CENTRE-STATE FINANCIAL FLOWS
AND
INTER-STATE DISPARITIES IN INDIA

THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF DOCTOR OF PHILOSOPHY UNDER THE FACULTY OF SOCIAL SCIENCES, UNIVERSITY OF COCHIN.

BY
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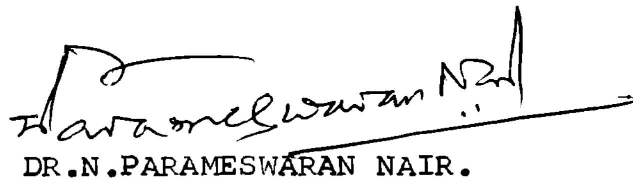
C E R T I F I C A T E

This is to certify that the thesis "Centre-State Financial Flows and Inter-State Disparities in India" submitted by Shri. K.K.George for the Degree of Doctor of Philosophy under the faculty of Social Sciences is a record of the original work done by him under my supervision and guidance.



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CERTIFICATE

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PREFACE

It [illegible] nearly seven years since I have been involved with the study of the larger problem of regional disparities in India economic development and its different dimensions. It was when I was in the Economic Research Department of the State Bank of India in 1975 that I was first involved with the question in an indirect way. One of my research assignments was a study of the regional pattern of the deployment of bank funds. I had the opportunity to pursue this subject further when I was awarded a research fellowship by the ICSSR to make a study of the problem. After I joined the University of Cochin I was registered for research leading to the degree of doctor of philosophy on the present problem. I wish to take this opportunity to express my deep gratitude for the facilities offered to me to pursue this study in its different aspects to the ICSSR and the Centre for Development Studies, Trivandrum where I worked on the fellowship; and the School of Management Studies, University of Cochin. I am particularly grateful to late Prof. J.P. Naik, the then Secretary of the ICSSR.

I am grateful to my supervising teacher, Dr. N. Parameswaran Nair, Director, School of Management Studies for his guidance as also for the encouragement and support given.

I had benefited considerably from the discussions I had with Dr. I.S. Gulati, a member of the Sixth Finance Commission, who had shared his rich experience in this area.

Discussions with other Fellows and Research Associates at Centre for Development Studies like Dr.K.N. Raj, Dr. P.G.K. Panikar, Dr. Krishnan, Shri C.P. Chandrasekharan, Shri and Shri D. Narayana had been of considerable benefit.

During the course of my work in this area I had received considerable assistance from my colleagues and students. A special word of thanks is due to Miss.K.C. Ranjini who assisted me with some of the statistical work.

My acknowledgement to my wife Shirly, goes beyond the usual custom of thanking one's wife. Despite having to shoulder the burdens of running a household, she found time to help me with the enormous tabulation work involved in this study. On this occasion, I also remember my three young ones - Justin, Jean e, and Ann - who in a sense had borne the real costs of this work.

In decoding my handwriting and bringing out this thesis so neatly and in time, Shri M.S. Mukundan and the secretarial team at the School had gone beyond their calls of duty. I acknowledge thanks to them.

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CHAPTER I

STATEMENT OF THE PROBLEM

The problem of regional disparities in economic development is for India an inheritance from the colonial past. At the beginning of the First Five Year Plan (1950-51), three years after the advent of independence, the per capita State income showed considerable inter-state variations. The per capita income of Bihar which stood at the bottom of the State income ladder was only less than two fifths that of West Bengal which stood at the top. Also, Bihar's per capita income was only three fifths that of the national average[1] as may be seen from Table I-1.

It has been pointed out that this uneven development resulting in regional disparities was not due to any uneven resource endowments. Development was concentrated in a few areas to suit the interests of the foreign government. Regions with proximity to ports or producing export commodities or with military importance developed at the cost of others[2]. It was understood by the Indian planners that left to the market forces, this uneven growth will perpetuate itself and that any further widening of inter-state disparities would not be desirable either from the political or economic angle. One of the objectives of all Indian Five Year Plans therefore was to reduce the inter-state disparities[3].

TABLE I.1

Per Capita State Incomes - Deviations from All States Averages (%)

States	1950-51 (N)	1955-56 (N)	1960-61 (N)	1960-61 (C)	1964-65 (C)	1968-69 (C)	1970-71 (C)	1973-74 (C)	1975-76 (C)
	1	2	3	4	5	6	7	8	9
Andhra Pradesh	87	90	86	103	105	89	95	102	93
Assam	113	109	98	115	106	109	92	79	88
Bihar	61	63	66	71	72	75	68	66	69
Gujarat	129	123	120	125	125	117	136	131	128
Haryana	--	--	--	--	--	136	151	154	156
Himachal Pradesh	--	--	--	--	--	113	109	112	120
Jammu & Kashmir	--	--	--	--	--	76	90	84	85
Karnataka	97	100	93	96	100	103	109	116	107
Kerala	103	102	97	91	94	101	103	103	103
Madhya Pradesh	80	90	87	90	89	81	79	84	82
Maharashtra	126	131	143	138	126	126	131	136	150
Manipur	--	--	--	--	--	94	66	93	93
Meghalaya	--	--	--	--	--	--	104	86	93
Nagaland	--	--	--	--	--	84	82	80	98
Orissa	85	81	80	74	83	92	87	90	86
Punjab	137	127	131	126	138	177	172	174	174
Rajasthan	87	89	81	89	85	75	102	97	90
Tamil Nadu	83	95	102	113	104	101	100	101	103
Tripura	--	--	--	--	--	103	91	86	90
Uttar Pradesh	91	85	87	80	89	85	80	79	75
West Bengal	159	146	137	127	119	123	118	108	114
All India	100	100	100	100	100	100	100	100	100

Notes: N - National Council of Applied Economic Research (NCAER) - The State Incomes are at 1960-61 prices.

C - Central Statistical Organization (CSO) - The State Incomes are at current prices.

Source: For columns 1-3, NCAER, Estimates of state income, New Delhi p.57, 1967.
For column 4, Finance Commission, Report of the Finance Commission (Vth), Government of India, New Delhi 1969, p.128.
For columns 5-9, Central Statistical Organization, National Accounts Statistics, quoted by Majumdar Grace and Kapoor J.L., "Behaviour of Inter-State Income Inequalities in India", *Journal of Income and Wealth*, Calcutta, Jan 1980, pp.6-8.

The numerous empirical studies, however, have shown that this regional objective of Indian Plans has not been achieved. In fact, the regional disparities have only widened during the plan era as may be seen from Table I-2. The coefficients of variation of per capita State Domestic Product (SDP) from the national/all-States averages given in Table I-2 is indicative of the widening regional disparities over the last 30 years.

Table I-2

Coefficients of Variation (CV) from the Average per capita income of All States.

Year	CV	Source of data
1950-51	0.251	N.C.A.E.R.
1955-56	0.213	
1960-61	0.242	
1960-61	0.221	C.S.O.
1961-62	0.198	
1962-63	0.214	
1963-64	0.210	
1964-65	0.195	
1967-68	0.226	
1968-69	0.242	
1969-70	0.269	
1970-71	0.262	
1971-72	0.270	
1972-73	0.250	
1973-74	0.260	
1974-75	0.235	
1975-76	0.271	

The formula used is $\dfrac{\sqrt{\frac{1}{n}\sum (x_1 - \bar{x})^2}}{\bar{x}}$

Where

$\bar{x}$ = All India per capita income.

x_i = Income of the ith State.

n = No. of States.

Source: Computed from the data given in,
1) National Council of Applied Economic Research, Estimates of State Income (New Delhi, 1967) p.57.
2) Majumdar Grace and Kapoor, J.L., "Behaviour of Inter-State Income Inequalities in India", in the Journal of Income and Wealth, (Calcutta, Jan. 1980) p.3.

Any inter temporal comparison based on the Table has to be made with caution due to the difference in the sources of State income data before and after 1960-61[4]. However, it may not be wrong to infer that the income disparities increased slightly during the Second Plan. The trend during the Third Plan was one of decline. During the Annual Plan period, the trend was reversed again. During the Fourth Plan, the disparities more or less remained where it was. During the first two years of the Fifth Plan, the trend towards increase was resumed again. This may also be seen from Table I-3. The distance from the State with the topmost per capita income came down in the case of all except two out of the 14 States during the first decade of Planning. The distance of the all States average from the top income State also came down. The distance between the lowest income State and the topmost income State too was reduced. The coefficient of variation from the per capita SDP of the richest State given in Table I-4 too brings out more or less the same trends.

TABLE I.3

Per Capita State Incomes - Deviations from the top ranking State

States	1950-51 (N)	1955-56 (N)	1960-61 (N)	1960-61 (C)	1964-65 (C)	1968-69 (C)	1970-71 (C)	1973-74 (C)	1975-76 (C)
Andhra Pradesh	55	62	60	75	76	56	55	58	53
Assam	71	75	68	83	77	62	53	46	50
Bihar	38	43	46	52	52	43	39	38	40
Gujarat	81	84	84	91	91	66	79	75	73
Kerala	65	70	68	66	68	57	60	59	59
Madhya Pradesh	50	62	61	65	65	46	46	48	47
Tamil Nadu	52	65	72	82	75	57	58	58	59
Maharashtra	79	90	100	100	91	71	76	78	86
Karnataka	61	69	65	70	73	58	63	67	61
Orissa	54	55	56	54	60	52	51	52	49
Punjab	86	87	92	91	100	100	100	100	100
Rajasthan	54	61	57	65	62	42	59	56	52
Uttar Pradesh	58	58	61	58	65	48	46	46	43
West Bengal	100	100	96	92	87	69	68	62	65
Haryana	--	--	--	84	88	76	87	86	90
Himachal Pradesh	--	--	--	--	82	63	63	64	69
Jammu & Kashmir	--	--	--	64	59	43	52	49	49
Manipur	--	--	--	--	45	53	38	53	54
Meghalaya	--	--	--	--	--	--	60	49	53
Nagaland	--	--	--	--	--	46	48	46	56
Tripura	--	--	--	--	65	58	53	49	52
All India	63	68	70	73	73	56	59	57	58

Source: The same as in Table I.1.

C.S.O, estimates in 1960-61 increased to 41 per cent in 1970-71 and to 42 per cent in 1975-76. Between 1960-61 and 1975-76, the distance of 11 states except Haryana, from the top ranking States increased. The distance between the lowest income State (Bihar) and the highest income State (Maharashtra in 1960-61 and Punjab in 1970-71 and 1975-76) increased from 48 per cent in 1960-61 to 60 per cent in 1975-76 as may be seen from Table I-3.

Paradoxically, it was during these later Plans that the problem of regional disparities got wider attention in India. For instance, it was during the Fourth and the Fifth Plans that a new multipronged strategy for correcting regional disparities based on the Gadgil formula[5] and the Pande and Wanchoo working group's[6] recommendations was implemented.

Though industrial dispersal was one of the corner stones of the regional policies of Indian planners, industrial growth during this period was much more uneven than the growth in State income, although the share of secondary sector in the State income increased in the case of all States, except Assam. This may be seen from Table I-5. In 1950-51, the share of the secondary sector in the SDP was more than the national average in the case of seven out of 14 States. But by 1975-76, the share of secondary sector was above the national average in case of only four out of 19 States. The coefficients of variation of the per capita income originating in the secondary sector given in Table I-6 shows a much higher skewness of distribution than the per capita State income. What is more, the skewness is steadily growing.

Table I-4

Coefficients of Variations from the Top Ranking States

Year	CV.	Source of Data
1950-51	0.390	N.C.A.E.R.
1955-56	0.356	
1960-61	0.334	
1960-61	0.293	C.S.O
1961-62	0.260	
1962-63	0.294	
1963-64	0.290	
1964-65	0.307	
1967-68	0.397	
1968-69	0.438	
1969-70	0.440	
1970-71	0.429	
1971-72	0.433	
1972-73	0.440	
1973-74	0.436	
1974-75	0.398	
1975-76	0.428	

The formula is = $\dfrac{\sqrt{\frac{1}{n}\sum (x_i - x_o)^2}}{x_o}$

where: x_o = Income of the top ranking State

x_i = Income of the ith State

n = Number of States.

Subsequent Plans, however, saw the reversal of this healthy trend as may be seen from the same tables referred to above. The distance between the all States average and the top income State which was 27 per cent according to

TABLE I.5

Structure of State Domestic Product - Share of Secondary Sector

Figures in %

States	1950-51 (N)	1960-61 (N)	1960-61 (S)	1970-71 (S)	1977-78 (S)
Andhra Pradesh	8.4	9.5	12.8	13.7	17.3
Assam	12.7	14.2	19.1	14.0	15.0
Bihar	16.9	17.2	10.6	16.8	20.6
Gujarat	16.5	20.9	25.7	20.8	27.3
Kerala	16.1	15.8	15.2	16.4	18.7
Madhya Pradesh	13.3	12.5	14.9	15.2	17.8
Tamil Nadu	16.4	16.9	17.6	25.6	32.3
Maharashtra	19.4	22.4	26.4	33.3	32.2
Karnataka	14.1	15.2	12.4	18.6	21.0
Orissa	6.2	8.0	12.4	12.0	12.9
Punjab	11.1	14.1	16.5	13.3	16.7
Rajasthan	7.0	7.5	15.8	13.2	16.8
Uttar Pradesh	8.9	9.2	11.1	14.9	16.0
West Bengal	18.1	23.7	24.3	23.0	24.3
Haryana	--	--	16.1	16.1	17.9*
Himachal Pradesh	--	--	--	16.9	21.4
Jammu & Kashmir	--	--	8.7	15.0	18.2
Manipur	--	--	--	8.3	6.8
Meghalaya	--	--	--	--	--
Nagaland	--	--	--	--	--
Tripura	--	--	--	7.0	8.5
All India	13.7	15.7	19.1	19.7	22.1

Notes: *Relates to 1976-77

Sources: For columns 1 and 2, N.C.A.E.R., op.cit. P. 67
For columns 3-5, the Primary Sources of data are the State Statistical Bureaus (S). The data is used as reported in the Reserve Bank of India, Estimates of States' Domestic Product, Reserve Bank of India Bulletin, Bombay, April 1978 and September 1981.

Table I-6

Per capita Income originating in the secondary sector: Coefficients of variations from the national Average:

Year	Source of data	Coefficient of Variation
1950-51	N.C.A.E.R.	0.43
1960-61	N.C.A.E.R.	0.49
1960-61	C.S.O.	0.48
1970-71	C.S.O.	0.53
1975-76	C.S.O.	0.52

Sources: 1) Computed from the State Income data of N.C.A.E.R., op.cit. p.57.

2) Computed from data given in Reserve Bank of India, Estimatesof State Domestic Product, op.cit.

Agricultural growth during this period also was highly uneven. Agricultural growth had been either stagnant or declining in nearly half the districts of the country. The per capita food output of Punjab was three times that of Bihar in 1975-76. The growth rate of food production in Punjab was seven times that of Madhya Pradesh. Similar disparities are visible when we look at the relative status of States with regard to absorption of inputs like irrigation, water and fertilizers[7].

Disparities exist not only in State income but also in the unemployment rates. The coefficient of variation in inter-State unemployment rates increased marginally from 67.9 per cent in 1972-73 to 68.3 per cent in 1977-78. The

ratio of maximum to minimum unemployment rate was 14 1 in 1977-78[8].

There is considerable inter-state variation in poverty too. For instance the coefficients of inter-state variation in rural poverty ratios calculated by Raj Krishna[9] show that rural poverty remained undiminished during the period 1957-58 to 1973-74 as may be seen from the Table I-7.

