis brings out that by and large, the Finance Commissions have not based their recommendations on the principles of 'tax-effort', 'economy in expenditure' and cared little to equalise the standards of social services in the States. Except the Sixth and the Seventh Finance Commissions which were required by their terms of reference, the Commissions have taken the approach that the responsibility for this task did not fall on them. The principles of 'tax-effort' and 'economy in expenditure' though accepted by them as unexceptionable have been held difficult to be applied in the absence of reliable statistical data regarding the finances of the States. The Commissions have largely based their recommendations for grants-in-aid on the budgetary deficits of the States without taking into account the above principles. This system if continued, would penalise tax-efficiency, inhibit resource mobilisation, create financial instability for States with marginal surplus,

62. Id. at 71.
contribute to developmental inequity and thwart dynamism.\textsuperscript{63}

For, the States secure in the knowledge that their annual budgetary gaps would be fully covered by devolution of Union resources and grants-in-aid, they would develop an allergy to tax their resources to full and would attach little importance to a proper and adequate control of their expenditure.

\textbf{Approach of the Finance Commissions}

In the following paragraphs, the State-wise distribution of grants-in-aid is analysed with a view to review the practical operation of the Finance Commissions and to find out as to how these grants have shown an equalising bias.

The terms of reference of the First Finance Commission, \textit{inter alia}, required them to make recommendations under Article 275(1), as to the needs of assistance of the States and the sums payable to such States as grants-in-aid of their revenue. Neither did the terms of reference nor the Commission themselves, made any distinction between the Plan and Non-Plan revenue needs of the State.\textsuperscript{64} They observed, "So far as the claims relate to finance required for schemes of capital outlay, these are hardly likely to be met by grants from revenue with which we are primarily concerned. Nor are we concerned with the provision of finance for the various individual schemes included in the Five-Year Plan taken by themselves. In so far as they involve expenditure on revenue account, this will have to be met from the revenues, as augmented by the States' efforts or by our scheme."\textsuperscript{65} The Commission came to the conclusion that budgetary needs of the States should provide the basis for grants-in-aid. Having so considered the budgetary needs, allowing for 'a reasonable margin for expansion', the extent to which these needs had been met by the devolution of revenue from taxes and other payments, special problems created by partition, the Commission recommended unconditional grants-in-aid to seven States. The Commission,

\begin{flushleft}

\textsuperscript{64} The First Five Year Plan had already come into operation, when the Commission was constituted.

\textsuperscript{65} \textit{Report}, First Finance Commission, 100, 1952.
\end{flushleft}
however, failed to take into account factors like natural calamities such as famine or floods and movement of human population, nor did they succeed in making any forecast as to these. Rather their efforts were reduced to arithmetical calculations based on financial position of states as disclosed by their actual revenue and expenditure in recent years, corrected where necessary with reference to their budget estimates for the year 1952-53 and such subsequent information affecting these estimates as became available to them. The grants-in-aid so recommended for each year to various states were as following:

Table IX(1)
Grants-in-aid Under Article 275(1)

<table>
<thead>
<tr>
<th>States</th>
<th>Grant</th>
<th>Total for 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assam</td>
<td>100</td>
<td>500</td>
</tr>
<tr>
<td>Mysore</td>
<td>40</td>
<td>200</td>
</tr>
<tr>
<td>Orissa</td>
<td>75</td>
<td>375</td>
</tr>
<tr>
<td>Punjab</td>
<td>125</td>
<td>625</td>
</tr>
<tr>
<td>Saurashtra</td>
<td>40</td>
<td>200</td>
</tr>
<tr>
<td>Travancore-Cochin</td>
<td>45</td>
<td>225</td>
</tr>
<tr>
<td>West Bengal</td>
<td>80</td>
<td>400</td>
</tr>
</tbody>
</table>

(Source: Report, First Finance Commission, 12, 1952)

In addition to these general grants and in consonance with the principle of 'equalisation of the standards of social services' the First Commission recommended grants-in-aid for the improvement of primary education in eight states. These grants were made on the specific condition that they should be utilised to expand primary education. The grants made are set out below:

66. Id. at 101.
Grants for the expansion of Primary Education
under the First Finance Commission

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bihar</td>
<td>41</td>
<td>55</td>
<td>69</td>
<td>83</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>25</td>
<td>33</td>
<td>42</td>
<td>50</td>
</tr>
<tr>
<td>Hyderabad</td>
<td>16</td>
<td>22</td>
<td>27</td>
<td>32</td>
</tr>
<tr>
<td>Rajastan</td>
<td>9</td>
<td>12</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>Punjab</td>
<td>20</td>
<td>20</td>
<td>33</td>
<td>40</td>
</tr>
<tr>
<td>Madhya Bharat</td>
<td>14</td>
<td>15</td>
<td>23</td>
<td>28</td>
</tr>
<tr>
<td>Fepsu</td>
<td>9</td>
<td>6</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>150</strong></td>
<td><strong>200</strong></td>
<td><strong>250</strong></td>
<td><strong>300</strong></td>
</tr>
</tbody>
</table>

(Source: Report, First Finance Commission, 104, 1952)

The recommendations of the First Commission in regard to the grants for primary education were challenged by the Planning Commission on the ground that federal payments for national purposes should be made only on the recommendations of the Planning Commission and in accordance with the Five Year Plans but the grants were allowed to stand by the Union Government. 67

With regard to the grants-in-aid under Article 275(1), the terms of reference of the Second Commission were wider than those of their predecessors. The Commission, this time, was asked, in addition to have regard to the requirements of the Second Five Year Plan and to consider the efforts made by the States to raise additional revenue from their own sources. This led the Commission to renew the path laid down by their predecessors as for the grants-in-aid. The Commission however took the view that Planning Commission and the National Development Council were responsible for ensuring equalisation. 67. Chanda, 202.
of essential social services in the States and therefore, did not recommend any grant for such purposes. The grants-in-aid made by the First Commission for the spread of primary education were allowed to lapse. The Second Commission confined themselves to the plan and non-plan revenue expenditure of the States and ignored the capital expenditure. Within this limited area, the Commission admitted it difficult to make a reasonable forecast of expenditure for the next five years. The Commission, therefore, sought to formulate a scheme of grants-in-aid which would have, under normal conditions, enabled the States to balance their budgets after meeting their normal revenue expenditure as well as the revenue expenditure of the Second Plan. Grants-in-aid, the Commission emphasized, should be largely a residuary form of assistance to be given in the form of general and unconditional grants. The gap between the ordinary revenue of a State and its normal inescapable expenditure should, in their opinion, be met by sharing of taxes. The eligibility of a State to grants-in-aid and the amount of such aid should depend upon its fiscal need in a comprehensive sense. The Commission observed: "In a Union, in which the Centre and the States co-operate for planned development, grants-in-aid should subserve this end. Priorities and provisions in the Plan itself should determine the fiscal needs for development for the period of the Plan." The Commission failed to assess the tax-efforts of the States with reference to their taxable capacity, nor did they choose to penalize the defaulting States because they found it difficult to decide whether a State was taxing its people adequately in relation to their income and taxable capacity. They, however, took into account the likely expenditure by the States on unforeseen natural calamities like famine, floods and droughts. After taking into account the committed needs of the States and their needs for revenue expenditure for the Plan, the Second Commission recommended