Table I-7

Coefficients of inter-state variation of rural poverty ratio

1957-58	25.19
1960-61	28.34
1970-71	25.05
1973-74	24.34
Average (1957-58 to 1973-74)	24.52

Source: Raj Krishna, *op.cit.* p.6

II

The above analysis shows that the tendency towards convergence, albeit marginal, noticed during some of the earlier Plans was reversed during the later Plans. The trend towards divergence appears to have taken over during the later Plans, in spite of the fact that Indian planning had set balanced regional development as one of its goals[10].

It is sometimes argued that since there is a 'trade-off' between the national objective of high growth rate for the economy as a whole and the regional equity objectives,

widening regional disparities are unavoidable or even necessary to achieve a high growth rate.

This argument would have held good if the early development had taken place in accordance with the factor endowments of different regions. As seen earlier, development of selected regions in India took place due to historic reasons and to subserve the military and economic objectives of the colonial power[12]. Some of the poorest States in India today are also the richest in natural resource endowments[13]. Besides, as Benjamin Higgins points out:

> "Tying rich and poor regions together in such a way as to reduce the discrepancies between them, to permit full use of the labour force without serious inflation is the very crux of the development problem. Unless and until an economy is integrated both regionally and sectorally neither tax policy nor any other branch of Central Government's monetary and fiscal policy can assure full employment, high rates of growth and reasonable price stability all at once"[14].

There are others who pin their hopes on the market forces themselves to bring about convergence trends after the initial divergence[15]. But as Friedman observes, the market system that actually exists today which brings about regional disparities is not the market system of Adam Smith.

> "It is not a competitive economy of small producers. In fact, what we have is a set of small number of monopolistic producers, who in intimate conjunction with the government are managing the economy. So, what we have is a managed economy rather than a market

economy and unequal development, slums, poverty, megacities etc. are the result of management, not automatic results or spontaneous results coming from heaven"[16]

Besides, regional changes take place only slowly over the decades, unless policy measures are taken to speed up the process[17] This is because, "where large regional gaps persit within the same national economy, it is apparent that there is some degree of immobility of factors of production. Capital does not flow to the poorer region in sufficient quantities to provide jobs and raise incomes and thus eliminate the gaps; nor does labour move to the rich region finding there higher income and employment so that the gap disappears"[18]. Though there has been some inter-state migration, it has not been of such a high magnitude as to bring about reduction in inter regional disparities, because in a country of India's size, even distance can inhibit the factor mobility. Added to this are the differences in language, religion, race and culture. The federal constitutional set up itself imposes some barriers for factor mobility in India. On top of this, there have been the 'Sons of the Soil' agitations, with or without the support of the local or State governments or political parties. In such an economy, the "trickling down effects" of development are likely to be smaller [19] than the "polarisation effects".

It is sometimes argued that the regional disparities are smaller in India than in many other developed and developing, capitalistic and socialistic economies[20]. But as the Sixth Finance Commission which noted this argument

observed, even the relatively small disparities cannot be ignored when the absolute levels of per capita income are low[21]. This is all the more true in the absence of social security schemes administered by national government which assure a minimum subsistence to all, in all the regions.

The correction of regional disparities, desirable in itself, is also a means to a desirable end; viz., reduction of inter personal disparities in income. As Raj Krishna notes, "Since millions of poor households are concentrated in a few regions, the reduction of inter regional disparities will inevitably lead to the reduction in the number of those below the poverty line"[22]. The three year average (1973-76) per capita income of Punjab (Rs.1,586) was 2½ times that of Bihar (Rs.645). Conversely, the poverty ratio in Bihar was 2½ times higher than that in Punjab (in 1972-73)[23].

The reduction of inter-state disparities is a desirable end in itself in a nation with many sub national groupings. The Indian polity with its regional constituents organised on linguistic basis with its distinctive cultural overtones cannot be expected to withstand for long, the weight of the lop-sided economic development. It has often been pointed out that the political events in North East, Assam, and of late in Punjab have certain economic undertones also[24]. The threat to federal polity comes not only from the poorest constituents, but also from the richest as noted by R.J. May. Surveying the experiences of large number of federal states the world over, May observes "where a small rich unit is ranged against a large poor unit, or of course, one or two

large rich units are ranged against a number of poor units two broad outcomes are possible: (i) either the small unit accepts the pressure from the large unit and assists it to achieve the higher material standards going in the small unit or else; (ii) the small unit will resist this pressure and seek to secede"[25].

All the above discussions lead to the conclusion that in a nation like India, one cannot patiently wait for the 'spread effects' or the 'trickling down effects' to counter the 'backwash effects' or 'polarisation effects"[26]. Time cannot be entrusted with the task of solving this problem. As Nevin notes "policy can seldom allow its horizons to extend into infinity"[27].

III

The widening regional disparities in India bear eloquent testimony to the failure of regional policies to counter the pulls of external economies, already developed physical infrastructure and social overheads exerted by the developed regions.

In the present study, it is proposed to examine how far one set of regional policies aimed to regulate inter-regional transfer of financial resources, was effective in achieving the objective of reducing the disparities in State incomes. It is not claimed that it is only the quantum of financial flows that determines the growth in State income. The pattern of expenditure financed by these financial flows is also equally important. The social, economic, political

and administrative environments too have their roles to play and in the absence of the desirable environment, the absorption capacity of financial flows from outside will be less. But it has to be conceded that financial flows, if directed to the appropriate sectors and sub sectors, can help to change this environment. It is also admitted that the role of the financial flows is more limited than in a planned economy which also employs administrative controls like industrial licensing and other mechanisms as a means to economic development. But even then, getting control of the financial resources is necessary to get control over real resources though sanctioned by administrative authorities. For instance, a quota alloting scarce raw materials will not be helpful unless the industrialist has necessary finance, either from his own sources or from the financial institutions[28] In any case, the role of administrative controls is progressively getting reduced in recent years and the role of financial controls is correspondingly on the increase.

Left to the market forces, poverty or opulence in a region can be its own cause. An examination of the composition of State income will make the position clearer. The State income is constituted by (i) Government's consumption and investment expenditure, i.e., the budgetary expenditure of Centre and States in India. (ii) Private consumption and investment expenditure of corporate and household sectors[29].

The levels of State Government's expenditure as also private expenditure are likely to be higher in the high income States and lower in the low income States. This may tend to

widen the inter-state income disparities unless the budgetary policies of the Central Government and the credit policies of the monetary authorities are geared to bring about an outward flow of funds from the high income States to low income States to finance the necessary higher level of public and private expenditure in the latter group of States. Apart from the volume of expenditure, the size of the regional multipliers also may tend to widen the regional disparities[30]. The size of the regional multipliers, which *inter-alia* depends on a region's import propensity - the higher the import propensity, the smaller the multiplier - is likely to be smaller in the low income States, especially those States with little diversification of their economic structure. "One will sometimes find also that a mature economy is relatively self sufficient whereas an immature one is subject to severe regional leakages; thus a large proportion of a rise in a backward area's income may leak out to an advanced area in the form of dividends and imports of manufactured goods"[31].

In India, the capacity of the Union Government to bring about resource transfers in the interests of inter-regional equity is higher than in other federal States. This is because of the tightness of the Indian federal polity which is partly due to the constitutional provisions and partly on account of the centralised political and planning processess. The constitutional provisions relating to Centre-State financial relations have been copied from the Government of India Act, 1935 which provided for disproportion between the financial powers and administrative responsibilities of States.

The concentration of resource raising powers with the Union Government and the flexibility which the Centre has got in the allocation of these resources result in the dependence of the States on the Centre.

Whatever may be the other drawbacks of these arrangements - it reduces the autonomy of the States - it has to be conceded that given the will, it permits the Union Government to bring about inter-state redistribution through the fiscal transfer mechanism so as to achieve higher levels of governmental expenditure in the low income States. "The principle of strict allotment of revenue to individual budgets or firmly fixed sharing conceals the possibility of disproportion between planned requirements and financial possibilities in individual territorial units: in some areas and republics there will be more revenue than necessary while in others there will be an acute shortage"[32]. According to Chanda, the framers of the Indian Constitution too had these considerations in mind.

> "It was not that the Constituent Assembly was not aware that in adopting the financial provisions of the 1935 Act, it was making the States lean heavily on the Union for financial support. It was a deliberate act to provide for a measure of Central coordination of social and economic activities of the States to ensure their balanced and harmonious growth"[33].

As Kaushalendra Rao noted, "the experience of the three leading federal systems conveys a warning that in a federal system, uniform distribution of powers between the federations and the S States does not necessarily mean the equal allocation of resources to fulfil the functions assigned under the Constitution"[34].

Apart from the Union Government's influence on the volume of State Government's expenditure through its control on the purse strings, its own direct expenditure is sizeable enough to raise the aggregate public expenditure levels in a State. The Union Government's aggregate revenue and capital expenditure amounted to Rs.18,790 crores in 1980-81 which formed 86 per cent of the combined revenue and capital expenditure of all States[35].

Besides, unlike in other federations, the Union Government has a virtual monopoly control over all financial institutions which mobilise the financial savings of the household sector[36]. The corporate and to a great extent the household investment levels in different States can be influenced by the policies followed by these institutions, controlled and in most cases owned by the Union Government[37]. This is all the more true now as the dependence of the corporate and household sectors on these institutions is on the increase as will be seen in Chapter VIII.

OVERVIEW OF THE LITERATURE

In the above context, a survey of the existing literature on the subject reveals disproportionate concern with one particular stream of financial flows, viz., statutory financial flows effected periodically under the awards of the Finance Commissions. The periodic appointment of the Finance Commissions, their visits to State capitals and public recording of memoranda generate every five years a large volume of literature on the subject. But because of the semi

judicial character of the Commissions, the interpretation of constitutional provisions gets undue emphasis in these discussions. States' autonomy therefore is an issue which gets prominence in this body of literature. Besides, till recently the analysis was more in terms of the progressiveness of each stream of statutory transfers, viz., income tax sharing, excise sharing, statutory grants, etc.[38]. In any case these statutory transfers account for only less than two fifths of the aggregate budgetary transfers[39].

The working of the Administrative Reforms Commission and its various study groups and working groups have contributed to the generation of some literature on the Plan transfers[40]. Most of the discussions on this subject too suffers from the drawbacks of the discussions on statutory transfers noted earlier. Besides the extra constitutional status of the Planning Commission and the misuse of Articles 282 and 293 of the Constitution are issues which have merited attention. There have been some studies of the Central Plan assistance to different States and its regressiveness[41]. But again the plan transfers account for only less than one third of the Central budgetary transfers[42].

One major drawback of the earlier studies has been the exclusion of an important stream of budgetary financial flows, viz. the nonstatutory, nonplan transfers effected by the different Union Ministries according to their discretion. These discretionary transfers which account for about one third of the total budgetary transfers were given very little attention by the researchers presumably due to data problems[43].

Another limitation of the earlier discussions on fiscal transfers is that the equalising effects of the combined budgetary transfers comprising all the three streams of budgetary flows in its totality had rarely been studied[44]. Besides the progressive/regressive nature of budgetary flows had been examined independently outside the context of its effectiveness in bringing about progressiveness in the budgetary expenditure of State governments. A progressive fiscal transfer by itself need not bring about regional income equalisation except if it is of such a degree as to counter the influences of States' own resources. Another drawback of the literature on budgetary flows is its omission to study the debt servicing problems as also debt rescheduling policies from the angle of their effects on regional disparities.

That the flow of finance through individual financial institutions has been more towards the developed States and regions has been brought out in a few studies[45]. But no systematic study of the impact of the financial flows from all the major institutions together on the regional disparities has been made. What is more, these institutional financial flows have been rarely studied from the Centre-State financial relations angle. Yet, such a study is vitally important as these institutions are under Central ownership and like the Central budget they too draw from the same pool of financial savings of the community[46]. The present study seeks to examine the direction of both budgetary and institutional finance, first separately and then together with a view to study their impact on regional disparities.

One of the major limitations of the earlier studies has been that they discuss each stream of financial flows in isolation. Secondly, each of the studies follows its own units and criteria of backwardness. For instance, Planning Commission in the early days used to take contiguous areas with similar climatic and physical endowments as their units of backwardness.for their evaluation studies[47]. Official studies conducted by the term lending institutions now take, especially after the implementation of the Wanchoo Committee's recommendations (noted earlier on p.4) the districts as the units of backwardness. In this confusion regarding unit of backwardness as well as criteria of backwardness, the impact of each stream of financial flows on the overall disparities among States is lost sight of. Throughout the present study, for reasons explained later, we have taken States as the units and per capita income as the yardstick of backwardness.

METHOD OF STUDY

The study is evaluative in nature and uses secondary data derived from the budget documents,[48] as also the annual reports of the financial institutions. The study on the budgetary flows covers a quarter century beginning with 1955-56 and ending with 1980-81. The study could not be extended to earlier years due to the data problems connected with the re-organisation of States. The study could not be brought more upto date as the Revised Estimates are available only for 1980-81. The Budget Estimates available now are liable to substantial revisions and therefore are considered not reliable enough

for inclusion in the study at this stage. For institutional finance, the study, due to nonavailability of comparable data, had to be restricted just to seven years ending 1979-80.

For the purpose of the study, the States have been ranked and grouped according to the three year averages of per capita State Domestic Product for the years 1967-70 compiled by the Central Statistical Organisation for the Sixth Finance Commission[49]. The quantum of financial flows from each stream to each State and each group of States has then been calculated, on a per capita basis over different Plan periods. Besides the rank correlation coefficients between State income at the beginning of the Plan periods and financial flows during the subsequent Plan periods are calculated to determine the regressive/progressive nature of the financial flows. For the calculation of the rank correlation, only 15 States have been taken into account. The special category States have been excluded from these calculations for two reasons. First is the non availability of income data for these States for all Plan periods. Second is the special nature of the economies of these States and the special nature of their problems, not all of them economic, which necessitated abnormal financial flows to these States. The inclusion of these seven States which together accounted for only 2.2 per cent of the total population of all States - less than the individual population of all other States except Haryana - would have distorted the results.

Due to the imperfections and likely margins of errors in State income data, it was considered inadvisable to classify States into two groups, viz., those whose per capita income

are below and above the national average as is being done by the Planning Commission while applying the Gadgil formula[50]. Accordingly, the States have been clustered into four groups - three of them solely according to per capita income and one according to other considerations besides per capita income. The groups are (i) five top income States - those with per capita SDP of more than 10 per cent of all States' average. Included in this group are Punjab, Haryana, Maharashtra, Gujarat and West Bengal which accounted for 26.8 per cent of the population in 1981; (ii) middle income States with SDP in the 10 per cent range around all States' average, viz., Tamil Nadu, Kerala, Orissa, Assam, Karnataka and Andhra Pradesh accounting for 31.8 per cent of the population; (iii) low income States with SDP below 10 per cent of all States' average - Uttar Pradesh, Rajasthan, Madhya Pradesh and Bihar accounting for 39.2 per cent of the population; (iv) Seven border States - Jammu & Kashmir, Himachal Pradesh, Nagaland, Meghalaya, Manipur, Tripura and Sikkim are grouped as special category States.

In classifying the seven border States into special category States irrespective of their per capita income, we have been following the usual practice followed by the Finance Commissions as also the Planning Commission. This is being done for a variety of reasons. Except for Jammu & Kashmir, all these are relatively new States. Three of these were Union Territories till 1971. Most of them are relatively small and sparsely populated. The density of population ranges from 31 per square km. in case of Nagaland to 62 for

Himachal Pradesh as against the all India average of 177 as per the 1971 census.[51]. The population comprises mostly of hill tribes. All of them have a narrow resource base with little diversification of their economies. Besides, all these States except Himachal Pradesh had per capita income less than the all States' average during the period ~~the period~~ 1967-70 which is taken by us for grouping the States.