69. *Id.* at 25.
70. This amount was calculated roughly on the basis of the average annual expenditure incurred over a decade.
grants-in-aid to eleven States amounting to nearly Rs.1,878 million over the next five years. The following Table IX(3) shows the split-up of grants State-wise.\textsuperscript{71}

\begin{table}[h]
\centering
\begin{tabular}{lcccccc}
\hline
\hline
Madhya Pradesh & 4.00 & 4.00 & 4.00 & 4.00 & 4.00 \\
Assam & 3.75 & 3.75 & 3.75 & 4.50 & 4.50 \\
Bihar & 3.50 & 3.50 & 3.50 & 4.25 & 4.25 \\
Kerala & 1.75 & 1.75 & 1.75 & 1.75 & 1.75 \\
Madhya Pradesh & 3.00 & 3.00 & 3.00 & 3.00 & 3.00 \\
Mysore & 6.00 & 6.00 & 6.00 & 6.00 & 6.00 \\
Oriya & 3.25 & 3.25 & 3.25 & 3.50 & 3.50 \\
Punjab & 2.25 & 2.25 & 2.25 & 2.25 & 2.25 \\
Rajasthan & 2.50 & 2.50 & 2.50 & 2.50 & 2.50 \\
West Bengal & 3.25 & 3.25 & 3.25 & 4.75 & 4.75 \\
Jammu & Kashmir & 3.00 & 3.00 & 3.00 & 3.00 & 3.00 \\
\hline
Total & 36.25 & 36.25 & 36.25 & 39.50 & 39.50 \\
\hline
\end{tabular}
\caption{Grants-in-aid under Article 275(1)}
\end{table}


The Second Commission, thus, took a very favourable view towards the States and enhanced the fiscal-need grants seven-fold when compared with the award of the first Commission. The Commission proposed to make a part of the grants-in-aid conditional upon the States' implementing the revenue portion of the Five-Year Plan, but decided not to impose any condition.\textsuperscript{72}

\textsuperscript{71} Id. at 50.
\textsuperscript{72} Ibid.
The Third Commission made a big departure from the approach followed by their predecessors in regard to the interpretation of the 'fiscal needs' of the States in need of assistance. The Commission propounded that while calculating the fiscal needs, account should be taken not only of non-Plan expenditure but also of Plan expenditure because they maintained that in a planned economy, it was difficult to draw a distinction between Plan and non-Plan expenditure, 'for what was classified as non-Plan expenditure in the present case, was itself due to projects launched in the previous Plan periods'. The Commission interpreted 'fiscal needs' of the States too broadly so as to include 75 per cent of the revenue component of the Five Year Plan. The Commission recommended that the grants-in-aid and devolution of taxes together should cover the non-Plan revenue gap as well as 75 per cent of the Plan revenue gap. This recommendation of the majority in the Third Commission was dissented to by the Member Secretary of the Commission Shri G.R. Kamat as having serious impact on the concept and mechanism of national planning. Referring to the Second Commission's recommendation for grants made towards the revenue component of the Second Five Year Plan, he said that the majority had misunderstood their precise purpose. At that time, the Centre had not undertaken to underwrite the State Plans. Further, what the Second Commission took into account in making their recommendations was the estimated gap in the revenue plan of the States which was not covered either by their own resources or by the grants proposed by the Centre under Article 282. Therefore, what the Second Commission gave was not in lieu of grants for the revenue component of the Plan but what was needed by the States over and above the Article 282 grants as then estimated. Shri Kamat was of the view that the Union Government should exercise some control on the way resources were spent by the States and it was its obligation to oversee that the Plan objectives were accorded their due place. If these grants were made statutory as would be the case

74. Id. at 32.
under the majority's recommendations, he said, the Central Government would have no control over them. All this raised a controversy as to whether Plan grants should be unconditional and made on the recommendations of the Finance Commission or be tied to specific purposes and be made on the recommendations of the Planning Commission. As the majority suggestions would have affected the planning processes very seriously the Government of India did not accept them and preferred to continue the system of Plan-grants under Article 282. Thus these grants were taken out of the purview of the Finance Commission for all times to come.

The Third Commission revived the scheme initiated by the First Commission, to make grants for specific purposes and they selected development of roads as an activity deserving attention. The Commission recommended Rs. 36 crores being approximately 20 per cent of proceeds of the duty on motor spirits, to be distributed for this purpose, to ten States according to their relative needs. It resulted in excluding this revenue (20 per cent of excise-duty on motor spirits) from becoming divisible amongst all the States but allotted to only such of them as were backward in this respect.

The Commission, although accepted the principles laid down by the First Commission for grants-in-aid, as unexceptionable, but based their forecasts of revenue and expenditure of the States on the past actuals and the forecasts made by the States reconciled with that settled by the Planning Commission. Thus, all the criteria such as 'tax effort', 'expenditure-economy' and 'general financial prudence' became redundant.

The Commission marked seriously the overlapping of functions of the Planning and Finance Commissions. Due to the emergence of the Planning Commission as an apparatus for national planning, they held that the role and function of the Finance Commission, as provided in the Constitution, could no longer be realised fully.

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75. Minute of dissent by Shri Kamat, id. at 51-60.
76. Id. at 32-33.
77. Majority view dissented to by Shri Kamat, the Member Secretary.
They, therefore, suggested that either the functions of the Finance Commission be expanded to cover all financial assistance to the States or that the Planning Commission be transformed into the Finance Commission at the appropriate time. The Commission was not happy with the continuing growth of discretionary grants made under Article 282, which by 1961-62 had reached 80.2 per cent of total assistance to States. The payment of such large sums in conditional grants under the plans and for other purposes, the Commission said had diluted the autonomy of the States. Another disturbing feature of such grants was that the States were becoming dependent on Central assistance on an ever-increasing scale which had diluted the accountability of the State Cabinets to their Legislatures and coming in the way of the development of a greater sense of responsibility in State administration. This, in their opinion, had the spreading effect among the States of the allergy to tap resources. The Commission, therefore, suggested that a high-powered independent Commission should be appointed to have a more detailed examination and fuller consideration of many important inter-related questions of Union-State financial relations. The grants-in-aid recommended by them were as given in Table IX(4).

When the Fourth Commission was appointed, the requirements of the Five Year Plan were not mentioned in their terms of reference. Their task was somewhat limited to make recommendations in terms of the substantive provision of Article 275(1). The Commission thus reverted to the procedure adopted by the Second Commission to make recommendations as to the revenue requirements of the States and accepting fiscal needs as the basis for grants-in-aid without attempting to cover grants under the Five Year Plan.

78. Report, Third Finance Commission, 35-39, 1961. These general recommendations of the majority of the Commission, regarding the role of grants-in-aid and for the review of the financial provisions of the Constitution were not at all popular with the Planning Commission and were rejected by the Central Government.
Grants-in-Aid under Article 275(1)

<table>
<thead>
<tr>
<th>States</th>
<th>Grants-in-aid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>1200</td>
</tr>
<tr>
<td>Assam</td>
<td>900</td>
</tr>
<tr>
<td>Bihar</td>
<td>800</td>
</tr>
<tr>
<td>Gujarat</td>
<td>950</td>
</tr>
<tr>
<td>Jammu and Kashmir</td>
<td>325</td>
</tr>
<tr>
<td>Kerala</td>
<td>850</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>625</td>
</tr>
<tr>
<td>Madras</td>
<td>800</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>-</td>
</tr>
<tr>
<td>Mysore</td>
<td>775</td>
</tr>
<tr>
<td>Orissa</td>
<td>1600</td>
</tr>
<tr>
<td>Punjab</td>
<td>275</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>875</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>200</td>
</tr>
<tr>
<td>West Bengal</td>
<td>850</td>
</tr>
</tbody>
</table>

(Source: Report, Third Finance Commission, 33, 1961)

...or other special purpose grants. The Commission justified their approach on the ground that the Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard and that it would not be appropriate for the Finance Commission to take upon themselves the task of dealing with the States' Plan expenditure. The Commission assessed the fiscal needs of the States by taking into account the revenue receipts as anticipated in the next five years on the basis of taxation levels of 1965-66, the requirements as to committed expenditure on the maintenance and upkeep of schemes completed during the Third Plan and the special considerations such as the expenditure devolving on the