The selection of the years, 1967-70 as also the averaging of the State incomes for three years require some explanation. Because of the dominance of agricultural sector in the States' domestic products and this sector's proverbial dependence on climatic factors, which vary widely among States, taking one year's State income as the yardstick is likely to be distorting. Therefore three year averages are generally worked out to smoothen these fluctuations.[52] Similarly, in view of the divergence in the trends in prices among States, comparison of State domestic products at State prices will again be distorting[53]. Comparison will be more relevant if the State Domestic Products are worked out at abstract all-India prices, though this also is not fully satisfactory. A comparison of the SDPs worked out using the State prices and all India abstract prices shows considerable variations for the period 1967-70[54]. The difference between the two sets of estimates ranged from Rs.62 in case of Orissa and Re.1 in case of Madhya Pradesh. The first time such State income data based on all India abstract prices were available was for the Sixth Finance Commission and related to the years 1967-70. Therefore, our classification of States had to be based on

1967-70 data though classification based on a three year average income data prior to the study period would have been better. Besides State income data for all the present States are available only from 1967-68 onwards. In fact, data for Meghalaya, the youngest State, are available only from the year 1970-71.

LIMITATIONS

Following the national and international practices, per capita income is used in the study as the yardstick to measure a State's relative development. It is readily admitted that State income is an inadequate index, though it is the single most appropriate index, used most commonly[55]. It would have been ideal if a properly weighted composite index of the socio-economic variables were available. But past attempts to construct such indices have not met with much acceptance due to conceptual, data and weighting problems[56]. Therefore, per capita income, despite its limitations had to be used.

The second most important limitation is the exclusion of one important stream of financial flows viz.: the Central Government expenditure. The magnitude of such expenditure has already been noted. The exclusion was necessitated by the non availability of State-wise data except those relating to the value of gross block in Central Government undertakings, other than departmental undertakings. These data cover only one twelfth of the aggregate revenue and capital expenditure of Union Government and therefore may not be a true indicator of the regional pattern of Central Government's direct expenditure in States.

It may be argued that even if there is regressiveness *per se* in Union-State budgetary transfers, some inter-state redistribution takes place in as much as the developed States get back only less than what they contribute by way of taxes which are progressive to the Central pool and the backward States get more than what they contribute. It would have been better if this argument could be tested empirically. But this could not be done due to the almost insurmountable data problems. It is almost impossible, for example to assign Centre's resources like deficit financing and market borrowings from within the country and abroad to any State. Even conceptually, it is now difficult to trace the origins of the contributions of different States to the Union exchequer as this capacity is not the result of State's policies alone[57]

SCHEME OF THE STUDY

This study consists of ten chapters, including this long introduction. Chapter II examines the disparities in budgetary expenditure of different States arising mainly out of the differences in their 'own' resources position, which in turn is a result of the level and structure of States' income. The role of the budgetary support extended by financial institutions in contributing to the disparities in States' expenditure is also examined.

Chapter III discusses the aggregate budgetary transfers from the Centre to different States during different Plan periods. It highlights the failure of the fiscal transfer mechanism to correct the disparities in budgetary expenditure of States, noted earlier.

In seeking to explain the failure of the fiscal transfer mechanism, Chapters IV to VI analyse each individual stream of budgetary flows.

Chapter IV examines the redistributive effects of statutory financial transfers effected under the aegis of the different Finance Commissions.

Chapter V examines the regional pattern of Central Plan assistance to different States as well as the States' Plan outlays during different Plan periods.

Chapter VI examines the nonstatutory non-Plan transfers effected by the Planning Commission and the different Union Ministries according to their discretion.

Chapter VII examines the aggregate budgetary transfers according to the instruments of transfers. The relative importance of these instruments of budgetary transfers,-share in taxes, grants and loans - are examined.

Chapter VIII discusses the reverse flow of funds from the States to the Centre in the form of repayment of loans and interest payments. The regional equity aspects of the debt rescheduling effected according to the recommendations of the Sixth and the Seventh Finance Commissions are also examined here. This chapter also examines the reasons for the mounting debt servicing obligations. The terms and conditions of the Central loans to different States are examined in comparison with the Centre's own internal and external loans.

Chapter IX discusses the flow of institutional finance from the leading financial institutions under Central ownership, viz., commercial banks and development banks including Life Insurance Corporation and the Unit Trust of India.

Chapter X sums up the findings and analyses the reasons why financial flows showed the regional pattern noted in earlier Chapters.

Notes and References:

1. National Council of Applied Economic Research, (NCAER), Estimates of State Income, New Delhi, 1967, p.57

2. See (1) Thavaraj, M.J.K., "Regional Imbalances and Public Investment in India" (1860-1947), Social Scientist, Trivandrum, November 1972, pp.1-24,
   (2) Hashim, S.R., "Location, Flows and the Problem of Regional Development - Some views along with a Historical Review of Indian Situation", Balanced Regional Development. Bombay, Popular Prakasan, 1970 p.38

3. For a discussion of the evolution of regional objectives, strategies and policies during different plan periods, see 1) Nair, K.R.G., Regional Experience in a Developing Economy, New Delhi, Wiley Eastern, 1982, p.132.
   2) Godbole, M.D., Industrial Dispersal Policies, Bombay, Himalaya Publishing House, 1978, p.63.

4. The source for estimates of States Income for 1950-51, 1955-56 and 1960-61 is the National Council of Applied Economic Research. The first available data published by the Central Statistical Organisation (CSO) is for the year 1960-61. Thus for 1960-61, there are two sets of data available. For 1965-66 and 1966-67, there is no estimate available either from the NCAER or from the CSO. The only estimates available for these years are those from the State Statistical Bureaux. But their estimates, till recently, suffer from the differences in concepts and methodology, as we will be seeing shortly. For these estimates, see Reserve Bank of India, "Estimates of State Domestic Products," Reserve Bank of India Bulletin Bombay, April 1978 and September 1981.

5. The Gadgil formula named after the late Prof. D.R. Gadgil, Vice Chairman of the Planning Commission at the time of the formulation of the Fourth Five Year Plan, relates to the allocation of Central Plan Assistance among the States. The formula first applied during the Fourth Plan, is still in use, with some changes. It is also known as the NDC (National Development Council) formula. for details, see Chapter V.

6. The National Development Council for evolving a strategy for correcting regional disparities had asked the Planning Commission to appoint two Working Groups, one for identification of backward areas and another for recommending fiscal and financial incentives in such areas. The former Working Group was chaired by B.D. Pande, and the latter by N.N. Wanchoo. Their reports are: Planning Commission (a) Identification of Backward Areas, Government of India, New Delhi, 1969,
(b) Fiscal and Financial Incentives for Starting Industries in Backward Areas, Government of India, New Delhi, 1969.
For the list of backward districts identified and incentives made available, see Industrial Credit and Investment Corporation of India, (ICICI), Attracting Industries to Developing Areas, Bombay, 1978, p. 79.

7. See Raj Krishna, "The Centre and the Periphery: Inter-State Disparities in Economic Development", Social Action, New Delhi, Jan-March 1982 p.8.

8. Ibid. p.6

9. Ibid. p.6

10. See (a) Nair, K.R.G., op.cit. p.132.
(b) Godbole, M.D., op.cit. p.63.

11. The first three Five Year Plans, sometimes implicitly and sometimes explicitly, assumed such a trade off. See Nair, K.R.G., op.cit. pp.134-135.

12. Thavaraj, M.J.K., op.cit., Also Raj Krishna, op.cit.

13. For the resource endowments of some of the poorest States like Bihar and Madhya Pradesh in India, see Raj Krishna, op.cit. p.9

14. Higgins, Benjamin, "Taxation and Trade Off curves", The Economic Times, Annual Number, Bombay 1974.

15. For a brief survey of this and other theories of regional development see (1) Nair, K.R.G., op.cit. Chapter 1 and
(2) Stillwell Frank, Regional Economic Policy, Macmillan, London, 1972, Chapter III.

16. Friedman, J., in Growth Pole Strategy and Regional Development Planning, United Nations Centre for Regional Development, Nagoya, (Japan) 1975 p.404.

17. (a) Nair, K.R.G., op.cit. Ch.
    (b) Stillwell Frank, op.cit. Ch. III

18. Higgins, Benjamin, op.cit.

19. Hirschman's terms for the factors leading to convergence and divergence. Myrdal calls them 'spread effects' and 'backwash' effects see (1) Hirschman, A.O., The Strategy of Economic Development, New Haven, (1961), (2) Myrdal, G., Economic Theory and Under Developed Regions, Mathuen, London, 1957.

20. See (1) Williamson, J.G., "Regional Inequality and the process of National Development", Economic Development and Cultural Change, Vol.XIII, No.4, quoted by Majumdar Grace and Kapur J.L., op.cit. p.4 (2) May, R.J., Federalism and Fiscal Adjustments, Clarendon Press, (1969) p.170. (3) For the regional income differentials in U.S.S.R., see Gertrude, E., Schroeder in (ed.) Bandera V.N. and Melnyk V.L., The Soviet Economy in Regional Perspective.

    Much cannot be made of international comparisons of regional disparities as the years taken as also the methodology and sources for compiling income data are different.

21. Finance Commission, Report of the (Sixth) Finance Commission, Government of India, New Delhi, 1973, p.8.

22. Raj Krishna, op.cit. p.1.

23. Ibid, p.4.

24. One of the demands of the Khalistan movement as also the present Akali agitators in Punjab is that the Union Government should implement the Anandpur Sahib Resolution of 1973. The resolution inter alia says: "In the new Punjab the authority of the Centre should be confined only to the defence of the country, foreign relations, communications, railways and currency All residuary subjects should be under the jurisdiction of new Punjab. The new Punjab should have the right to frame its own constitution for these subjects". Quoted by Shouri, Arun in "The troubles in Punjab," Indian Express, Cochin, May 14, 1982.

    For the economic undertones of the present Assam Agitation; see Ghanshyam Pardesi, "Internal Colony in a National Exploitative System", Economic and Political Weekly, Bombay, July 7, 1980.

25. May R.J., op.cit. p.51.

26. These expressions have been used by Hirschman and Myrdal, see F.N. 19.

27. Nevin, E., "The Case for Regional Policy", Three Banks Review, Quoted by Stillwell Frank, op.cit. p.16.

28. For a discussion of the role of financial resources in a controlled economy, see George K.K. (1) "Planning and Banking System's Control of Working Capital" in(ed.) Gupta L.C. Banking and Working Capital Finance, Macmillan, Delhi, 1978 p.91. (2) ________, "Tandon Committee Recommendations: Implications", The Economic Times, Bombay, 2-3 Dec. 1975. (3) _______, "Planning without Credit and Credit Without Planning", Economic Times, 18-19 Oct. 1972, (4) _______, "Credit Planning and Industrial Licensing", State Bank of India Monthly Review, Bombay, Oct 1973.

29. It may be noted that household sector comprises not only of individuals and families, but also of all non corporate, non government enterprises in agriculture, trade and industry.

30. The regional multiplier refers to the number of times the regional income will increase as a result of a unit of expenditure in a State. It is expressed as a numerical coefficient. See Stillwell Frank, op.cit. pp.48-52. For the application of the concept in regional policy, see Foot note 1, in Chapter II.

31. Martillaro, A. Joseph., Economic Development in Southern Italy, Catholic University of America Press, Washington, 1965 p.85.

32. Diachenko V.P., Sitaryan, S.A., "The Budget and the Inter territorial Distribution of National Income," Public Finance, Vol.23, 1968 p.147.

33. Chanda, A.K., "Financial Aspects of Union-State Relations" in ed. Kashyap, S.C., Union-State Relations in India, Institute of Constitutional and Parliamentary Studies, New Delhi, 1967, p.138.

34. Kaushalendra Rao, R., Minute to the Report of the (First) Finance Commission, Government of India, New Delhi, (1952) p.112.

35. Reserve Bank of India, (RBI), Report on Currency and Finance, 1980-81, Bombay, Vol.II, 1981 pp.101-106.

36. This aspect is discussed in greater detail in Chapter IX.

37. For the importance of household savings in the aggregate savings, the share of financial savings in the household sector savings and the relative importance of different types of financial assets in the household sector's savings portfolio, see Reserve Bank of India, the Report on Currency and Finance, op.cit. Vol.I, Chapter II.

38. The earliest to point out the futility of such a discussion was Sastry, K.V.S., in Federal State Financial Relations, Oxford University Press, London, 1966, p.71.

39. Report of the (Seventh) Finance Commission, Government of India, New Delhi, 1978, p.174.

40. 1) Administrative Reforms Commission, (ARC), Report of the Study Team on Centre-State Relationships - Vol.I-III, Government of India, New Delhi, 1968.

    2) ________, Report of the Study Team on Financial Administration, Government of India, 1968.

41. An important early work in this area is by Amiya Chatterjee, The Central Financing of State Plans in the Indian Federation, U.L. Mukhopadhya, Calcutta, 1971, See also Grewal B.S., 'Centre-State Financial Relations in India , Punjab University Press, Patiala, 1975.

42. Report of the (Seventh) Finance Commission, op.cit. p.176.

43. The author had studied this stream in 1978. See George, K.K., "Non-Statutory, Non Plan Budgetary Transfers in India", The Economic Times, 22-23 June 1978.

44. The first attempt to quantify the aggregate flows was by Gulati, I.S., and George K.K., "Inter-State Redistribution through Budgetary Transfers", Economic and Political Weekly, Bombay, March 18, 1978.

45. See George, K.K., (1) "Deployment of Bank Funds and Regional Disparities", The Economic Times, Bombay, 5 Sept. 1975.

    (2) ________, "Institutional Investments in Industry - A Regional Study", Southern Economist, Banking Survey Bangalore, 10 Mar. 1976.

46. See Gulati, I.S., and George, K.K., "Inter-State Redistribution through Institutional Finance", Economic and Political Weekly, (Special Number) August 1978.

47. See Planning Commission, Economic Development in Different Regions in India, Government of India, New Delhi, 1967.

48. Due to easier accessibility, we have relied mostly on the annual studies of State finances being conducted by the Reserve Bank of India as our source of Data. We could also have made use of the Combined Finance and Revenue Accounts of Central and State Governments. published annually by the Comptroller and Auditor General of India. But the time lag in its publication is more than that of RBI data.

49. Finance Commission, Report of the (Sixth) Finance Commission, Government of India, New Delhi, 1973, p.163.

50. "It is also true that the cut off point of the national per capita income for determining the relative position of a State is arbitrary. As such it might be desirable to classify the States in given slabs for determining the stages of development of a State or of a region . Central Statistical Organisation (C.S.O), Report of the Committee on Regional Accounts (First Report) Government of India, New Delhi, 1974, p.9.

51. Ministry of Information and Broadcasting, India-1981 Government of India, New Delhi, 1981, p.8.

52. See for instance, (1) Report of the (Sixth) Finance Commission, op.cit. p.163. (2) Report of the (Seventh) Finance Commission, op.cit. Appendix, p.88. The Commissions have used three years' average income data wherever per capita State income data were to be used. (3) Majumdar and Kapoor, op.cit. p.3.

53. "The problem of Inter-State price differentials becomes particularly important in the context because not only do the prices differ among States but their movement over time is not uniform for all States. This creates distortions in the inter regional comparisons of per capita incomes . . . ", C.S.O., Committee on Regional Accounts, op.cit. p.16.

54. "The method adopted by the Sixth Finance Commission to account for the price factor has been the recalculation of State Domestic Products of all States using a common set of prices. The All India Weighted average prices have been used for the purpose and a fresh set of comparable estimates have been obtained", Ibid, p.16.

55. The major streams of criticisms against per capita income are two fold. irstly, it does not reflect fully the structure of the economy as also the distribution of income. Secondly, the estimates of State Income data in India are imperfect. For the former view, see Bhat, V.V., "On Measuring the Pace of Development", Reserve Bank of India Bulletin, Bombay, April 1968 and McGranahan D.V., et.al., Contents and Measurement of Socio-Economic Development, (A Staff study of the U.N. Research Institute for Social Development), Praeger Publishers, New York, 1972,pp.6-9. For the latter line of argument, see the Central Statistical Organisation, New Delhi, Report of the Committee on Regional Accounts, 1976. Subsequent to the Committee's report, partly due to its recommendations, the recent income estimates have become more comparable.