States for servicing of their debts (outstanding and those likely to be incurred in the Fourth Plan) as well as provision for contribution to sinking funds for public loans. The revenue expenditure of the Fourth Plan was not taken into account by the Commission while making their assessments. The Commission undertook the usual exercise of converting the forecasts of revenue and expenditure received from the States on a comparable basis by making necessary adjustments. As required by the term of reference, the Commission applied the principle of economy in States expenditure and excluded from their assessment of expenditure items such as losses in the working of public enterprises and assumed full realisation of current interest due from States' Corporations. The Commission did not include in their assessment, certain increases in pay-scales and dearness allowance of the employees of State Governments, local bodies and aided-school teachers, in cases of States which could not supply their firm decisions and detailed data concerning the expenditure. But the Commission required that such expenditure might be taken into account while determining the amount to be granted under Article 275. On the revenue side the Commission included the proceeds of betterment levies and sale of State property. On the expenditure side, the Commission included the interest liability on past loans outstanding at the end of each year, the interest liability on non-Plan loans likely to be raised during the coming years, as also the requirements for payment of full interest on Fourth Plan loans that were to be raised by the States during 1966-71. The Commission was further of the opinion that the service and amortization of the market borrowings of the State Governments should form part of their revenue liabilities. Taking into account these considerations, the Fourth Commission found ten States having revenue deficits aggregating to Rs.609.45 crores for the financial years 1966-67 to 1970-71 and on that basis recommended annual grants-in-aid of Rs.121.89 crores in each of the five years commencing from 1st April,1966. The Table below shows the State-wise split-up of these grant.

80. Id. at 58.
81. Id. at 63-68.
82. Id. at 75.
The Fifth Commission was specifically asked not to take into consideration, the requirements of the Plan for the purpose of recommending grants-in-aid under Article 275. The Commission, therefore, refused to consider the effects of the Plan expenditure on the revenues of the States, although the State Governments suggested them to do so. Their terms of reference also enjoined the Commission to consider the question of fiscal management so that wasteful expenditure could be avoided. During the period of Fourth Plan, certain unforeseen difficult situations were faced by the country. The hostilities with Pakistan, sudden cessation of American aid, devaluation of the rupee and serious failures of the monsoon made for an extremely uncertain and gloomy situation. Food prices rose sharply, growth of industrial production slowed down and real incomes fell. These contributed to the huge increase in governmental expenditure. Poor showing of public undertakings and departmentally-managed schemes, revision of pay and allowances of Government employees added to the plight.
of the States. In this situation, the efforts made by the State Governments for raising more revenues and effecting economy in expenditure were on an extremely inadequate scale. The aggregate result was that only six States showed surplus on revenue account and others showed a substantial deficit on revenue as well as capital accounts. The Commission, therefore, felt themselves incompetent to judge the propriety of the policies of taxation adopted by the States. What the Commission could do was to keep in view broad considerations which could be applied to all the States as regards their total tax effort, overall expenditure levels and returns from investment. There were a few items of revenue receipts and expenditure in respect of which, the Commission could adopt no suitable general consideration. All that the Commission did to work out the deficits of the States was the usual exercise of converting the estimates furnished by the States into comparable figures. The Commission observed that in view of the rapid growth of States' expenditure and the very large size of budgetary deficits which, as indicated in the States' forecasts came to Rs. 7,368 crores, the emphasis should shift significantly from budgetary needs to broad fiscal needs. The Commission took into account the revenue resources of the States on the basis of 1968-69 levels of taxation and their requirements for expenditure on revenue account including committed plan-expenditure and interest charges. The Commission did not take into account the losses in the schemes of road transport expecting that the State Governments would take effective measures to obtain return from them. As regards the amortisation of debts from revenue, the members of the Commission held different views and agreed to make only a limited provision for it. After assessing the forecasts of the revenue receipts the non-Plan revenue expenditure of the States and making suitable adjustments in accordance with the principles and considerations explained above, the Fifth Commission recommended grants-in-aid to ten States as follows:

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84. Id. at 48.
85. Id. at 50.
86. Id. at 66. The Fifth Commission did not make any specific purpose grants.
Table IX(6)
Grants-in-aid under Article 275(1)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
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<td>9.93</td>
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<tr>
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<td>10.30</td>
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<tr>
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<td><strong>140.15</strong></td>
<td><strong>127.57</strong></td>
<td><strong>114.99</strong></td>
<td><strong>102.41</strong></td>
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</tbody>
</table>

(Source: Report, Fifth Finance Commission, 66, 1969)

The terms of reference of the Sixth Commission marked an improvement over those of their predecessors in two respects. Firstly, for the first time, assessment of the non-Plan capital gap was brought within the purview of the Finance Commission, thus requiring the Commission to take into account the total resources and expenditure, revenue as well as capital, on non-Plan account. The Commission were expected to evolve norms for estimating the requirements of resources for the maintenance of capital assets. Secondly, for the first time the Finance Commission were called upon to estimate the requirements for upgrading the standards of general administration prevailing in the backward States. The Commission were enjoined to keep in mind the Central assistance for financing State Plans while recommending revenue grants under Article 275(1). Furthermore, other important items bearing on their expenditure commitments like the interest charges in respect of their debt, transfer of funds to local bodies and aided institutes and other committed expenditure were also to be considered by the Commission. They were also asked to consider the scope of possible
economy in expenditure consistent with efficiency. But the Plan grants and the grants to be made under the provisos of Article 275(1) were kept out of their purview. 87

The Sixth Commission made some break-through from the conventional-ridden approach of the earlier Commissions. They approached the whole question from the point of view of reducing the regional disparities. The most significant departure they made from the approach of their predecessors was in the process they initiated of enabling the States, that were backward in standards of general administration, to come up to a certain national minimum. For this purpose, the Commission identified certain administrative and social services 88 as to be of crucial importance and proposed that within a span of five years, the standards of these services in the backward States should come up to the national minimum. But the Commission was seized of the outcome of similar attempts made by the First and the Third Commissions and conceded that special grants recommended by these Commissions were not utilized for the purposes for which they were intended. Without over-emphasizing the need for effective and purposeful monitoring of the special grants earmarked for administrative upgradation, the Sixth Commission suggested that the concerned administrative Ministry at the centre and the Planning Commission should as part of their scrutiny of the Annual Plans of the States, take special care to verify whether the funds provided by them for the specified services had been utilized on those services. They further suggested that only such expenditure on these services, as was in excess of the provisions indicated by them under these heads should alone be treated as Plan expenditure qualifying for Central assistance. 89 The mechanism proposed here was indeed a well-intentional move, but it required cooperation between the Finance Commission and the Planning Commission. In order to achieve this coordination, a member of the Planning Commission was nominated

88. See supra.
90. Ibid.
to the Sixth Finance Commission. 91

It was brought to the notice of the Commission that since the Finance Commissions had been taking into consideration the rate of growth of the Union's divisible taxes in the scheme of devolution, such schemes failed to take care of the new unanticipated but substantial demands on States' exchequers such as revision of dearness allowance that emerges during the period between the awards of two Finance Commissions. This required the Commission to take a realistic view of the rates of growth of revenue receipts and non-Plan expenditure of State Governments so that there might be room for flexibility in budgetary operations.

The Commission started their exercise with the spirit of 'harmonious and fruitful fiscal relations between the Centre and the States'. They were of the view that the resources belonged to the nation and they should be applied at points where they were most needed. The root cause for dissatisfaction among the States, in their opinion, was the fact that the rate of growth of our economy had not been fast enough to meet the rising expectations of our people. The Commission emphatically asserted, "when the emphasis is on social justice, there is no escape from a realignment of resources in favour of States, because services and programmes which are at the core of a more equitable social order come within the purview of the States under the Constitution." The question of allocation of resources between the Centre and the States could not be viewed in isolation from the allied issue of the relative shares of the States in the pool of national resources. 92 The Commission proposed to accord due priority to the need for correction of disparities among the States in their scheme of devolution.

The terms of reference of the Sixth Commission required them to have regard among other things, to fiscal management and economy consistent with efficiency in expenditure of the State Governments. This required the consideration of both qualitative

91. Dr. B.S. Minhas was the member of the Planning Commission nominated to the Finance Commission.

and quantitative aspects of fiscal management and such a detailed exercise, in their opinion, was difficult to be accomplished within the time at their disposal. Still the Commission devoted considered attention on the matter. They did not adopt the approach of mechanical filling up of the gap between the receipts and expenditure of the States. Their proposals envisaged determined and purposeful efforts on the part of the State Governments at reduction of arrears of taxes and improvement of returns from investments in quasi-commercial and commercial projects. The Commission adopted a normative approach in processing the demands of the States for funds for raising emoluments of Government employees, teachers in aided institutions and employees of local bodies. They also re-assessed the receipts by way of interest on loans advanced to electricity boards, road transport undertakings and third parties, according to certain minimum standards of performance. They also considered the legitimate grievances of States about inadequacy of funds for maintenance of existing assets such as building, irrigation works and roads at reasonably satisfactory levels. On the basis of the above considerations, the Sixth Commission made recommendations of grants-in-aid of Rs. 2509.61 crores for 14 States for filling up their revenue gaps. Table IX(7) shows the State-wise split-up of grants-in-aid under Article 275.

The grants-in-aid so recommended by the Sixth Commission indicated a major increase over the amount of such grants made by the Fifth Commission. This increase was partly because of the grants recommended in respect of the States of Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland and Tripura which had virtually no resource bases of their own and whose requirements, had to be totally met through Central transfers. Partly, it was because the Commission made provision for the maintenance of capital assets and upgradation of administrative and social services in backward States for which their terms of reference specifically enjoined them. Thus the Commission trod on new paths.

93. Id. at 67.
94. Id. at 73.
<table>
<thead>
<tr>
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<td>34.73</td>
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<td>44.30</td>
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<td>46.57</td>
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<td>503.12</td>
<td>500.44</td>
<td>510.70</td>
<td>513.68</td>
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</table>

(Source: Report Sixth Finance Commission, 109, 1973)

The fact that the Commission gave special consideration to the backwardness of the States in matters of social services goes to prove that the basic postulate of grants-in-aid propounded by the Sixth Commission for reducing regional disparities, was well kept by them in making their recommendations under Article 275(1).

The terms of reference of the Seventh Commission were different in one respect from that of their predecessors. This time the same considerations were set out which were to be kept in mind by the Commission while making recommendations in regard to both sharing of taxes as also in the determination of grants-in-aid. This did not bring any change in their working for, recognising the past practice, the Commission held that tax-sharing and grants-in-aid under Article 275 had always been inextricably linked in the scheme of transfer of the past Commissions. The principles

adopted by the First Commission for the grants-in-aid and endorsed by the subsequent commissions, were considered by the Seventh Commission. Taking some of these principles in the nature of guidelines for the internal work of the Commission and some others concerning the Planning Commission they formulated their own principles. In their opinion, the grants-in-aid were primarily given to enable the States to cover the fiscal gaps left after devolution of taxes and duties so as to enable the States to maintain the levels of existing services. Further, that the grants-in-aid might be made correcting intended to narrow down the disparities in the availability of various administrative and social services between the developed and the less-developed States, with the object that every citizen irrespective of the State boundaries, was provided with certain basic national minimum standards of such services. Grants might also be made to enable the States to meet their special burdens on their finances because of their peculiar circumstances.

The Commission while keeping in mind the tax efforts of the States, projected their expenditure requirements on the revenue accounts in a manner as to induce them to improve efficiency and to regulate their expenditure carefully. For narrowing down the disparities in the standards of services, the Commission recommended specific grants-in-aid. Indicating the percentage of the tax-revenues of the States and comparing these with that of the Centre, they were of the view that in the matter of additional resource mobilisation, the States had not lagged behind the Central Government and that the performance of the States had been creditable.

The Commission held the view that the role of the Finance Commission should not be negative of filling in the revenue gaps only, but positive in that, their scheme of devolution should give a better start for developmental outlay. Considering the grants-in-aid as the residuary gap filling device, the Commission contended that the bulk of the fiscal transfer should be effected

96. Id. at 59.
97. See supra.
mainly if not wholly through devolution of taxes. As regards the indicators of levels of development of States, the Commission held that the proportion of people below the poverty line might differ between the States with the same per capita income level. It might be depending on the way the resources had been allocated and on policies followed for the reduction of poverty by different States. Poverty problem might be the result of special factors with a State and the Commission decided to give some weight to this factor while making their recommendations. Taking the above considerations into account, the Commission’s recommendations in respect to grants-in-aid were as follows:  

Table IX(8)

<table>
<thead>
<tr>
<th>States</th>
<th>Total to be paid in 2 yrs</th>
<th>1979-80</th>
<th>1980-81</th>
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<td>43.05</td>
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<td>46.59</td>
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<td>Orissa</td>
<td>136.92</td>
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<td>37.74</td>
<td>29.03</td>
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<td>9.44</td>
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<td>6.70</td>
<td>7.11</td>
<td>7.54</td>
<td>8.05</td>
</tr>
<tr>
<td>Tripura</td>
<td>136.57</td>
<td>24.36</td>
<td>25.77</td>
<td>27.29</td>
<td>28.35</td>
<td>30.32</td>
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<td><strong>Total</strong></td>
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<td>232.34</td>
<td>230.56</td>
<td>235.62</td>
<td>234.67</td>
<td>231.93</td>
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</table>

(Source: Report, Seventh Finance Commission 69, 1978)

The Seventh Commission also recommended that the Central Government should pay grants-in-aid under Article 275 for meeting the losses in excise revenue which might result from steps the States would take in introducing prohibition. They also set out the manner in which such grants should be calculated by the Central Government. Following the practice adopted by the Sixth Commission,

99. Ibid.
they also recommended the grants-in-aid for financing the relief expenditure.

**Evaluation of Approach to Grants-in-aid**

The foregoing analysis brings out that the successive Finance Commissions have not been able to evolve a fixed and workable criteria to assess the grants-in-aid. The broad conclusions which emerge from the working of the seven Finance Commissions reported till now, may be discussed here. It has been seen that there had been a regular increase in the additional terms of reference of the Commissions, particularly insofar as the grants-in-aid are concerned. Also the scope of Article 275, in respect of grants-in-aid has been interpreted differently by successive Finance Commissions. The principles enunciated by the First Commission to determine the eligibility of the States for grants-in-aid, though endorsed by the subsequent Commissions as unexceptionable, have not been applied by them in their true sense. The Commissions have, by and large, based their recommendations solely on the budgetary deficits of the States. Here also their methods of assessing the budgetary needs of the States have been deficient in several respects.

As far the terms of reference, the policy of the Union Government had not been consistent. For instance, the terms of the First Commission were silent as to the recommendations for non-Plan or Plan assistance. Because of this reason the Commission included Plan requirements of the States while recommending grants under Article 275. The Second Commission was, in fact, specifically asked through their terms of reference to take into account the financial requirements of the States for the Second Five Year Plan. The Third Commission was also required to take into account the financial requirements of the States for the Third Plan. But when the Third Commission used the terms of reference to widen the scope of their recommendations under Article 275, the Union Government resented to the move and rushed
to a conclusion that it was outside the purview of the Finance Commission to consider plan requirements of the States as it was the sole jurisdiction of the Planning Commission. Looking to the fate of the Third Commission's recommendations and with an express limitation in their terms, the Fourth and Fifth Commissions did not venture to go beyond and confined their work to assess the non-plan revenue requirements of the States and thus excluded the requirements of Five Year Plans of the States. Thus the controversy in regard to the bifurcation of grants under Article 275 as revenue grants and those under Article 282 as capital grants did not arise. But this bifurcation was lost sight of when the Sixth and Seventh Finance Commissions were enjoined by their terms reference to estimate the non-plan capital requirements of the States as also to take into account, while determining the grants-in-aid, the scheme and extent of Plan assistance provided to the States on the recommendations of the Planning Commission. This is sufficient evidence to prove that the Union Government has not been having any clear-cut idea about the relative roles of the Finance Commission and the Planning Commission, as also about the scope of Article 275 and that of Article 282. Adding to this, is the practice, on the part of the Union Government of using imprecise, loose and ambiguous expressions in the additional references made in their terms of reference. This failure on the part of the Government of India, invariably creates confusion and leads to the Finance Commission paying inadequate attention to certain matters of national concern, which are important from the point of view of sound finance of the States. This all had adverse impact on the working of the Finance Commission.¹