56. See (1) Nath, V., "Regional Development in Indian Planning", Economic and Political Weekly, Bombay, January, 1970.
(2) Rao, S.K., "A Note on measuring economic distances between regions in India", Economic and Political Weekly, Bombay, 28 April, 1973.
(3) The Report of the (Fourth) Finance Commission, Government of India, New Delhi, 1965, p.29.
(4) Report of the (Fifth) Finance Commission, Government of India, New Delhi, 1969, p.36.
(5) Planning Commission, Identification of Backward Areas, op.cit.

For the conceptual problems involved in preparing a composite index, see (1) McGranahan, D.V., et.al., op.cit. (2) Jan Drewnowski, Studies in the Measurement of levels of living and Welfare, U.N. Research Institute of Social Development, Geneva, 1969. (3) Report of the (Sixth) Finance Commission, 1973 op.cit. p.16, The Report deals with not only conceptual problems, but also the special problems in using such composite indices in allocating resources in the federal set up of India.

57. See (1) Najundappa, D.M., Inter Governmental Financial Relations in India, Sterling, New Delhi, 1974, p.46.
(2) Minute by Kaushalendra Rao, Report of the Finance Commission, op.cit., p.112-113.
(3) Minute by Raj Krishna, Report of the (Seventh) Finance Commission, op.cit, p.150.

CHAPTER II

DISPARITIES IN BUDGETARY EXPENDITURE OF STATES

One of the instruments of regional policy available to governments is their expenditure policy. Variations in the government expenditure in different States in favour of the low income States can tend to bring about equalisation of State incomes over a period. The degree of such desirable variations depends on the existing disparities in income levels, the period within which income levels are sought to be equalised, the existing shares of public expenditure in State incomes and the size of the regional multipliers.

Objectives of Public Expenditure Policy

One objective, albeit the most modest one, is to equalise the per capita public expenditure - of both Central and State governments - in different States. This implies that public expenditure is to be allocated in direct proportion to population. Whether and how soon regional incomes will be equalised under this scheme depends on the size of the regional multipliers which in turn depends on the sectors in which expenditure takes place, the import propensity of a region, the saving rates, etc. It is likely that low income States with their narrow economic base will have higher import propensity and, therefore, smaller regional multipliers.

A still more ambitious objective for public expenditure policy is to distribute the expenditure in inverse

proportion to the per capita income of different States. Again, by how much and how soon equalisation will take place depends on all the above factors.

Any model for regional distribution of public expenditure will have to take into account the size of the regional multipliers which is to be worked out on the basis of inter-regional and inter-sectoral relationships. Reiner has developed a simple model for allocating public expenditure in two regions which incorporates the variable of regional multiplier[1]. But even Reiner's simple model of allocation of public expenditure among regions cannot be worked out now in India, given the present state of data availability. On the expenditure side, the distribution of Central government's direct expenditure in different States is not available. A second reason is the absence of data regarding inter-state trade. According to the Central Statistical Organisation's (C.S.O.) Committee on Regional Accounts, "with the present availability of data, it is next to impossible to estimate the net exports to all other regions and the rest of the world independently" in India[2].

In the absence of any such model for distribution, government expenditure in States varied largely according to the fiscal capacity of States. The bargaining capacity of the States with the Centre also has played a role in attracting more Central funds, both for supplementing the States' own budgetary resources and for direct Central government expenditure in their regions. The budgetary support extended by the All-India financial institutions to different

State government also accounts for the variations in the States' budgetary expenditure.

As it is difficult to work out a model of allocation of government expenditure due to data constraints noted earlier, our study evaluating the regional pattern of public expenditure in India at present will have to confine itself to an examination whether such distribution of State governments' expenditure has met with the minimum objective of equalisation of per capita expenditure. In this context, it also examines the contributory roles of the Central budgetary transfers as also the budgetary support to State governments provided by financial institutions under the control of the Central government.

Budgetary Expenditure (Gross and Net)

Table II-1 gives the per capita budgetary expenditure of different States in gross terms. Budgetary expenditure includes both revenue and capital expenditure. The expenditure figures in Table II-2 are net of repayments of Central loans including interest payments.

It can be seen from these tables that the budgetary expenditure pattern of States during the quarter century reviewed in the study had been clearly regressive. The per capita gross expenditure of low income Group C States was only 65 per cent of the per capita expenditure of the high income Group A States. Again, the per capita gross expenditure of the low income States has been only a little more than three fourths that of the middle income States. Special category States understandably, spent more than twice that of the national average Among individual non-special category

TABLE II.1

Per Capita Aggregate (gross) expenditure - Revenue & Capital 1956-81

States	Rupees per Capita							Index Numbers						
	II	III	AP	IV	V	VI	All	II	III	AP	IV	V	VI	All
Punjab	232	353	437	880	1779	927	4608	129	128	167	150	161	157	154
Haryana	232	353	276	848	1689	888	4286	129	128	105	145	153	150	143
Maharashtra	215	327	346	775	1523	783	3969	119	119	132	132	138	132	132
Gujarat	212	308	293	668	1525	753	3559	118	112	112	114	120	127	119
West Bengal	219	272	232	554	1003	561	2841	122	99	89	95	91	95	95
GROUP A	218	311	306	703	1363	731	3632	121	113	117	120	124	124	121
Tamil Nadu	188	310	298	612	1052	596	3056	104	113	114	104	95	101	102
Kerala	192	309	298	636	1192	617	3244	107	112	114	109	108	104	108
Orissa	163	324	274	542	995	555	2853	91	118	105	92	90	94	95
Assam	234	359	350	660	1018	508	3129	130	131	134	113	92	86	104
Karnataka	198	316	316	704	1229	654	3417	110	115	121	120	112	111	114
Andhra Pradesh	185	302	248	542	1072	563	2912	103	110	95	92	97	95	97
GROUP B	189	315	289	608	1094	587	3082	105	115	110	104	99	99	103
Uttar Pradesh	126	193	200	434	842	432	2227	70	70	76	74	76	73	74
Rajasthan	197	323	327	713	1149	613	3322	109	117	125	122	104	104	111
Madhya Pradesh	183	255	227	446	929	539	2579	102	93	87	76	84	91	86
Bihar	127	176	176	365	653	367	1864	71	64	67	62	59	62	62
GROUP C	144	229	226	452	846	459	2356	80	83	86	77	77	78	79
Himachal Pradesh	232	355	--	875	1970	1099	4531	129	129	--	149	179	186	151
Jammu & Kashmir	354	573	540	1462	2800	1207	6936	197	208	206	249	254	204	232
Tripura	--	--	--	774	1675	1015	3464	--	--	--	132	152	172	116
Manipur	--	--	--	1201	2599	1459	5259	--	--	--	205	236	247	176
Nagaland	204	361	615	3368	6653	2702	13903	113	131	235	575	604	457	464
Meghalaya	237	358	354	1058	2111	1116	5234	132	130	135	181	192	189	175
Sikkim	--	--	--	--	4120	2592	6712	--	--	--	--	374	439	224
GROUP D	294	459	516	1233	2514	1248	6264	163	167	197	210	228	211	209
ALL STATES	180	275	262	586	1102	591	2996	100	100	100	100	100	100	100

Sources: Annual studies of State Finances published in the R.B.I. Bulletins, Various issues.

Notes:

1. Figures are of actuals except for 1980-81 for which year they are of Revised Estimates.
2. Data for States which were reorganised again after 1956-57 have been computed by dividing the composite state's figures by the reorganised states' population.
3. Data for some of the present states while they were Union territories are not included. The figures for all Plans in respect of Himachal Pradesh, Tripura and Manipur are therefore not comparable.
4. For arriving at the per capita figures, 1951 population has been used for the second Plan, 1961 population for the third plan and the three annual plans, 1971 population for the Fourth and Fifth Plans and 1981 population for the sixth plan.
5. AP refers to the three Annual Plans for the years 66-67, 67-68 and 68-69.
6. All the five years from 1974-75 to 1978-79 are included in the Fifth Plan. Likewise, the sixth plan is taken to include 1979-80 as also 1980-81. This is not strictly according to the Planning Commission's calendar regarding the beginning and end of the sixth plan and fifth plan respectively.
7. States have been ranked according to their ranks in per capita SDP during 1967-70.
8. Index numbers have been calculated taking the all states average as the base.
9. No correction has been made for changes in prices between plan periods.

TABLE II.2

Aggregate Net Budgetary Expenditure of States, 1956-81
(Revenue and Capital)

States	Rupees per Capita							Index Numbers						
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	191	292	361	776	1556	857	4033	118	122	164	159	157	157	152
Haryana	191	292	200	695	1517	830	3725	118	122	91	142	153	152	141
Maharashtra	201	301	313	695	1419	752	3681	124	125	142	142	143	138	139
Gujarat	199	282	258	593	1206	723	3261	123	118	117	122	122	132	123
West Bengal	203	242	205	454	872	491	2466	125	101	93	93	88	90	93
GROUP A	198	279	267	610	1232	683	3269	122	116	121	125	124	125	123
Tamil Nadu	167	273	253	524	978	560	2755	103	114	115	107	99	103	104
Kerala	173	261	257	532	1068	584	2875	107	109	117	109	108	107	109
Orissa	138	275	213	422	884	508	2440	85	115	97	86	89	93	92
Assam	222	304	273	490	890	467	2646	137	127	124	100	90	86	100
Karnataka	182	280	268	581	118	600	3029	112	117	122	119	113	110	114
Andhra Pradesh	158	251	190	424	975	519	2517	98	105	86	87	98	95	95
GROUP B	167	270	236	494	992	544	2703	103	113	107	101	100	100	102
Uttar Pradesh	116	171	171	370	755	394	1977	73	71	78	76	76	72	75
Rajasthan	180	268	252	524	1001	515	2740	111	112	115	107	101	94	104
Madhya Pradesh	162	221	183	366	859	508	2299	100	93	83	75	87	93	87
Bihar	119	151	144	305	544	331	1594	73	63	65	63	55	61	60
GROUP C	133	200	188	370	749	415	2055	82	83	85	76	76	76	76
Himachal Pradesh	191	292	--	780	1778	1062	4103	118	127	--	160	179	195	155
Jammu & Kashmir	278	492	532	1065	2407	1084	5858	172	205	242	218	243	199	221
Tripura	--	--	--	660	1579	1005	3244	--	--	--	135	159	184	123
Manipur	--	--	--	1070	2350	1331	4751	--	--	--	219	237	244	179
Nagaland	192	306	584	3246	6202	2615	13145	119	128	265	665	626	479	497
Meghalaya	225	303	276	974	2043	1090	4911	139	126	125	200	206	199	186
Sikkim	--	--	--	--	4096	2566	6662	--	--	--	--	413	470	252
GROUP D	238	391	496	1018	2257	1173	5574	147	163	225	209	228	215	211
ALL STATES	162	240	220	488	991	546	2647	100	100	100	100	100	100	100

Notes: Aggregate net budgetary expenditure equals total expenditure on revenue and capital accounts minus repayment of principal and interest of earlier central loans.

Other notes and sources, are the same as for Table II.1.

States, Punjab which had the highest per capita income had spent the largest amount too. Bihar with the lowest per capita income, on the other hand, spent the least. Bihar's per capita expenditure was only two fifth that of Punjab. Per capita expenditure of Uttar Pradesh, another low income State, was only 48 per cent that of Punjab. All high income States barring West Bengal, had per capita expenditure more than that of all other non special category States. Even the per capita expenditure of West Bengal which was below the all States average, was more than that of Uttar Pradesh, Madhya Pradesh and, of course, Bihar. Among the middle income States, the per capita expenditure of only Orissa and Andhra Pradesh lagged behind the all States' average. Among the low income States, only Rajasthan spent more than the national average. In other words, of the six States which had spent less than the all States' average, three were low income States, two were middle income States and only one was a high income State. It may be remembered that the three low income States accounted for 34.6 per cent of the total population of the States. All the six States which spent less than the all States' average together accounted for about 54 per cent of all States' population and 59.6 per cent of the country's population below the poverty line.

The inter-state disparities in per capita expenditure do not show any signs of decline as may be seen from the indices in tables II-1 and II-2 for different Plan periods constructed with all States' average as base. The coefficients of rank correlation with per capita State income which were positive throughout the Plan periods show a steady

increase after the decline during the Third Plan period. By the Sixth Plan period, it was back to the Second Plan position. (This may be seen from Table II-8). That there has been no major change in the regional pattern of State governments' expenditure during the Plan periods is brought out again by the high positive value for the coefficient of concordance which is 0.873 for gross expenditure[3]. Analysis based on net expenditure given in Table II-2 also leads to similar conclusions regarding the regressive nature of States' expenditure. That there has been no substantial change in the pattern over years of net expenditure is seen by the high value of the coefficient of concordance (0.853).

Development Expenditure

Table II-3 shows the State-wise position of the per capita development expenditure both on revenue and capital accounts. The disparities in development expenditure follow closely the disparities in aggregate expenditure. As in the case of aggregate expenditure, the disparities in development expenditure came down during the Third Plan and then onwards went on steadily increasing till the Sixth Plan. However, the correlation between per capita income and development expenditure, though positive and high, is less than that of aggregate expenditure, both gross and net. This leads to the inference that as compared to development expenditure, the correlation between per capita income and non-development expenditure is higher. This implies that the higher level of development expenditure per head in the developed States has been made possible not by their better economy in non-development expenditure, but in spite of higher levels of non-developmental expenditure[4].

TABLE II.3

Aggregate (Revenue & Capital) Development Expenditure of States, 1956-81

States	Rupees per Capita							Index Numbers						
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	137	167	189	454	989	562	2498	138	121	172	151	149	152	149
Haryana	137	167	101	441	1036	598	2480	138	121	92	147	156	162	148
Maharashtra	104	149	127	398	846	475	2099	105	108	115	133	128	128	125
Gujarat	108	155	119	371	789	455	1997	109	112	108	124	119	123	119
West Bengal	116	135	93	259	570	331	1504	117	98	85	86	86	89	90
GROUP A	114	149	120	358	778	444	1963	115	108	109	119	118	120	117
Tamil Nadu	94	158	110	318	595	336	1611	95	114	100	106	90	91	96
Kerala	120	171	163	366	783	438	2041	121	124	148	122	118	118	122
Orissa	103	200	126	280	649	399	1757	104	145	115	93	98	108	105
Assam	136	178	173	343	618	306	1754	137	129	157	114	93	83	104
Karnataka	122	182	152	348	747	396	1947	123	132	138	116	113	107	116
Andhra Pradesh	112	161	97	268	706	386	1730	113	117	88	89	107	104	103
GROUP B	111	171	127	314	681	377	1781	112	124	115	105	103	102	106
Uttar Pradesh	66	81	78	205	479	265	1174	67	59	71	68	72	72	70
Rajasthan	108	150	128	324	726	363	1799	109	169	116	108	110	98	107
Madhya Pradesh	94	129	105	247	575	343	1493	95	93	95	82	87	93	89
Bihar	75	93	72	188	376	212	1016	76	67	65	63	57	57	61
GROUP C	78	108	93	223	437	279	1218	79	78	85	74	66	75	73
Himachal Pradesh	137	167	--	602	1329	806	3041	138	121	--	201	201	218	181
Jammu & Kashmir	149	316	311	774	2063	915	4528	150	229	283	258	312	247	270
Tripura	--	--	--	448	1215	790	2453	--	--	--	149	184	214	146
Manipur	--	--	--	825	1782	1054	3661	--	--	--	275	269	285	218
Nagaland	136	179	397	2146	4382	1871	9111	137	130	361	715	662	506	543
Meghalaya	136	179	175	707	1501	858	3556	137	129	159	236	227	232	218
Sikkim	--	--	--	--	3512	2122	5634	--	--	--	--	531	574	336
GROUP D	143	240	296	741	1779	930	4129	144	174	269	247	269	251	246
ALL STATES	99	138	110	300	662	370	1679	100	100	100	100	100	100	100

Notes: Development expenditure comprises of expenditure on economic services as well as social and community services. It includes both plan and non plan expenditure. The classification followed is the same as that of the Reserve Bank of India used in their annual studies of State Finances. These have undergone some periodic changes.