The scope of Article 275(1) has been left by the Constitution to be defined by the Finance Commission.² The successive Finance Commissions have interpreted this provision differently. This Article has been modelled on Section 142 of the Government of India Act 1935 and these Commissions while recommending grants-in-aid for States, have invariably based their approach on the Award of

² See Article 280(1)(b).
Sir Otto Niemeyer given in 1936, under the latter provision. Sir Otto took an integrated view of the finances of the Centre and the Provinces and recognised that any scheme of devolution which sought to help the financially weaker Provinces involved subsidisation at the expense of financially stronger Provinces. His basic approach was that "the Provinces and the Centre have to balance their budgets within their available resources and the needs of the Provinces, which cannot be met by devolution of shares of taxes, have to be covered by grants-in-aid." Sir Otto put too much emphasis on the need of securing budgetary equilibrium in the Provinces that he regarded grants-in-aid as a form of residuary assistance for certain Provinces after taking into account the sharing of taxes and the adjustment of debt. The Finance Commissions have followed this approach devised by Sir Niemeyer, without giving any consideration to the diverse needs and resources of the States and thus retained the outmoded approach. Sir Otto was more concerned, in his award, with the immediate short-range purpose of putting the Constitution of 1935 into effect rather than with considerations of the theory of federal finance. It was a static view of fiscal federalism and should have been replaced by the overriding needs of economic growth and planning in the context of an underdeveloped economy.

The Constitution does not define the expression grants-in-aid, but it could be construed as being limited to such grants which would augment the resources of the receiving States. The First Finance Commission, after reviewing the scope of grants-in-aid in pre-independent India and in other countries, came to the conclusion that the provision separately made for making grants for public purpose, did not limit the scope of grants-in-aid. Article 275, which gives constitutional imprimatur to Union grants, in their opinion, should not have been interpreted in a narrow or limited sense, rather it should have been held to cover in its sweep special grants also. The grants-in-aid in their opinion should also be directed towards broad and well defined

3. See Chapter III supra.
4. Ibid.
purposes of economic and social significance. They, therefore, on such interpretation, recommended a special grant for stimulating primary education in the States in addition to unconditional grants-in-aid of revenue they had separately recommended. The Third Commission also held the same view and recommended special grants for the improvement of communications in the interest of national economy and national integration. However, the Second and the Fourth Commissions held different views on this point. The Second Commission accepted that inequalities in the standards of social services in States should be removed but believed that, in a planned economy it was the function of the Planning Commission and the National Development Council to ensure such equalisation on national considerations. The Fourth Commission observed that even if special grants could be made under Article 275(1), such a grant would be merged in the general revenues and its utilization could be reviewed only by the next Finance Commission which would be of little practical utility. The approach of the Fifth Commission, was, more or less, the same on the point and they were expressly asked in their terms of reference to exclude grants for plan purposes. The Sixth and the Seventh Commissions made a significant departure from the earlier Finance Commissions and recommended special grants for the upgradation of essential administrative and social services in the States. It brings out that the scope of Article 275(1) and that of grants-in-aid of revenue has not been finally settled by the successive Finance Commissions.

Article 275 speaks only of 'grants-in-aid of revenues' of States. The earlier Commissions interpreted this provision to cover only revenue gaps of the States for non-Plan purposes and did not consider the gaps on account of capital expenditure on non-Plan schemes. But the Fifth Commission observed that "as the language of Article 275 stands, there is nothing to exclude from its purview grants for meeting revenue expenditure on Plan schemes, nor is there any explicit ban against grants for capital purposes." This controversy, however, was laid

5. The Fourth Finance Commission also did not recognise the limitation of Article 275 grants only to revenue expenditure of the States for non-Plan purposes, but dropped the exercise on some other pretext. Report, Fourth Finance Commission, 9, 1965.
to rest on the appointment of the Sixth Commission when their terms of reference enjoined them to take into account the non-Plan capital gaps of the States for the period 1974-75 to 1978-79. Same was the requirement on the part of the Seventh Commission. Such an uncertainty as to whether the Finance Commission should take into account the non-Plan capital gaps also or confine only to revenue gaps of the States, limits the scope of the working of Finance Commissions.

The Finance Commissions have differed on the criteria for determining eligibility and the quantum of grants-in-aid as well as their scope. They started with the hypothesis that 'fiscal need' was the starting point but 'fiscal needs' have been defined and determined differently by successive Finance Commissions. The Commissions have not adopted uniform rules for scrutiny of the budgets of the States. Their approach on the point as to whether certain expenditures are admissible or not has not been consistent and they have taken contradictory positions in this respect. The anomalies in fixing amounts of grants-in-aid for States also arise because of several flaws inherent in the methodology adopted by the successive Finance Commissions.

The grants-in-aid recommended by the successive Finance Commissions under Article 275, after considering tax-devolution to the States, have been used to bridge up the residual gap. The successive Finance Commissions have based their recommendations solely on the budgetary deficits of the States. This has encouraged the States to exaggerate their revenue requirements in the hope of qualifying for the grant from the Commission. The First Finance Commission had recommended that budgetary needs of the States should be an important criterion for determining the amount of the grants-in-aid to the States. Though an important factor, the Commission required that a number of adjustments were to be made in States' budgetary forecasts to make them comparable. While reducing the budgets to comparability unusual and non-recurring items of revenue and expenditure were to be eliminated. Apart from

6. For methodology, see Chapter VII, supra.
the budgetary plight of a State, the Commission set forth specific criteria like (a) tax efforts; (b) economy in expenditure; (c) standards of social services; (d) special obligations and broad purposes of national importance. Due allowance, according to the First Commission should be made for "clear cases" where the tax-efforts were not maximised and economy in expenditure was not maintained. Furthermore, grants-in-aid should help equalise the standards of basic social services in the various States. It is possible that the amount of assistance, calculated for two States on the basis of budgetary need may be the same but the State with a relatively lower level of social services should according to the First Commission qualify for a higher amount of assistance. This cannot be achieved if too much emphasis is laid on budgetary equilibrium and the grants are made on that basis. It is for this reason that we find that a poor State like Uttar Pradesh was not recommended any amount by way of grants-in-aid, by the first five Finance Commissions and Bihar was also not recommended any grants-in-aid by the Fourth and the Fifth Finance Commissions.

It may be emphasised that under such a situation, when budgetary deficits of the States on a Standard basis have become the main base of grants-in-aid recommended by the Finance Commission, States with high level of expenditure or relatively low levels of taxation, would get grants irrespective of their economic strength. The principles enunciated by the First Finance Commission relating to the grants-in-aid have been approved by the successive Commissions but none in fact put them into practice satisfactorily. The budgetary gaps have thus been the bed-rock of statutory grants and almost all the Finance Commissions have adopted a gap-filling approach, although each of them has declined this mechanism.

The gap arises because on the one hand some States do not raise enough taxes, on the other hand, other things remaining equal, if a State, like Kerala, spends large sum of money on education etc., a revenue gap may arise. It may also be the result of mismanagement and incompetence in the running of the undertakings like the electricity boards, road transport and
irrigation works. Without objective criteria of some kind, the gap-filling approach whichever way one looks at it, has to be arbitrary and this kind of arbitrariness in grants is unavoidable. It puts a premium on a state's propensity to increase its expenditure and not raise its revenue. What is worse about this, is that, any type of expenditure that the State wants to indulge in, whether it is nationally important or not, gets ultimately included in the non-Plan revenue outlay of the State. This is an unsound practice and leads to undesirable developments.