This is brought out more clearly from Table II-4 which gives the percentage share of development expenditure in the aggregate net expenditure of States[5]. The share of development expenditure was the highest for the special category States except during the Second and Third Plan periods. It was the lowest for the high income States except during the Fifth Plan. During the whole period under study, all except Uttar Pradesh among the low income States had a higher proportion of development expenditure than all the high income States, with the exception of Haryana. Even the proportion for Uttar Pradesh was more than that of Maharashtra. Among the non-special category States, the middle income States spent proportionately more on development services during all Plan periods. The rank correlation between per capita income and the proportion of development expenditure in States was not statistically significant for any Plan periods. This absence of correlation should once again show that the higher level of development expenditure in high income States is not due to their better economising on non development expenditure.

States' Internal Resources

The reasons for the disparities in the aggregate and developmental expenditure among the States are not far to seek. They are because of (i) the differences in the levels of internal budgetary resources of States. The States' own resources accounted for 52.6 per cent of their total receipts and 30.3 per cent of their capital receipts. (ii) the failure of the fiscal transfer mechanism to countervail the differences in the States' own resources. The resources transferred from

TABLE II.4

Percentage Share of Development Expenditure in Aggregate Net Expenditure

States	II	III	AP	IV	V	VI	All
Punjab	72	57	52	59	64	66	62
Haryana	72	57	50	63	68	72	67
Maharashtra	52	50	41	57	60	63	57
Gujarat	54	55	46	63	65	63	61
West Bengal	57	56	45	57	65	67	61
GROUP A	58	53	45	59	63	65	60
Tamil Nadu	56	58	43	61	61	60	58
Kerala	69	66	63	69	73	75	71
Orissa	75	73	59	66	73	79	72
Assam	61	59	63	70	69	66	60
Karnataka	67	65	57	60	67	66	64
Andhra Pradesh	71	64	51	63	72	74	69
GROUP B	66	63	54	64	69	69	66
Uttar Pradesh	57	47	46	55	63	67	59
Rajasthan	60	56	51	62	73	70	66
Madhya Pradesh	58	58	57	67	67	68	65
Bihar	63	62	50	62	69	64	64
GROUP C	59	54	49	60	58	67	59
Himachal Pradesh	72	57	-	77	75	76	74
Jammu & Kashmir	54	64	58	73	86	84	77
Tripura	-	-	-	68	77	79	76
Manipur	-	-	-	77	76	79	77
Nagaland	71	58	68	66	71	72	69
Meghalaya	60	59	63	73	73	79	72
Sikkim	-	-	-	-	86	83	85
GROUP D	60	61	60	73	79	79	74
ALL STATES	61	58	50	61	67	68	63

TABLE II.5

Per Capita Own Revenue and Capital Resources 1956-1982

States	Plan Periods							Index Numbers						
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	132	218	273	588	1156	567	2934	140	165	208	206	185	186	187
Haryana	132	218	178	508	1180	579	2795	140	165	136	178	189	190	178
Maharashtra	128	197	219	476	1140	537	2697	136	149	167	166	183	176	172
Gujarat	119	157	163	384	884	491	2198	127	119	124	134	142	161	140
West Bengal	115	142	126	246	524	282	1435	122	108	96	86	84	92	91
GROUP A	124	176	183	402	909	457	2251	132	133	140	141	146	150	143
Tamil Nadu	115	167	162	358	658	368	1828	122	127	124	125	105	121	116
Kerala	101	137	142	304	702	338	1724	107	104	108	106	113	111	110
Orissa	57	116	83	185	402	178	1021	61	88	63	65	64	58	65
Assam	117	102	83	165	350	133	950	124	77	63	58	56	44	60
Karnataka	105	148	178	400	823	396	2050	112	112	136	140	132	130	130
Andhra Pradesh	96	141	109	255	601	300	1502	102	107	83	89	96	98	96
GROUP B	100	142	133	294	618	310	1597	106	108	102	103	99	102	102
Uttar Pradesh	65	100	99	218	455	178	1115	69	76	76	76	73	58	71
Rajasthan	94	129	128	241	568	273	1433	100	98	98	84	91	90	91
Madhya Pradesh	93	110	117	241	567	279	1407	99	83	89	84	91	91	90
Bihar	61	73	70	144	266	144	759	65	55	53	50	43	47	48
GROUP C	72	98	98	205	437	201	1111	77	74	75	72	70	66	71
Himachal Pradesh	132	218	--	233	575	304	1462	140	165	--	81	92	100	93
Jammu & Kashmir	94	188	115	316	797	365	1875	100	142	88	110	128	120	119
Tripura	--	--	--	3	217	97	317	--	--	--	1	35	32	20
Manipur	--	--	--	93	145	190	428	--	--	--	33	23	62	27
Nagaland	122	102	--	165	722	203	1314	130	77	--	58	116	67	84
Meghalaya	117	102	83	95	288	127	812	124	77	63	33	46	42	52
Sikkim	--	--	--	--	664	447	1111	--	--	--	--	106	147	71
GROUP D	109	144	99	208	553	269	1382	116	109	76	73	89	88	88
ALL STATES	94	132	131	286	624	305	1572	100	100	100	100	100	100	100

the Centre accounted for 45 per cent of the aggregate receipts and 59.2 per cent of capital receipts. (iii) the differences in the budgetary support given by financial institutions to State governments. These accounted for 2.4 per cent of the combined receipts and 10.4 per cent of the capital receipt

The disparities in the levels of revenue resources of States are evident from Table II-5. The internal resources of the low income group of States were less than half that of the high income States and less than two thirds that of the middle income States. Bihar's own resources were only less than one fourth that of Punjab. The internal resources of Punjab, Haryana and Maharashtra, alone could sustain expenditure levels higher than the aggregate gross expenditure of Bihar and Uttar Pradesh. The ~~revenue~~ resources of Gujarat and Karnataka were more than the aggregate net expenditure of Bihar. The resources of Tamil Nadu and Kerala were more than the aggregate development expenditure of Madhya Pradesh and Uttar Pradesh. The own resources of even West Bengal were more than the development expenditure of Uttar Pradesh. The rank correlation between per capita income and internal resources is reaching out to plus one.

The relative position of the developed States in the level of own resources has been increasing and that of least developed States declining as may be seen from the index numbers. The only exception was West Bengal whose resources position came below the all States average from the three Annual Plan period (1966-69) onwards. The middle income States are just maintaining their position.

Such inter-state differences in the own resources position have not been the result of better tax efforts on the part of the developed States. Reddy's study (1975) of tax efforts by the States has shown that Bihar which had the lowest amount of own resources in per capita terms had made the highest tax efforts among the sixteen Indian States.[6]. Reddy's ranking of States is given in Table II-6. Madhya Pradesh, the State which was the second lowest in the matter of per capita income among the 15 non-special category States stood second, in tax efforts. Rajasthan's position in tax efforts which was sixth, was higher than that of eight other States with higher per capita incomes. Among the low income States, only Uttar Pradesh with its 15th rank showed poor tax efforts. On the other hand, Punjab which had the highest internal resources was only eighth according to the tax efforts criterion, and the rank of Gujarat which was fourth in per capita internal resources, was as low as the eleventh in tax efforts. West Bengal was the lowest among all Indian States in tax efforts and that may partly explain the below the average position of the State in raising internal resources despite its high per capita income and industrial development. The tax efforts of Haryana and Maharashtra among the developed States were satisfactory. The rank correlation between per capita income and tax efforts was not significant statistically.

The levels of the States' internal budgetary resources are dependent largely on their levels of per capita income. The sectoral origin as well as distribution of income are also important in determining the revenue raising

TABLE II.6

Ranking of States according to Tax Effort

Sl.No.	States	Rank
1	Punjab	8
2	Haryana	3
3	Maharashtra	4
4	Gujarat	11
5	West Bengal	16
6	Tamil Nadu	9
7	Kerala	7
8	Orissa	13
9	Assam	14
10	Karnataka	10
11	Andhra Pradesh	5
12	Uttar Pradesh	15
13	Rajasthan	6
14	Madhya Pradesh	2
15	Bihar	1
16	Jammu & Kashmir	12

Source: Reddy, K.N.,"Inter State Tax Effort", Economic and Political Weekly, Dec. 13, 1975.

potential of the States. Nearly nine-tenths of the States' own tax revenues are derived from taxes on commodities and services, sales tax alone accounting for nearly three-fifths. The developed States have a distinct advantage in mobilising these taxes since the potential of such taxes is dependent largely on the levels of per capita consumption which in turn is largely a function of per capita income. The industrially developed States have a further advantage. Not only can they tax directly the population residing within their own States, they can also tax indirectly the residents of other States by employing inter-state sales tax on semi-manufactured and manufactured products originating within their boundaries. They can also levy general sales tax on the first stage of the sale of goods manufactured within their territory[7]. The developed States have an edge over the less developed States in almost all other tax avenues like the taxes on income, property capital transactions, etc. In the matter of non-tax revenues like interest receipts, dividends and return on social and economic services, the resources potential of developed States is clearly larger.

The principal internal sources of a State's capital receipts are the State provident funds, small savings, reserve funds, deposits and advances and recovery of loans and advances. All these sources are dependent largely on the levels of the past and present per capita income as also the scale and pattern of budgetary operations.

Internal Debt

The own resources of States are supplemented by the budgetary support given by the All-India financial

TABLE II.7

Internal Debt of States other than Loans from the Centre

States	Internal Debt				Market Borrowings				Index Numbers (for all Plans)	
	IV	V	VI	ALL	IV	V	VI	ALL	Internal Debt	Market Borrowings
Punjab	46	93	65	204	23	31	10	64	287	121
Haryana	48	58	32	138	32	49	18	99	194	187
Maharashtra	27	34	12	73	20	28	11	59	103	111
Gujarat	35	44	19	98	27	36	14	77	138	145
West Bengal	21	24	19	64	14	17	6	37	90	70
GROUP A	30	40	22	92	21	28	11	60	130	113
Tamil Nadu	35	40	15	90	24	33	13	70	127	132
Kerala	31	35	22	88	16	28	16	60	124	113
Orissa	19	40	22	81	19	34	9	62	114	117
Assam	9	33	9	81	18	29	7	54	72	102
Karnataka	26	50	17	93	20	33	11	64	131	121
Andhra Pradesh	20	37	14	71	18	29	9	56	100	106
GROUP B	25	40	16	81	20	31	11	62	114	117
Uttar Pradesh	13	31	8	52	11	23	7	41	73	77
Rajasthan	16	52	17	85	22	43	14	79	120	149
Madhya Pradesh	17	18	8	43	11	12	4	27	61	51
Bihar	11	18	6	35	8	14	4	26	49	49
GROUP C	12	27	9	48	12	21	7	40	68	75
Himachal Pradesh	10	38	15	63	7	24	8	39	89	74
Jammu & Kashmir	13	25	10	48	12	23	5	40	68	75
Tripura	Neg.	79	41	120	-	53	22	75	169	142
Manipur	24	100	52	176	23	96	33	152	248	287
Nagaland	65	365	96	526	60	294	82	436	741	823
Meghalaya	25	76	30	131	22	63	22	107	185	202
Sikkim	-	31	25	38	-	-	-	-	54	-
GROUP D	14	60	25	99	13	47	15	75	139	142
ALL STATES	21	35	15	71	17	27	9	53	100	100

Note: Internal Debt includes Market borrowings and loans received from financial institutions commodity boards.

institutions under the ownership and control of the Central government like Commercial Banks, Life Insurance Corporation, Reserve Bank of India, Rural Electrification Corporation and Housing and Urban Development Corporation. Other autonomous organizations like the Commodity Boards, Khadi and Village Industries Commission, National Co-operative Development Corporation and Warehousing Corporation, created, controlled and nurtured by funds from the Union Government also supplement the internal resources of the more developed States to a larger extent than that of the less developed States. This may be seen from Table II-7 which gives the State-wise distribution of the internal debt and its principal component viz. market borrowings[8]. The problem of availability of data on a comparable basis restricts the present analysis to the Fourth, Fifth and Sixth Plan periods only.

Market Borrowings

The expression 'Market borrowing' is really a misnomer in India as all the loans are subscribed largely by the financial institutions under the control of the Central Government. In other words, the market for borrowing by the States is really a captive market of the Union Government. The quantum of market borrowings of each State and its subscription by different agencies are actually determined by the Planning Commission, the Union Ministry of Finance and the Reserve Bank of India. Nearly three fourth of the State Government securities outstanding at the end of March 1980 were owned by Commercial Banks, Life Insurance Corporation and the Employees' Provident Funds[9].

TABLE II.8

Rank Correlation Coefficients

	II	III	AP	IV	V	VI
1. Per Capita aggregate budgetary expenditure (Gross)	0.875	0.518	0.548	0.621	0.881	0.890
2. Per Capita aggregate budgetary expenditure (Net)	0.884	0.604	0.701	0.837	0.855	0.864
3. Per Capita aggregate development expenditure	0.647	0.107	0.363	0.692	0.793	0.749
4. Percentage share of development expenditure in aggregate expenditure	- 0.292	- 0.436	- 0.335	- 0.195	- 0.339	- 0.188
5. Per Capita own resources (Capital and revenues)	0.930	0.782	0.821	0.757	0.929	0.921
6. Per Capita Internal Debt of States other than loans from the centre	-	-	-	0.710	0.645	0.699
7. Per capita Market borrowings	-	-	-	0.536	0.505	0.610
8. Direct budgetary support from financial institutions	-	-	-	0.647	0.632	0.525

Notes: Rank correlation is worked out between per capita income at the beginning of the Plan Period(subject to the constraints of data availability)and financial flows during the subsequent Plan Periods. Thus the coefficient for second Plan is with per capita income of the year 1955-56 (N.C.A.E.R. data), for third Plan with 1960-61 (C.S.O. data), Annual Plans with 1964-65, Fourth Plan with 1968-69, fifth Plan with 1973-74 and Sixth Plan with 1975-76.

2. Values of coefficients above 0.524 are significant at 5% level and those above 0.687 are significant at 1% level.

Table II-7 clearly brings out that these financial institutions helped only to aggravate the problem of disparities in States' own resources instead of countervailing their disequalising tendencies. The positive correlation between per capita income on the one hand and internal debt and its major component - market borrowings - on the other, was statistically significant.

Summing up, in the absence of any model for distribution of public expenditure designed to equalise State incomes within a pre-determined time span, the government expenditure of States varied according to their fiscal capacity. The disequalising fiscal capacity, instead of being countervailed by the financial institutions controlled by the Central government, was only strengthened by their policies regarding budgetary support and subscription to State loans.

How far, then, did the fiscal transfer mechanism of the Central government succeed in countering these disequalising trends? This question is examined in the next chapter.

Notes and References

1. Reiner's model shows how a given expenditure (X) should be allocated between two regions (a and b) in order to equalise per capita income by a given target date. Given the data on total income (Y) and population (N) in each regions and the values of regional multipliers (M) and value of Government expenditure to be allocated to region, a is determined as

$$Xa = \frac{(Yb + MbX)/Nb - Ya/Na}{Ma/Na + Mb/Nb}$$

The value of expenditure to be allocated to region b is X - Xa.