If the Finance Commission adopts a gap-filling approach, the incentive to raise revenue and desist from extravagance will be sharply eroded. On the other hand, if a State has over a period built up a strong resource system and a reasonably competent collection machinery, it should not be penalised. Its larger tax base may be due to its own tax-efforts, economic measures it has taken, and its political decisions over the decades and the extent of money it spends on public services.

But how to withdraw from the gap-filling approach? It will be difficult to suddenly cut away from something on which the States have been brought upon for a long time. Since they have already built up an increasing base of expenditure which they cannot finance and are expecting that all the tabs will be picked up by the Finance Commission, it has to be done in stages. The first thing to do is to get a measure of what might be called "fiscal deficiency" of the individual States. To do this the Commission is to estimate realistically the figures and performances of a State for a particular year and to look how it will work out in the next five years. After this is made up, the Commission may add certain amount to enable the States that are lagging behind in certain essential services and administrative competence to reach the average levels for all the States. These two together can constitute the total amount of grant a State is entitled to. Take for example, a State has 'x' fiscal deficiency and is not going to make up what it needs to spend on its services which are already on the ground. Then that amount of money has to be provided for it. The Seventh Finance Commission
adopted "fiscal deficiency" as one of the factors for determining the share of a State in the divisible pool of Union excises. As in Australia and Canada, the notion of "fiscal deficiency" can be used for the distribution of Grants by the Finance Commission.

But unless some monitoring mechanism is introduced, this kind of devolution will go unvalued. For, whatever the criteria, the Finance Commission may adopt for reckoning "fiscal deficiency" or filling the gap or whatever it decides a priory what should be the level of services for the next five years, but there is no way of ensuring that in the five years, these services of the agreed standard will in fact be created by the States. But there are formidable problems regarding monitoring. Firstly, not much information is made available by the States, secondly, even when information is available, it would not be easy to identify the results. Besides, it is difficult to have any meaningful monitoring in terms, first of evolving the norms of improvement for a five years period, and then of evaluating the performance of individual State Governments as measured by these norms. The Seventh Finance Commission went into the question of the objectives, scope, methods and agencies for monitoring, with due regard to the need of the system, being effective without becoming cumbersome to operate or self defeating in the ultimate analysis. The Commission suggested that the provisions for upgradation of standards should have to be used on the basis of physical plans of action which are to be formulated by each State in consultation with the administrative Ministry concerned at the Centre. The State should then proceed to utilise the upgradation provisions in accordance with the plans of action, the progress being reviewed by the concerned administrative Ministry at the Centre, on the recommendation of which the Ministry of Finance should make releases by way of grants to match the expenditure in respect of the upgradation provisions the Commission has allowed. Such a monitoring mechanism it is suggested would go a long way to ensure that the funds provided for specific purposes are actually utilised for those purposes and are not diverted.
Discretionary Grants-in-aid

Apart from the resources made available to the States by the Union on the basis of the recommendations of the Finance Commission large grants have been made to them by the Centre under Article 282. This Article enables the Centre to make discretionary grants to the States for non-Plan purposes. These grants are meant partly to buttress the States resources and partly to enable the State Governments to carry out certain special purposes. Though they are called non-Plan grants but they are multifarious in nature and can be made for any purpose contained in the three lists of the Seventh Schedule to the Constitution. However, the broad purpose for which these grants are meant is to assist the States in specific directions outside the Plans. In some cases, the assisted schemes are such as are under the usual classification, cannot be included in a Plan. For example, grants made for the development and expansion of administrative services which are classified as non-developmental activity and fall outside the Plan.7 Secondly, some of the schemes which are actually Plan-schemes are temporarily treated as non-Plan for they are initiated subsequent to the finalisation of the Plan. For example, the scheme for educated unemployed was taken up by the Central Government subsequent to the finalisation of the annual Plan for 1971-72 and during that year the scheme as well as the assistance for it was treated as non-Plan. In the subsequent year 1972-73, the scheme was transferred to the Central Plan for 1972-73 and the grant for the same ceased to be non-Plan. There may also be an arbitrary classification by the Government of similar schemes into Plan and non-Plan categories. As the Study Team on Centre-State Relationship pointed out that development activities like construction of wells, tanks, and roads for the resettlement of six hundred families in Panna district were treated as non-Plan scheme by the Madhya Pradesh Government, while similar schemes for the settlement of eighty families in Betul and Noshangabad districts were treated as Plan schemes. Further there may be a case where non-Plan discretionary-grant under Article 282 is made to supplement the assistance provided by the Finance Commission, for

7. It may be mentioned that the Plans are drawn exclusively for economic and social developmental schemes.
example, assistance given for natural calamities. 3

The justification for such grants lies in the fact that
the schemes and programmes are of national or inter-State
importance. Some activities though being exclusive responsibility
of the State Government, by virtue of their external economy
effects, need to be promoted in the general interest of the
country. There may also be schemes, where the concerned State
Government not being enthusiastic for their promotion, special
assistance can be used by the Central Government for providing
the States the required incentive. 9

These grants have been criticised both from the legal as
well as fiscal points of view. They are accused of promoting
defederalising trends. It is said that through this mechanism,
the Union Government encroaches upon the autonomy of the States.
Further that these grants stifle the States' initiative at
resource mobilisation. 10 Justice Kulparkar has gone so far
as to state that "squandering of the proceeds for such public
purposes on matters outside the legal ambit of the Union and the
States strikes at the root of federalism and leads to partisanship
and misuse of revenue and financial resources to the detriment
of true growth of federalism. 11 The Chairman of the Fourth
Finance Commission commenting on the form of grants made under
Article 282, observed, "Article 282 contemplates a grant for
a public purpose. I doubt if grants under Article 282 can be made
without such grants being tied to a specific public purpose." 12
In his opinion, Article 282 was not intended to serve the purpose
for which it is now being so largely used. It is a well-recognised
concept that the spending power of the units as well as the general

8. Report, Study Team on Centre-State Relationship, Administrative
10. Dr. Bajaj, 126.
133, University of Bombay, Bombay, 1967.
12. F.V. Rajmanthan's separate Minute appended to the Report of
Government in a federation is co-extensive with their legislative powers. It would therefore be incompetent to the Union to spend money for a purpose not covered by the Union list, the Concurrent List and for the State for a purpose not covered by the Concurrent or State list. 13 'The real purpose of Article 282' he opined was 'to validate such expenditure on purposes which went beyond the legislative purposes of the Union and the States'. He suggested that while Article 282 may continue to stay for the purpose for which it was originally intended, "a specific constitutional provision may be added to enable the Union Government to make conditional grants to States for implementation of any project whether falling within or without the Plan scheme on terms and conditions which will ensure a proper utilisation of the grants."

But these views have not been appreciated by the Study Team of the Administrative Reforms Commission. The team after analysing the history and scope of Article 282, reached the conclusion that the legality of the present use of Article could not be questioned. 15

The rationale of such assistance may depend on the presumption that the Union Government is a better judge of peoples' interests even in functions which belong to the States. Such an assistance may be given in the nature of reimbursement for expenses in connection with Central Government's policies or State problems with predominantly all-India impact. The grants are made without being based on general principles applied in one type of assistance or another. Following, we have discussed some of such schemes where the Central Government made the assistance to the States under Article 282.

On the recommendations of the University Grants Commission the Central Government started a scheme of grant assistance to the State Governments in order to enable them to improve the salaries of teachers in the Universities and affiliated colleges. The scheme commenced with effect from April 1, 1966. The Central

13. Ibid.
14. Id. at 92.
grants covered 80 per cent of the additional expenditure required to be made by the States in the form of "Grants for improvement of salary scales of University Teachers."

The grants for "Merit Scholarship Scheme" provide for the Central Government to bear full cost of the merit scholarships given by the State Governments to the children of teachers of primary and secondary schools.