See Reiner, T., "Sub-national and National Planning: Decision Criteria" in Regional Science Association; Papers and Proceedings (1965) Quoted in Stillwell Frank J.B., Regional Economic Policy, Macmillan, London, (1972), p.48. For further elaboration of this Concept and its application, see (1) Archibald G.C., "Regional Multiplier Effects in the U.K.," Oxford Economic Papers (March 1967); (2) Steele, D.B., "Regional Multipliers in Great Britain", Oxford Economic Papers, July 1969); (3) Sadler Peter et.al, Regional Income Multipliers, University of Wales Press, Wales 1973.

2. Central Statistical Organisation, Final Report of the Committee on Regional Accounts, Government of India, New Delhi 1976, p.15.

3. The formula used is:

Coefficient of concordance, ie., $W = \frac{12\,S}{m^2(n^3-n)}$

where S = Sum of squares of the actual deviations about the mean,

m = Number of Rankings (ie. number of Plan Periods in this Study).

n = Number of States.

4. Non Developmental expenditure comprises of expenditure on (1) Organs of State, (2) Fiscal Services, (3) Administrative Services, (4) Debt Servicing Payments and (5) Pensions and Miscellaneous General Services. For details of Development Services, see footnote to Table II-3.

5. The ratio has been calculated with net instead of gross expenditure in order to eliminate the influence of an important item i non development expenditure viz., Debt Servicing, over which the States have little control.

6. Reddy, K.N., "Inter-State Tax Efforts", Economic and Political Weekly, December 13, 1975. See also Hanumantha Rao "Growth, Poverty and Tax Effort: An Inter-State comparison with special reference to Bihar, Institute of Economic Growth Delhi, 1979 (mimeo.)

7. Swaminathan, C., Minute to the Report of the (Fifth) Finance Commission, Government of India, New Delhi, 1969, p.101.

8. The Internal Debt comprises of market borrowings and loans directly taken from the financial institutions Commodity boards, etc.

9. Reserve Bank of India, Report on Currency and Finance, Bombay, 1980-81, Vol.II, p.116.

CHAPTER III

AGGREGATE BUDGETARY TRANSFERS

Role of Budgetary Transfers

One of the valid tests of the success of the fiscal transfer mechanism should be its ability to bring about progressiveness in the State Governments' expenditure by countervailing the regressive influences of both their internal resources and the larger institutional financial flows that they receive. Regretably, Centre-State financial transfers in India are often discussed outside the context of inter-state disparities in public expenditure and institutional financial flows. Besides, the regressive/progressive character of each individual stream of budgetary transfers is being discussed in isolation. As a result, even the magnitude of aggregate budgetary flows to different States during different Plan periods has not been quantified till recently.[1] The independent discussions of this nature on each stream of budgetary transfers are, however, only of limited relevance as the effect of even the aggregate budgetary transfers on regional disparity is only indirect, through its influence on the quantum and pattern of States' budgetary expenditure. Progressiveness of transfers by itself does not lead to reduction in inter-state disparities unless it is of such a degree and magnitude as to bring about progressiveness in the aggregate budgetary expenditure of States.

Judged by this criterion, the fiscal transfer mechanism in India has clearly failed as may be seen from the regressive character of the budgetary expenditure of States discussed in Chapter II. The budgetary financial flows failed to bring about inter-state equity inspite of the larger capacity of the Union Government in India to exert countervailing influence on the quantum and pattern of States' expenditure. The dependence of the States on the Centre resulting from the concentration of resources with the Union Government and the flexibility which the Centre has got in the allocation of resources permit inter-state redistribution through the fiscal transfer mechanism. As is well-known, the degree of financial dependence of the Indian States on the Central Government is much higher than that of the constituent units in most other federations.

Dependence of States on Central Transfers

Central budgetary transfers financed 45 per cent of the aggregate budgetary expenditure and 46 per cent of the Plan outlays of the States in India during five quinquennia under our study. The degree of dependence was much more for the backward States as may be seen from Table III-1. There is a high negative rank correlation between the proportion of expenditure financed by Central transfers and per capita income as may be seen from Table III-7. During all Plan periods, the coefficient was statistically significant at 5 per cent level. Such a high degree of dependence of the constituent units on the Centre, whatever may be its other

TABLE III.1

Proportions of Budgetary Transfers to Budgetary Expenditure, 1956-81

Figures in Percentages

States	Plan Periods II	III	AP	IV	V	VI	ALL
Punjab	40.1	41.1	32.7	28.8	32.9	25.0	31.5
Haryana	40.1	41.1	37.0	37.7	27.2	29.1	32.1
Maharashtra	30.2	34.9	29.5	35.0	23.8	30.0	28.9
Gujarat	34.4	46.4	38.6	36.5	30.9	31.3	34.3
West Bengal	46.1	43.8	40.9	49.3	48.7	44.2	46.6
GROUP	37.6	40.5	34.3	38.1	32.1	32.8	34.6
Tamil Nadu	34.0	39.0	35.9	35.8	33.2	35.2	35.0
Kerala	40.1	52.8	47.9	48.1	41.0	34.7	42.9
Orissa	66.9	55.9	64.6	62.9	55.9	64.1	60.3
Assam	45.7	67.9	68.6	74.5	66.1	63.0	66.3
Karnataka	36.9	41.1	46.2	39.9	30.4	33.5	35.8
Andhra Pradesh	40.5	48.0	56.5	50.2	40.9	43.0	45.1
GROUP B	41.3	45.6	50.2	48.2	40.9	42.6	44.3
Uttar Pradesh	40.5	53.6	45.5	46.5	51.1	55.1	49.4
Rajasthan	46.7	51.0	56.9	63.8	46.0	49.4	52.3
Madhya Pradesh	44.8	58.0	49.3	42.8	38.4	44.2	43.0
Bihar	62.2	48.0	37.7	57.2	62.3	64.3	61.0
GROUP C	47.9	40.8	48.7	51.5	49.8	53.6	50.5
Himachal Pradesh	40.1	67.0	--	70.6	68.5	72.8	66.3
Jammu & Kashmir	53.7	--	78.9	76.7	66.6	69.8	69.6
Tripura	--	--	--	98.6	85.0	82.6	87.3
Manipur	--	67.9	--	82.3	89.1	85.9	86.7
Nagaland	52.5	68.2	242.4	41.5	81.4	87.9	91.6
Meghalaya	45.1	--	67.8	90.1	87.2	83.0	82.4
Sikkim	47.6	55.3	--	--	75.5	75.4	75.4
GROUP D	--	--	93.0	79.0	74.4	77.7	74.9
ALL INDIA	42.8	46.9	46.6	47.4	42.3	44.5	44.6

Source: Reserve Bank of India, "Finances of State Governments, Reserve Bank of India Bulletin various issues.

drawbacks could have facilitated the realisation of the objective of balanced regional growth, an objective to which all the agencies, particularly the successive Finance Commissions and the Planning Commission had repeatedly declared their allegiance.

In this Chapter, it is proposed to examine how far the large budgetary resources transferred by the Centre to States aggregating Rs.71,900 crores during 1956-1981 had been utilised to meet this declared objective. After all, these fiscal powers have been given to or gradually taken over by the Centre at the cost of States' autonomy. What then had been the trade-off in terms of equity for the States?

State-wise Flow of Central Funds

Table III.2 shows the per capita aggregate budgetary transfers to different States classified according to the range of their per capita State incomes. The per capita figures given in this table are gross in two ways. Firstly, transfers effected by way of loans involve repayment. Secondly, these transfers do not take into account the contribution of each State to Centre's resources.

Table III.2 showsthat there had been no clear and consistent progressive trends in aggregate budgetary flows. The rank correlation with per capita income was not statistically significant during any Plan periods (see Table III-7). When budgetary transfers are themselves not clearly progressive,

TABLE III.2

Aggregate (Gross) Budgetary Transfers, 1956-81

States	Rupees per Capita			Plan Periods				Index Numbers			Plan Periods			
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	93	145	143	253	586	232	1452	121	112	117	91	125	88	109
Haryana	93	145	102	320	459	258	1377	121	112	84	115	98	98	103
Maharashtra	65	114	102	271	362	235	1149	84	88	84	97	78	89	86
Gujarat	73	143	113	244	410	236	1219	95	111	93	88	88	90	91
West Bengal	101	119	95	273	488	248	1324	131	92	78	98	104	94	99
GROUP A	82	126	105	238	437	240	1258	106	98	66	96	94	91	94
Tamil Nadu	64	121	107	219	349	210	1070	83	94	88	79	75	80	80
Kerala	77	163	142	306	489	214	1391	100	126	116	110	105	81	104
Orissa	109	181	177	341	556	356	1720	142	140	145	123	119	135	129
Assam	107	244	240	492	673	320	2076	139	189	197	177	144	122	155
Karnataka	73	130	146	281	374	219	1223	95	101	120	101	80	83	92
Andhra Pradesh	75	145	140	272	438	242	1312	97	112	115	98	94	92	98
GROUP B	78	151	145	293	447	250	1364	101	117	119	105	96	95	102
Uttar Pradesh	51	88	91	202	430	238	1100	66	68	75	73	92	90	82
Rajasthan	92	173	186	455	529	303	1738	119	134	152	164	113	115	130
Madhya Pradesh	82	130	112	191	357	238	1110	106	101	92	69	76	90	83
Bihar	79	102	104	209	407	236	1137	103	79	85	75	87	90	85
GROUP C	69	110	110	233	421	246	1189	90	85	90	84	90	94	89
Himachal Pradesh	93	145	--	618	1349	800	3005	121	112	--	222	289	304	225
Jammu & Kashmir	190	384	426	1122	1864	842	4828	247	298	349	404	399	320	361
Tripura	--	--	--	763	1424	838	3025	--	--	--	274	305	319	226
Manipur	--	--	--	988	2317	1253	4558	--	--	--	355	496	476	341
Nagaland	107	245	1491	3098	5417	2376	12734	139	190	1222	1114	1160	903	953
Meghalaya	107	244	240	953	1841	926	4311	139	189	197	343	394	352	323
Sikkim	--	--	--	--	3110	1954	5064	--	--	--	--	666	743	379
GROUP D	140	254	480	974	1871	970	4689	182	197	393	350	401	369	351
ALL STATES	77	129	122	278	467	263	1336	100	100	100	100	100	100	100

Source: "Finances of State Governments," Reserve Bank of India Bulletin, various issues.

they cannot be expected to counteract the very strong regressive influence of the internal resources and institutional financial flows on the States' budgetary expenditure.

If a group-wise analysis is made, the picture revealed is much more unsatisfactory to many of the poorer States. Aggregate budgetary flows from Centre to States during the two and half decades under the present study show that such flows benefited the middle income States the most and the low income States the least. Of course, the special category States, received funds generously from the Union Government.[2] The low income States (Group C) secured only 95 per cent of the Central funds which went to the high income States and only 87 per cent of the funds which went to middle income States. All high and middle income States except Tamil Nadu received more Central funds than Uttar Pradesh, Madhya Pradesh and Bihar. It may be remembered that these three low income States account for 34.4 per cent of the country's population and 37.1 per cent of country's population below poverty line. Except in the case of Rajasthan, the Central transfers do not seem to have benefited the low income States. Bihar, the poorest of all States, got less than four fifths of what Pubjab got. Uttar Pradesh and Madhya Pradesh received still lower amounts - only three fourths of the funds going to Punjab.

Even if we take the net budgetary transfers to different States (net of debt servicing payments of Central

TABLE III.3

Aggregate Net Budgetary Transfers - 1956-81

Rupees Per Capita

States	Plan Periods							Index Numbers						
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	52	84	67	149	363	162	877	88	89	84	83	102	74	89
Haryana	52	84	26	167	287	200	816	88	89	33	93	81	92	83
Maharashtra	51	88	69	191	258	204	861	86	94	86	106	73	94	87
Gujarat	60	117	78	169	291	206	921	102	125	98	94	82	95	93
West Bengal	84	89	68	173	357	178	949	142	95	85	96	100	92	96
GROUP	62	94	66	175	306	192	895	105	100	83	97	86	88	91
Tamil Nadu	43	85	62	131	275	174	769	73	90	78	73	77	80	78
Kerala	58	115	101	202	765	181	1022	98	122	126	112	215	358	104
Orissa	84	132	116	221	445	309	1307	142	140	145	123	125	142	132
Assam	95	189	163	322	545	279	1593	161	201	204	179	153	128	161
Karnataka	58	94	98	158	263	165	836	98	100	123	88	74	76	85
Andhra Pradesh	48	94	82	154	341	198	917	81	100	103	86	96	91	93
GROUP B	56	106	92	179	345	207	935	95	113	115	99	97	95	99
Uttar Pradesh	41	66	62	138	343	200	849	70	70	78	77	96	92	86
Rajasthan	75	118	111	266	381	205	1158	127	126	139	148	107	94	117
Madhya Pradesh	61	96	68	111	287	207	830	103	102	85	62	81	95	84
Bihar	71	77	72	149	298	200	867	120	82	90	83	84	92	88
GROUP C	57	81	72	151	324	202	887	97	86	90	84	91	93	90
Himachal Pradesh	52	94	—	523	1173	763	2579	88	89	—	290	330	350	261
Jammu & Kashmir	114	303	418	725	1471	719	3750	193	322	523	403	413	330	380
Tripura	—	—	—	649	1328	828	2805	—	—	—	361	373	380	284
Manipur	—	—	—	857	2068	1125	4050	—	—	—	476	581	516	410
Nagaland	95	190	1460	2976	4966	2289	11976	161	202	1825	1653	1395	1050	1213
Meghalaya	95	189	162	869	1773	900	3988	161	201	203	483	498	413	404
Sikkim	—	—	—	—	3086	1928	5014	—	—	—	—	867	884	508
GROUP D	85	186	460	770	1620	895	3999	144	198	575	428	455	411	405
ALL STATES	59	94	80	180	356	218	987	100	100	100	100	100	100	100

loans) the position is not much different as may be seen from Table III-3. The rank correlation coefficients given in Table III-7 confirms this.

The larger sums received by the developed States were not a reward for their greater tax efforts. In fact, the coefficient of correlation between Reddy's ranks for States' tax efforts (1970-72) and aggregate budgetary transfers (during Fourth Plan) was negative[3] though not statistically significant. This was not surprising as both the Finance Commissions and the Planning Commission, in spite of their desire to reward tax efforts had failed to evolve a scientific criteria for tax efforts. The rank correlation between budgetary transfers and own resources of States was also not significant.

A State-wise review of the role of Central transfers in reducing inter-state disparities in budgetary expenditure reveals a disparate pattern. For this review, one has to read together Table III-2 in this Cahpter with the Tables in the earlier Chapter such as II-1, II-5 and II-8. At one end of the spectrum are three low income States - Uttar Pradesh, Madhya Pradesh and Bihar - which had very low levels of own resources, very low institutional support for their budgets and very low per capita Central transfers and, therefore, very low levels of budgetary expenditure. Paradoxically, the one deviant in high income group viz., West Bengal too falls in this category. It received less than average Central funds and budgetary support from institutions.

This coupled with their inadequate resource mobilisation led to a short-fall in their budgetary expenditure from the national average. Orissa spent less than the average because the large sums of Central funds and institutional finance which it received turned out to be inadequate to compensate for its own low levels of resources. The position was different for Andhra Pradesh which too spent less than the national average, though the shortfall was only marginal. They got average institutional support and had more than average of their own resources. But the Central assistance which they got was less.

Assam, Himachal Pradesh and Sikkim had low levels of own resources and received little institutional support. But they received large sums of Central transfers which enabled them to have relatively higher levels of budgetary expenditure. In case of Jammu and Kashmir, institutional support was less, but their own resources and Central transfers were large enough to enable them to spend considerably more than the national average. In the case of Rajasthan, Tripura, Manipur, Nagaland and Meghalaya, they got considerable budgetary support from financial institutions as also from the Centre which enabled them to spend more. In their case, the budgetary transfer mechanism can claim to have had some success in arresting further aggravation of regional disparities.

At the other end of the spectrum are Haryana and Punjab which had the highest per capita own resources, highest

institutional support and more than average amounts of Central funds which together enabled them to have a level of expenditure which was the highest among the non special category States. Kerala also belongs to this category though in their case the difference from the State's average is less.

Maharashtra, Gujarat, Tamil Nadu and Karnataka received less than average sums from the Union budget. But their own resources and the institutional support they got were higher than the average. They were, therefore, able to have above average per capita expenditure. In the case of Maharashtra, expenditure levels were the third highest among the non-special category States. The position of Gujarat and Karnataka in per capita expenditure was fourth and fifth respectively though they got only less than average amounts by way of transfers from the Centre.

Desirable and Actual Flow of Central Funds

Even the modest task of equalisation of aggregate net budgetary expenditure would have necessitated, ignoring for the present the inequitous pattern of institutional support, a policy of substantial reduction in the budgetary transfers to the developed States as may be seen from Table III-4. For example, during the two and half decades under review, Punjab and Haryana, would have been able to spend the all States' average amounts with marginal Central transfers. Maharashtra also would have been able to manage

TABLE III.4

The Desirable and Actual (Gross) Budgetary Transfers, 1956-81

States	Rupees per Capita			In Crores of Rupees
	A (E-R)	B	C	D
Punjab	62	1452	- 1390	+ 1884
Haryana	202	1377	- 1175	- 1779
Maharashtra	299	1149	- 850	- 4285
Gujarat	798	1219	- 421	- 1123
West Bengal	1562	1324	+ 238	+ 1055
GROUP A	746	1258	- 512	- 7424
Tamil Nadu	1168	1070	+ 98	+ 404
Kerala	1273	1391	- 118	+ 252
Orissa	1975	1720	255	+ 560
Assam	2046	2076	- 30	- 44
Karnataka	946	1223	- 277	- 812
Andhra Pradesh	1494	1312	182	+ 792
GROUP B	1400	1364	36	+ 619
Uttar Pradesh	1881	1100	781	6899
Rajasthan	1564	1738	- 174	- 448
Madhya Pradesh	1590	1110	430	1791
Bihar	2237	1137	1100	+ 6199
GROUP C	1884	1189	695	+14742
Himachal Pradesh	1534	3005	- 1471	- 509
Jammu & Kashmir	1121	4828	- 3707	- 1712
Tripura	2680	3025	- 345	- 54
Manipur	2568	4558	- 1990	- 214
Nagaland	1682	12734	-11052	- 570
Meghalaya	2184	4311	- 2127	- 215
Sikkim	1884	5064	- 3180	- 67
GROUP D	1612	4689	- 3077	- 3829
ALL STATES	1426	1336	90	4873

Notes: A = E-R. E = Aggregate revenue and capital expenditure per capita for all states.
R = The per capita own capital and revenue resources of each State.
B = Actual Aggregate Budgetary Transfers
C = Difference between Desirable and Actual Transfers per capita.
D = The difference in absolute amounts.

without much Central funds. On the other hand, Bihar would have required an additional sum of Rs.1,100 ~~crores~~ per capita by way of fiscal transfers from the Centre during the above period to reach even the very modest target of all States average in per capita expenditure. During this period, Uttar Pradesh should have received an additional Rs.781 per capita, Madhya Pradesh Rs.430, Orissa Rs.255 and Andhra Pradesh Rs.182 from the Union Government to raise their budgetary expenditure at least to the all States' average. Conversely, some of the more advanced States like Punjab, Haryana, Maharashtra and Gujarat should have received considerably less as is indicated in Table III-4. Group A States as a whole should have received considerably less. Group B should have received marginally more, though this group had received more than the all States' average of Central funds in per capita terms. This was because, Central transfers were not enough to finance average levels of budgetary expenditure. In absolute terms, during the two and half decades under review, Uttar Pradesh should have received an additional sum of Rs.6,900 crores, Bihar Rs.6,200 crores and Madhya Pradesh Rs.1,800 crores crores from the Centre to equalise their budgetary expenditure. Conversely, Maharashtra would have been given Rs.4,300 crores less, Punjab Rs.1,900 crores, Haryana Rs.1,200 crores and Gujarat Rs.1,100 crores less. Lest these figures appear too staggering, it may be reiterated that these calculations do not take into account the adjustments necessary to counter the influence of the budgetary support by financial institutions, in which the high income and some of the

middle income States had an advantage as seen earlier. Besides, even this approach, suggested implicitly, only tries to equalise government expenditure in States. Even with equal government expenditure, the existing disparities are likely to continue due to the regressive flow of aggregate institutional finance.[4] and the differences in the size of the regional multipliers in different States.

Plan-wise Aggregate Transfers

The relative position of the different groups of States in the receipt of Central funds has not changed substantially during the different Plans as may be seen from the high value for the rank coefficient of concordance for all Plans (0.662). Table III-1 above (gives the flow of budgetary funds in each plan both in per capita terms and by means of index numbers) also points out towards this. During all the Plans, the special category States received more Union Government funds than the other category of States. What is more, the percentage deviation of this group from the all States' average is much higher in the later Plans than in the Second and Third Plans. This certainly is a welcome trend. But this trend is not seen in the case of other low income States. Except during the two years of the Sixth Plan and the three years of the Annual Plan period, the low income States as a whole received less than both the high and the middle income States.

Agency-wise Budgetary Transfers

For understanding the reasons for the inequitous resource transfer, it is necessary to disaggregate the aggregate figures according to the agency of transfer. The budgetary funds from the Centre to States are allotted under the aegis of three agencies. The statutory transfers effected under the periodic awards of the Finance Commissions, as may be seen from Table III-4 ~~shows that statutory transfers~~ accounted for nearly two-fifths of the aggregate budgetary transfers during the entire Plan era (1951-1981). Plan transfers effected by the Planning Commission accounted for 30.5 per cent of aggregate transfers. Discretionary transfers effected by the different Union Ministries with the concurrence of the Planning Commission accounted for another 30.4 per cent. The relative importance of the different streams of transfer varied during different Plan periods as may be seen from Table III-5.

Per capita budgetary flows to different States effected by the three agencies are given in Table III-6. This table shows that in bringing about the inequitous resource flows, all agencies are almost equally responsible. The pattern of distribution of all the agencies had been largely similar. This may be seen from the high value for the coefficient of concordance for all the three types of transfer for the 25 year period (0.564). During all Plans, the special category States received very generous dispensation in the hands of all agencies. Among the three agencies, however,

TABLE III.5

Resource Transfers (Gross) Through Various Agencies, 1951-81

Plan Periods	Statutory Transfers	Plan Transfers	Discretionary Transfers	Total
First Plan (1951-56)	447 (31.2)	350 (24.5)	634 (44.3)	1431
Second Plan (1956-61)	918 (32.0)	1058 (36.9)	892 (31.1)	2868
Third Plan (1961-66)	1590 (28.4)	2515 (44.9)	1495 (26.7)	5600
Three Annual Plans (1966-69)	1782 (33.3)	1767 (33.1)	1798 (33.6)	5347
Fourth Plan (1969-74)	5421 (35.9)	3535 (23.4)	6145 (40.7)	15101
Fifth Plan (1974-79)	10873 (43.0)	7722 (30.5)	6683 (26.0)	25278
Sixth Plan (1979-81)	7647 (43.2)	5404 (30.5)	4644 (26.3)	17695
Total (1951-81)	28678 (39.1)	22351 (30.5)	22291 (30.4)	73320

Source: Report of the Seventh Finance Commission (1978) Page 172.

TABLE III.6

Aggregate (Gross) Budgetary Transfers, 1956-81

States	Rupees per Capita				Index Numbers			
	Statutory	Plan	Discretionary	Total	Statutory	Plan	Discretionary	Total
Punjab	405	443	604	1452	78	101	159	109
Haryana	389	498	490	1377	75	113	129	103
Maharashtra	461	291	397	1149	89	66	104	86
Gujarat	466	355	398	1219	90	81	105	91
West Bengal	524	314	486	1324	102	71	128	99
GROUP A	471	338	449	1258	91	77	118	94
Tamil Nadu	446	350	274	1070	86	80	72	80
Kerala	611	445	335	1391	118	101	88	104
Orissa	708	536	476	1720	137	122	125	129
Assam	742	675	659	2076	144	153	173	155
Karnataka	465	374	384	1223	90	85	101	92
Andhra Pradesh	504	427	381	1312	98	97	100	98
GROUP B	542	436	386	1364	105	99	102	102
Uttar Pradesh	446	390	264	1100	86	89	69	82
Rajasthan	553	451	734	1738	107	103	193	130
Madhya Pradesh	428	434	248	1110	83	99	65	83
Bihar	456	363	318	1137	88	83	84	85
GROUP C	459	398	332	1189	89	90	87	89
Himachal Pradesh	1102	1405	498	3005	214	319	131	225
Jammu & Kashmir	1304	2058	1466	4828	253	468	386	361
Tripura	1519	1125	381	3025	294	256	100	226
Manipur	2302	1331	925	4558	446	303	243	341
Nagaland	6080	3896	2758	12734	1178	885	726	953
Meghalaya	1702	1764	845	4311	330	401	222	323
Sikkim	722	3271	1071	5064	140	743	282	379
GROUP D	1701	1902	1086	4689	330	432	286	351
ALL STATES	516	440	380	1336	100	100	100	100

Sources: As in Table III.1

the Planning Commission appears to have been a little more generous to them than the statutory Finance Commission. The Union Ministries however were the least generous.

The low income States did not receive justice at the hands of any of these agencies as they did not get even the all States' average amounts under the dispensation of any one. Among the three, however, the Planning Commission as in the case of the special category States was slightly more equitable than the other two. The Union Ministries, inspite of the discretion they had, gave the lowest amount to the low income States as compared to other agencies.

The agency which benefited the middle income States relatively the most was the statutory Finance Commission. The Union Ministries also allotted more than average amounts to this group of States. The Plan transfers to this group were marginally smaller than the national average. The high income States benefited relatively the most by the Union Ministries and least by the Planning Commission. But the Finance Commissions too gave them less than the national average amounts.

Stated differently, among the non-special category States, the Finance Commissions favoured the middle income States the most and the low income States the least. The Planning Commission too allotted the highest amount of Plan funds to the middle income States, and then to the low income States. The dispensation of discretionary transfers

was the most regressive - with the high income States getting the maximum amount and the low income States getting the least amount. Prima facie, the dispensation of funds the Planning Commission was more equitable. But a closer analysis shows that even the Planning Commission was not guided by any principles of equity. This may be seen from the funds received by Bihar and Uttar Pradesh which was much less that of Haryana and Punjab.

The conclusion that emerges is that for the backward States, the choice of the agencies is only a choice between tweedledum and tweedledee. The Finance Commissions clothed with all the constitutional sanctions have failed to do justice to the poorer states.

The Planning Commission inspite of its primary responsibility to achieve the Plan goals have also failed even if they seem to have fared a shade better than all the Finance Commissions except the Sixth and the Seventh. The Union Ministries in dispensing discretionary funds at their command have totally ignored the equity criteria, which only goes to prove that it is not the rigidity of the Constitutional provisions, which stands in the way of equitable fiscal transfers.

How has it happened then that despite professions to the contrary, all the three types of agencies concerned have allowed inequity to creep into the fiscal transfers effected by them? This question is examined in greater detail in the next three Chapters.

TABLE III.7

Coefficients of Rank Correlation with Per Capita Income

	Plan Periods					
	II	III	AP	IV	V	VI
1. Proportion of Budgetary Transfers to Budgetary Expenditure.	- 0.527	- 0.604	- 0.536	- 0.614	- 0.832	- 0.910
2. Per capita Aggregate Budgetary Transfers (Gross)	+ 0.117	- 0.042	- 0.174	+ 0.161	+ 0.007	- 0.302
3. Per Capita Aggregate Budgetary Transfers (Net)	- 0.073	- 0.050	- 0.163	+ 0.121	- 0.278	- 0.443
4. Aggregate Gross Budgetary Transfers with per capita own Capital and Revenue Resources	+ 0.018	+ 0.023	- 0.058	- 0.026	- 0.154	- 0.489

Note: Value of coefficients above 0.524 is significant at 5% level and above 0.687 is significant at 1% level.

Notes and References

1. For the first time, aggregate flows to different States were quantified and analysed in 1978 by this author, jointly with Gulati, I.S. See Gulati I.S. and George, K.K., "Inter-State Redistribution through Budgetary Transfers" Economic and Political Weekly, March 18, 1978.

2. Even the figure of Rs.4689 for group D States given in Table III-2 is an underestimate because devolution to some of these States when they were Union Territories is not included in the figure.

3. Reddy, K.N., "Inter-State Tax Efforts", Economic and Political Weekly, Dec. 13, 1975. See also, Hanumantha Rao, C.H., "Growth, Poverty and Tax Effort", Institute of Economic Growth, Delhi, 1979 (mimeo).

4. Will be discussed in detail in Chapter IX.

CHAPTER IV

STATUTORY TRANSFERS

The Constitution and the Finance Commission

The Finance Commission occupies a key position in the constitutional scheme regarding Centre-State financial relations in India. The provision to appoint the Finance Commission every five years or earlier under Article 280 is the only major difference between the Indian Constitution and the Government of India Act, 1935 in the matter of Centre-State fiscal transfers.[1] While Section 142 of the Government of India Act, 1935 gives unfettered discretion to His Majesty in the determination of all grants-in-aid, the Constitution of India curtails such discretion of the Union Government which has to act on the recommendations of the Finance Commission in the matter of distribution of grants under Article 275 of the Constitution.[2] Unlike in Australia, the Finance Commission in India is given the right to determine not only the quantum of grants, but also the share of taxes, between the Centre and States on the one hand and among the various States on the other.[3]

The Constitution had given much freedom and flexibility to the Finance Commission in its operations.

The principles governing the distribution of grants in aid including capital grants under Article 275 were left entirely to be determined by the Finance Commission. The criteria for distributing among tates the proceeds of taxes to be shared mandatorily under Article 269 and 270 and permissively under Article 272 were to be determined solely by the Finance Commission.[4]

The Importance of Statutory Transfers

Though the Constitution had given the Finance Commission a pivotal role in the Centre-State budgetary transfers, the last three decades showed progressive erosion of this role as was seen in Chapter III from the low share of statutory transfers in the aggregate budgetary transfers. During the first 18 years of planning, the share of statutory transfers was less than one third of the aggregate transfers. During the second and Third Plan periods, the role of statutory transfers was less than that of Plan transfers. During the Annual Plan period, it was just equal. During the First and the Fourth Plans as also during the Annual Plan period (1966-69) the role of statutory transfers was less than that of even discretionary transfers. As a result, the Finance Commission today is a mere shadow of its original constitutional self. The advent of centralised national planning and the activities of the Planning Commission which is a permanent body, have contributed to the decline in the role of the Finance Commission. The Finance Commissions

themselves were prepared to take cognisance of these changes in management of the economy and to work within a self imposed narrower framework. Right from the First Finance Commission, all Commissions reduced the scope of their enquiries to consider only revenue grants, though capital grants were also within their powers under the Constitution.[5] From the Second Commission onwards they confined themselves further to consider only the non Plan revenue component of States' budgets though it was well understood that the size of the non Plan revenue budgets is increasingly becoming a function of the Plan expenditure made earlier. The Third Finance Commission which tried to look into the revenue component of the State Plans met with a rebuff in the form of non acceptance of its recommendations.[6] The fear of non acceptance of their recommendations possibly has made the subsequent Commissions to tread carefully within the confines of the terms of reference imposed by the Union Government which are getting progressively elaborate though the constitutional propriety of ~~some~~ such terms is in doubt.[7]

This gradual erosion of their role led the Third Finance Commission's Chairman to ask rather cynically, "Why all this fuss, one might ask, for a separate Finance Commission when its work is somewhat meaningless and even unnecessary?".[8] He went on to add, "the role of the Finance Commission comes to be at best that of an agency to review the forecasts of revenue and expenditure submitted by the States and the acceptance of the revenue element of

the Plan as indicated by the Planning Commission for determining the quantum of devolution and grants in aid to be made; and at worst its function is merely to undertake an arithmetical exercise of devolution based on amounts of assistance for each State already settled by Planning Commission to be made under different heads on the basis of certain principles to be prescribed".[9]

Chanda's remarks are a little too cynical as even with all these constraints, if the Finance Commissions wanted to do justice to the States particularly the poorer States it could still do so. The sharp increase in the quantum of transfers effected by the Seventh Finance Commission and the relatively more progressive bias they could build into their transfers, confirm this feasibility.