Under the "National Scholarship Scheme", though administered by the State Governments, the Central Government gives scholarship to the deserving students on merit/merit-cum-means basis. There are other schemes relating to education where assistance is given by the Central Government to cover whole or a substantial part of the expenditure involved.

'Agriculture' pertains to the State List. But agricultural production being of national importance, the Union Government has started some schemes for assisting the States in respect of some specific agricultural activities. For example, schemes for the "Award of Community Prizes for Increasing Agricultural Production" and "Bonus for Foodgrain Procurement".

Grants on matching basis are made by the Central Government to the State Governments in certain schemes of development of roads, bridges, ferries and other means of communication.

Numerous other schemes are there where the Central Government shares the expenditure with the States on matters requiring joint responsibility of both the Centre and the States, some of these may be briefly given below:\textsuperscript{16}

\begin{itemize}
  \item Assistance for Schemes of Relief and Rehabilitation.
  \item Grants for training of craftsmen.
  \item Grants for Preservation of Sites not Protected by the Archaeological Survey of India.
  \item Grants for Archaeological Excavations.
  \item Grants for Small Savings Schemes.
  \item Payments for Police Force.
  \item Grants for the Building and Maintenance of Border Roads.
\end{itemize}

\textsuperscript{16} Grewal, 138-150.
Grants for Rural Housing Research-cum-Training-cum-Extension Centre Wings.

Grants Relating to National Sample Survey.

Grants for Railway Safety Works.

The Central Government also makes grants under the second proviso to Article 275(1) which requires that special grants should be paid to the State of Assam for meeting the cost of such schemes of development as may be undertaken by the State with the approval of the Central Government for raising the level of administration of Tribal Areas of the State.\(^{17}\)

It may thus be noticed that the above mentioned grants are meant to foster services which for one reason or another assume national or inter-State importance. In matters where harmonization of State interests in essential, the Centre has a better vision and perspective. These grants are given to meet multifarious situations. Therefore, in terms of money and variety of programmes, such grants play a very significant role in the present-day pattern of Centre-State financial relationship.

**Grants for Plan Purposes**

As already stated the object of federal grants in the context of economic development is to maximise the national production for achieving inter-regional equilibrium. These grants also influence the relative growth of individual States because varying amounts of Central assistance are given to individual States depending on their relative planning needs. In addition to bridging the resources gaps at the State level, the Central assistance serves as an instrument for the Central Government to secure enthusiastic State approval and implementation of coordinated State Plans.

Grants for Plan purposes are given by the Central Government on the recommendations of the Planning Commission. The nature and scope of these grants and the criteria of making them are

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\(^{17}\) The grant amounts to Rs. 40 lakhs a year. On the formation of a separate state of Nagaland, the grant is divided between the two States in proportion to 3:2.
discussed below.

The practice of giving grants from the Centre to the Provinces for assisting them in the developmental schemes had been in vogue even before the advent of Five Year Plans. After Second World War, the Central and Provincial Governments in India had embarked on certain developmental projects which received Central assistance in the form of 'post-war development grants'. Some of these grants had stopped by 1950-51 but grants for 'Grow More Food' schemes and certain other special schemes continued. These grants were provisionally envisaged to be distributed on the criteria of population, but some weightage was given to the backward Provinces of Assam, N.W.F.P., Orissa and Bengal, which had been affected by the impact of the War in the North Eastern frontiers. In 1948, with the review of the development schemes, the criteria of allocation of these grants was fundamentally changed and the grants were made contingent upon the Provinces spending from their own resources at least equivalent amounts on specific schemes. 18

With the introduction of planning and the creation of the Planning Commission, Plan-grants have become an important component of receipts accounting for one-half to three-fourth of the States Plan outlay. In theory, these grants are meant to fill the gap between the own resources of the States (including statutory grants under Article 275) which can be spared for the Plan and the total financial costs of the State Plan. There is, however, no rigid principle to determine the size and investment of the State Plans and Central assistance which is meant to influence them. 19 The peculiar feature of these grants is that they are not compulsory like grants-in-aid under Article 275, rather they are discretionary grants made by the Finance Ministry on the recommendations of the Planning Commission. Their quantum is determined by the concerned Ministries at the Centre.

18. Tripathy, 194-95.
The main purpose of Plan grants is to help the States to undertake development schemes that have been given priority in the Five Year Plan. Such schemes may be classified into two categories viz. 'Centrally-Assisted' and 'Centrally-Sponsored'. The former schemes are exclusively mentioned in the State Plans and are initiated by the States with the approval of the Planning Commission. The latter are schemes which are suggested and initiated by the Centre with the consent of the Planning Commission and for the execution of which the Central Government may meet the entire or a part of expenses.

**Centrally-Assisted Schemes**

The planning assistance is largely meant to enable the States to fulfil their Plan, which has been settled in consultation with the Planning Commission. Planning in the context of India, as already stated, has three major aims - rapid economic development, balanced regional growth and an equalitarian bias. These objectives have to be reconciled in the best possible manner and a long-term planning policy must pay due regard to each without losing sight of the short-term needs and consequences of each step. This requires that the Central Government must carefully formulate the policy of Central assistance reflecting a definite attitude towards inter-regional development and specifying clearly, the inter-governmental relationship in the matters of formulation, financing and execution of the Plans. It may be interesting to examine how the Central assistance is made to the States since the commencement of the First Five Year Plan.

Under the **First Plan** Central grants for Plan purposes were both discretionary and statutory. The Plan comprised some of the post-war reconstruction and development schemes which were under implementation in the States and some new schemes of social services. In the First Plan, a number of schemes such as multi-purpose rivers valley schemes, community

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20. Id. at 86.  
22. Some of the States received grants on the basis of the recommendations of the First Finance Commission. See supra.
development, special minor irrigation programmes, local works, basic and social education, industrial housing etc., formed part of the Central Sector, though belonging to the State Sector and in fact, they were included in the State sector in the subsequent Plans. There existed no definite principles for the distribution of the Central assistance and no clear indication is available as to how the assistance to the States was decided upon. The quantum of assistance varied from scheme to scheme, was different within a scheme for different types of expenditure and sometimes changed from year to year. It resulted in much complication, confusion and delay in payment, to which was ascribed much of the halting progress of planning. Even though the amount of assistance was arrived at after discussions with the Chief Ministers of the respective States following an assessment of the States' own resources and their needs for development, yet the position could not be clearly visualised for reasons such as delay in the finalization of the Plans by the States and the late availability of the report of the First Finance Commission. The total Central assistance for development purposes of the States amounted to Rs.380 crores was actually paid to the States during the years 1951-56 on the basis of population of the States.

During the Second Plan, the Plan outlays of individual States were determined after discussions between the Planning Commission and the Chief Ministers of the States. The resources of all the States taken together amounted to Rs. 826 crores (approx.) against an approved outlay of Rs. 2,103 crores, thus leaving a gap of nearly Rs. 1280 crores. During the Second Plan, the quantum of Central assistance was not pre-determined. It continued to change from year to year in the light of the financial position of the States and the Centre and the requirements of projects taken up in both the States as well as, the Central sectors. At the time of the finalization of the annual Plans,

23. Lakdawala, 97.
Central assistance for each State was also settled. Against the original gap in the overall resources amounting to Rs. 1,280 crores, the total Central assistance given to the States during 1956-61 amounted to Rs. 1058 crores.

The Third Plan laid down the criteria in drawing the size of the Plans of individual States as "needs and problems of each State, past progress and lags in development, the likely contribution to the achievement of major national targets, potential for growth and contribution in human resources which the State is able to make towards its development Plans." The Planning Commission gave due consideration to the fact that those States whose own resources were unavoidably small did not have to limit development to a scale which was altogether insufficient because of paucity of resources. At the same time, the States which were able to make larger efforts in mobilizing their own resources were allowed to undertake development on an appropriate scale. Thus, in the Third Plan the importance of 'balanced regional development' was realised and Central assistance was made a balancing item once the outlay and the States' own resources were decided. The total Central assistance during this Plan amounted to Rs. 2,375 crores as against Rs. 1,462 crores as the States' own resources. Individual States were intimated as regards the quantum of assistance for the five year period they were entitled to.

During the first three Plans, it may be observed there existed no definite principles for the distribution of Central assistance for Plan purposes. The assistance was treated as a residuary magnitude, the State-wise distribution of which automatically followed from the determination of the State Plan outlays. The Plan assistance was invariably decided at the time of annual Plan discussions. The absence of an objective criteria for inter-State allocation of Central assistance was admitted by the Planning Commission in one of the meetings of the NDC.  

This approach of the Planning Commission towards Central assistance to States underwent a change in 1966 with the formulation of the Fourth Five Year Plan.29 The desirability of evolving objective principles was emphasized by several Chief Ministers during the discussions on the Preliminary Memoranda on the Fourth Plan held in July, 1965. The National Development Council accepted that Central assistance must be distributed on the basis of some objective criteria and discussed several proposals put forward by the Planning Commission and different State Governments. But no agreement was reached in the Council. Thereupon, the Planning Commission was authorised to formulate the principles in the light of the discussions held in the National Development Council.30 The Commission laid down the following criteria;31

(i) Every State should receive first a quantum of seventy per cent of the total amount to be distributed in proportion to its population.

(ii) The balance should again be distributed but after taking into account (i) the special needs of Jammu and Kashmir, Assam and Nagaland to enable them to have at least a modest and reasonable Plan, and (ii) the special needs of some States which are required to contribute large amounts of expenditure on continuing schemes of irrigation and power of national importance, and (iii) the need for accelerated development of certain backward regions like the hill areas, etc.

However, the principles could not be finalised because of the postponement of the Fourth Plan for three years and the uncertainties surrounding the overall resources position. The Annual Plan 1966-67 had to be finalized before the discussions on the Draft Plan 1966-71 concluded. Certain States had to be given additional assistance to meet the situation created by external aggression, devaluation of the rupees, draught conditions

30. Supra note 26 at 38.
31. Ibid.
etc. This allocation for 1966-67 was, therefore, decided on an ad hoc basis. As the conditions did not change, the distribution of Central assistance for the Annual Plan 1967-68 had again to be finalised on ad hoc basis. This ad hoc distribution during 1966-68 deprived some of the States of their share in the Central assistance which they could have received under the Draft Plan 1966-71. The shortfall in Central assistance to these States was decided to be corrected during the Annual Plan of 1968-69 up to the extent of one-third.32

The Planning Commission re-examined the question afresh at the time of the formulation of the new Fourth Plan 1969-74. In the light of the discussion held with the State Governments on the criteria, the Commission submitted certain proposals for the consideration of the National Development Council in July, 1968. It was finally in September 1968 that the Council adopted with some modifications the criteria proposed by the Planning Commission. The finally adopted criteria were:33

(i) The requirements of Assam, Jammu and Kashmir and Nagaland shall first be met out of the total pool of Central assistance;

(ii) The balance of Central assistance shall be distributed among the 14 States as under:
(a) 60 per cent on the basis of population;
(b) 10 per cent on the basis of per capita State income (assistance under the criterion going only to States having per capita income below the national average);
(c) 10 per cent on the basis of tax-effort in relation to State income;
(d) 10 per cent on the basis of spill-over of major continuing irrigation and power projects;

32. Hamlata Rao, 49.

10 per cent on the basis of special problems of States. The Commission has taken into consideration various major problems of individual States, such as chronically drought affected areas, tribal areas, floods, metropolitan areas etc.

The above criteria formed the basis of distribution of Central assistance for the Fourth Plan 1969-74. The total Central assistance amounted to Rs. 3,500 crores, out of which Rs. 400 crores were set aside for Assam, Jammu and Kashmir and Nagaland and the rest of Rs. 3,100 crores were distributed among the States.

The NDC also recommended at its meeting held in July 1968 that Central assistance to States for their Plan schemes be given in the form of block loans and grants, thus, providing for complete abolition of scheme-wise patterns. After taking into account the recommendations of the Administrative Reforms Commission and the views expressed by the State Governments, it was decided in consultation with the Ministry of Finance that Central assistance to States for the Fourth Plan would be given as block loans and grants each year. Each State was to receive 30 per cent of the total central assistance as grant and the balance of 70 per cent being in the form of loan.

The adoption of the new formula of Central assistance made important departures in the scheme. It was for the first time that objective criteria had been laid down for the distribution of Central assistance. With this, the weightage given to the objective of reduction in inter-State economic inequalities in the scheme of financial transfers became definitive. Thus so far, the Commission's approach to this issue was of general type. Secondly, under the new approach, the control of the Planning Commission and of the Central Ministries over the manner and the deviation of expenditure of assistance funds had considerably

34. This came to be known as the Gadgil formula, after the name of the then Vice Chairman of the Planning Commission.
35. Summary Records of the Meeting of the N.D.C. July, 1968. The N.D.C. recommended that the Central assistance be given in the form of block loans and grants.
reduced. Earlier to the Fourth Plan, the Union assistance was tagged to heads of development, sub-heads and to individual schemes according to the patterns of assistance. Diversion of funds to other schemes or heads was not possible without the concurrence of the Planning Commission and concerned Central Ministries. With the abolition of patterns of assistance in the Fourth Plan, the central assistance is no longer tied to individual schemes and projects. Unlike the past practice the States were not to seek Centre's permission to divert funds from one head to another. This represented a qualitative shift in the Commission's involvement in determining the structure of the States' Plan expenditure. The States are free to decide the direction and manner of their Plan expenditure. But in the interest of adherence to national priorities, State outlays on some Expenditure heads are earmarked by the Centre. 36

**Centrally Sponsored Schemes**

As stated earlier, Centrally sponsored schemes are those schemes and projects which are suggested and initiated by the Union Government for inducing the States to adopt those schemes which are considered to be of a high national priority by the Union Government but about which the States might not be equally enthusiastic. These schemes generally relate to the State subjects. In their cases, the Centre sponsors the schemes and undertakes to bear a part of the financial burden involved. These differ from the assisted schemes in two major ways. Firstly, in the sponsored schemes, the Centre has a more direct interest and the Central expenditure on them forms a part of the Central Plan, the corresponding State expenditure falls within State Plan expenditure. This assistance forming part of Central expenditure is given in addition to that given for Centrally-aided schemes. In such sponsored schemes, the Central Government usually attaches certain amount of conditions and the concerned State has to accept them if it wants the schemes to be located within

its jurisdiction. There is no merging of schemes into groups and groups into heads, and the identity of each scheme is maintained. Such schemes have not found favour with the States. But none of the States had the courage to say "No", since this might be interpreted by their own residents as an unjustified refusal to deprive them of the proper advantages of a liberal Central offer. But by accepting the schemes, the States undertake to bear a part of the expenditure which they could not provide out of their committed resources. On the organizational and the implementation side also, the Planning Commission and the Central Ministries maintain a detailed control and supervision in order to ensure balanced development and adherence to priorities considered essential by them. This leads to unrealistic planning by the States whose primary concern becomes to get the maximum from the Centre. But these schemes are justified on the ground that they provide initiative for States to take up programmes of national importance. Commenting upon the effective use of such schemes, the Member Secretary to the Third Finance Commission remarked: "Under the Constitution, the economic and social planning is a concurrent subject. But many functions undertaken in furtherance of the Plan are entirely in the State field in respect of which the Centre has no constitutional authority to require the States to execute the programme in any particular manner. The only way it can do so is by providing that at least for that part of the programme, which is considered to be of national importance, the States are given a financial inducement in the shape of tied grants to undertake and implement these schemes... I am not suggesting that the State governments cannot be trusted. But we cannot overtake the fact that in this large and diverse country of ours, there could be difference as to the national as distinct from the State or regional point of view."  

37. Lakdawala, 102-3.  