Finance Commissions and Equity

Inter-State equity was one of the objectives of all the Indian Finance Commissions. For that matter, even Otto Niemeyer's award of 1936 which set the pattern for all the Finance Commissions in independent India spoke of the need for transfer of revenue from the rich to the needy States. "Some provinces are intrinsically better off than others and at the moment less urgently in need of additional resources and it is both fair and inevitable that a certain measure of corrective should be applied even if it means that provinces which have been able to maintain higher standards of administration should now, to some slight extent, have to progress more slowly."[10]

The First Finance Commission agreed that "the scheme of distribution should attempt to lessen the inequalities between States".[11] All the subsequent Commissions, tradition bound as they were, concurred with this objective. In fact, the recent Commissions are becoming more and more articulate on this point. For example, the Fifth Finance Commission spoke of a "more positive redistributive policy" which has to "distinguish between more advanced and less developed States".[12] According to the Sixth Commission "the need for using the mechanism of fiscal transfers from the Centre to States as a means of redressing regional imbalances acquires special significance".[13] In their scheme or resource allocation to the States, they claimed to "have taken the view that the resources belong to the nation and they should be applied at points where they are most needed".[14] Obviously, if the poorer States suffered in the matter of fiscal transfers, it was not due to lack of good intentions on the part of the Finance Commissions.

In fact, the statements of the Finance Commissions regarding equalisation are too prolific to mislead even experts. According to May, the Finance Commissions had sought deliberately, both through the devolution of taxes and through grants-in-aid,to redistribute revenue from the richer to the poorer States.[15] Even Hanson, an astute observer, wrote: "In general terms, it may be said that the Planning Commission works to the matching principle while the Finance Commission is more concerned with equalisation."[16]

From Table III-4 in the previous Chapter, it was seen that the Finance Commissions, in practice, had failed to meet the equalisation objective they had set for themselves during the 25 year time span covered by this study.

The rank correlation coefficients between per capita income and per capita transfers which were positive during the Second, Third and Annual Plan periods turned negative during the later plans as may be seen from Table IV-7. But except during the Fifth and the Sixth Plans, the correlation was not significant. The credit for the progressivity during these two Plans must go to the Sixth and Seventh Finance Commissions. This welcome change in trend is also visible from Table IV-1 in this Chapter which gives the group-wise and State-wise statutory transfers during different Plan periods.[17]

State-wise Statutory Transfers

During the whole Plan period covered by us the per capita statutory transfers that went to the low income States were lower than that of both the high income and the middle income States. There has been a favourable change benefiting the poorer States during the later Plan periods. That even this had been erratic is seen from the low amounts received by Rajasthan as compared to Maharashtra, Gujarat and West Bengal during the Sixth Plan. Madhya Pradesh and Uttar Pradesh received smaller sums than Tamil Nadu,

Rupees per Capita — Aggregate Statutory Transfers [illegible] — Index Numbers

States	Plan Periods (Rupees per Capita)							Plan Periods (Index Numbers)						
	II	III	AP	IV	V	VI	ALL	II	III	AP	IV	V	VI	ALL
Punjab	24	33	31	82	144	91	405	96	92	78	83	71	80	79
Haryana	24	33	33	72	138	89	389	96	92	83	73	68	78	75
Maharashtra	22	34	40	99	164	102	461	88	94	100	101	81	89	89
Gujarat	29	50	36	86	161	104	466	116	139	90	87	80	91	90
West Bengal	35	33	34	101	215	106	524	140	92	85	102	106	93	106
GROUP A	28	36	36	94	176	101	471	112	100	90	95	87	89	91
Tamil Nadu	20	32	37	89	154	114	446	80	89	93	90	76	100	86
Kerala	23	45	67	110	253	113	611	92	125	168	111	125	99	118
Orissa	28	64	80	133	259	144	708	112	178	200	134	138	126	137
Assam		58	76	135	334	95	742	176	161	190	136	165	83	144
Karnataka	31	41	55	84	153	101	465	124	114	138	85	76	89	90
Andhra Pradesh	24	39	39	95	203	104	504	96	108	98	96	101	91	98
GROUP B	26	43	53	102	207	111	542	106	119	133	103	102	97	105
Uttar Pradesh	19	24	31	86	176	110	446	76	67	78	87	87	96	86
Rajasthan	24	40	39	102	251	97	553	96	111	98	103	124	85	107
Madhya Pradesh	22	32	30	83	152	109	428	88	89	75	84	75	96	83
Bihar	20	27	26	88	178	117	456	80	75	65	89	88	103	88
GROUP C	21	29	30	88	181	110	459	84	81	75	89	90	96	89
Himachal Pradesh	34	33	—	154	612	279	1102	96	82	—	156	303	244	214
Jammu & Kashmir	60	75	111	259	565	234	1304	240	208	278	262	280	205	253
Tripura	—	—	—	279	884	356	1519	—	—	—	282	438	312	294
Manipur	—	—	—	504	1317	481	2302	—	—	—	509	652	422	446
Nagaland		36	616	1581	2687	1116	6080	176	100	1540	1597	1330	979	1178
Meghalaya		58	76	251	906	367	1702	176	161	190	254	449	322	330
Sikkim	—	—	—	—	285	437	722	—	—	—	—	141	383	140
GROUP D	41	51	471	303	794	341	1701	164	142	430	306	393	299	330
ALL STATES	25	36	40	99	202	114	516	100	100	100	100	100	100	100

Notes: There is difference between the Plan Periods and the periods covered by the Finance Commission's Awards. The second and the third Commission's Awards cover the second and third plan periods. The Fourth Commission's Award covers the Annual Plan period. The Fifth, Sixth and Seventh Commission's awards govern the fourth, fifth and sixth Plan Period respectively.

Source: Reserve Bank of India, Finances of State Governments, op.cit. different issues.

Orissa and Kerala. The same was more or less the pattern repeated in the Fourth and Fifth Plans too. It has to be conceded, however, that all the Finance Commissions quite understandably had done justice to the special category States.

How is it then that despite their need based approach, all the Finance Commissions had failed to do justice to the poorer States who are more in need of their assistance? How is it that later Finance Commissions managed to do better justice to the poorer States than the earlier ones? To get answers to these questions, it would be useful to disaggregate further the statutory transfers into its components.

The grants-in-aid under Article 275 meant specifically for States "in need of assistance" accounted for only less than 20 per cent of the statutory transfers during the 25 years under our study. The remaining was by way of tax sharing. Even the Seventh Finance Commission dispensed only 7 per cent by way of grants. The share of excise duty in the total divisible pool of taxes has been progressively increasing from 45 per cent during the Second Plan to 75 per cent during the Sixth Plan. Correspondingly, the share of income tax has been progressively coming down from 55 per cent in the Second Plan to 25 per cent during the Sixth Plan. And the distribution of excise duty was relatively more progressive than that of income tax during all except the Second Plan period.

Per Capita Tax Shares and Grants 1956-81

States	Plan Periods													
	II		III		AP		IV		V		VI		ALL PLANS	
	T	G	T	G	T	G	T	G	T	G	T	G	T	G
Punjab	19	5	32	1	31	--	82	--	144	--	91	--	399	6
Haryana	19	5	32	1	33	--	72	--	138	--	89	--	383	6
Maharashtra	22	--	34	--	40	--	96	3	164	--	102	--	458	3
Gujarat	29	--	40	10	36	--	85	1	159	2	104	--	453	13
West Bengal	27	8	32	1	34	--	85	16	155	60	105	1	438	86
GROUP A	25	3	34	2	36	--	88	6	157	19	101	Neg.	441	30
Tamil Nadu	20	--	28	4	31	6	83	6	154	Neg.	114	Neg.	430	16
Kerala	18	5	30	15	30	37	86	24	149	104	113	Neg.	426	185
Orissa	18	10	31	33	30	50	82	51	145	114	114	30	420	288
Assam	22	22	34	24	33	43	74	61	147	187	94	1	404	338
Karnataka	19	12	27	14	29	26	78	6	153	--	101	--	407	58
Andhra Pradesh	19	5	28	11	28	11	79	16	153	50	103	1	410	94
GROUP B	19	7	29	14	30	23	81	21	151	56	107	4	417	125
Uttar Pradesh	19	--	24	--	27	4	86	--	151	25	107	3	414	32
Rajasthan	18	6	28	12	29	10	81	21	151	100	96	1	403	150
Madhya Pradesh	17	5	27	5	28	2	81	2	152	--	109	--	414	14
Bihar	16	4	25	2	26	--	87	1	153	25	116	1	423	33
GROUP C	18	3	26	3	27	3	85	3	152	29	100	2	416	43
Himachal Pradesh	19	5	32	1	--	--	69	85	146	466	95	184	361	741
Jammu & Kashmir	23	37	44	31	56	55	99	150	146	419	94	140	462	842
Tripura	--	--	--	--	--	--	40	239	149	735	110	246	299	1220
Manipur	--	--	--	--	--	--	37	467	148	1169	99	382	284	2018
Nagaland	22	22	36	--	378	238	70	1511	158	2529	86	1030	414	5330
Meghalaya	22	22	34	24	33	43	91	160	149	757	102	265	431	1271
Sikkim	--	--	--	--	--	--	--	--	27	258	21	416	48	674
GROUP D	18	23	33	18	77	94	74	229	145	649	96	245	443	1268
ALL STATES	20	5	29	7	30	10	84	15	153	49	106	8	422	94

Note T denotes Taxes G denotes Grants Source: As in Table IV.1.

States' Share in Divisible Taxes

Table IV-2 which shows the per capita share of each State in the divisible pool of all taxes during different Plan periods shows that as compared to aggregate statutory transfers, tax sharing arrangements were less progressive implying that it is the grant component which has been more progressive than the tax component. But the progressivity of tax sharing is gradually increasing as may be seen from the movement of the rank correlation coefficients between per capita income and tax sharing over the Plans shown in Table IV.7. The coefficients which were positive and significant during the first three Plans under our review, turned negative during the Fourth Plan though the correlation was not significant. During the Fifth Plan, it turned positive again, though not statistically significant. It was only during the Sixth Plan, covered by the Seventh Finance Commission's award that the correlation between tax shares and per capita income turned negative and significant statistically.

During the 25 year period taken together, the sharing of divisible taxes was more favourable to the Group A States (followed by Group B States) than the Group C States. This was the pattern which had prevailed during the three earlier Plan periods also. The relative position changed for better for the C 'p C States during the later three Plans though only marginally.

TABLE IV.3

Per Capita Income Tax Shares 1956-81

States	Rupees Per Capita							Index Numbers						
	Plan Periods							Plan Periods						
	II	III	AP	IV	V	VI	Total	II	III	AP	IV	V	VI	Total
Punjab	10	12	11	40	62	29	164	91	92	100	103	103	107	102
Haryana	10	12	10	35	56	26	149	91	92	91	90	93	96	93
Maharashtra	11	17	18	50	72	33	201	100	131	164	128	120	122	125
Gujarat	14	15	13	41	68	31	182	127	115	118	105	113	115	113
West Bengal	16	19	14	45	66	26	186	145	146	127	115	110	96	116
GROUP A	13	17	15	45	67	30	187	118	131	136	115	112	111	116
Tamil Nadu	11	14	13	42	64	30	174	100	108	118	108	107	111	108
Kerala	10	12	9	38	60	29	158	91	92	82	97	100	107	98
Orissa	10	11	10	35	56	26	148	91	85	91	90	93	96	92
Assam	11	11	11	36	57	24	150	100	85	100	92	95	89	93
Karnataka	10	12	11	39	60	27	159	91	92	100	100	100	100	99
Andhra Pradesh	10	12	10	39	59	27	157	91	92	91	100	98	100	98
GROUP B	10	12	11	39	60	28	160	91	92	100	100	100	104	99
Uttar Pradesh	10	11	10	38	57	25	151	91	85	91	97	95	93	94
Rajasthan	10	11	10	35	57	23	146	91	85	91	90	95	85	91
Madhya Pradesh	10	11	10	36	58	26	151	91	85	91	92	97	96	94
Bihar	10	11	10	35	60	26	152	91	85	91	90	100	96	94
GROUP C	10	11	10	37	57	26	151	91	85	91	95	95	96	94
Himachal Pradesh	10	12	-	23	57	25	127	91	92	-	59	95	93	79
Jammu & Kashmir	11	12	9	36	56	21	145	100	92	82	92	93	78	90
Tripura	-	-	-	16	57	24	94	-	-	-	41	95	89	58
Manipur	-	-	-	15	55	21	91	-	-	-	38	92	78	57
Nagaland	11	7	3	26	58	21	120	100	54	27	67	97	78	73
Meghalaya	11	11	11	37	58	25	153	100	85	100	95	97	93	95
Sikkim	-	-	-	-	27	16	43	-	-	-	-	45	59	27
GROUP D	9	10	9	28	57	23	136	82	77	82	72	95	85	84
ALL STATES	11	13	11	39	60	27	161	100	100	100	100	100	100	100

Sources and Notes: As in Table IV.1.

States' Share in Income Tax

The regressivity in the transfers during the three earlier Plans and the progressivity during the Sixth Plan had arisen as a result of the gradual loss in relative importance of income tax as compared to excise duty noticed earlier. As may be seen from Table IV-7, rank correlation coefficients of income tax shares with per capita income were positive and significant during all except the Fifth Plan periods. Even during the Fifth Plan, the correlation was positive though weak. A group-wise analysis shows that during the entire Plan period covered by us the share in income tax porceeds which went to the high income States was the highest and that which went to the middle income States, was the second highest. The low income States' position was the third. (See Table IV. 3). The special category States came last. This is not surprising as all the Finance Commissions had given 10 to 20 per cent weightage to the collection criteria, the most regressive of all criteria which helps the developed States.[18] The regressiveness of collection criterion is not surprising as the value of the coefficient of rank correlation between per capita income tax collections from different States and the per capita State income (in 1975-76) was as high as +0.938.

The other criterion employed is population which at best is only a neutral criterion. All the Finance Commissions had used this "population-collection cocktail formula"

Per Capita Excise Duty Sharing, 1956-81

States	Rupees Per Capita							Index Numbers						
	Plan Periods							Plan Periods						
	II	III	AP	IV	V	VI	Total	II	III	AP	IV	V	VI	Total
Punjab	9	18	15	41	80	61	224	113	129	94	93	88	78	89
Haryana	9	18	16	36	80	62	221	113	129	100	82	88	79	88
Maharashtra	9	15	20	45	92	68	149	113	107	125	102	101	87	59
Gujarat	9	23	21	43	90	73	259	113	164	131	98	99	94	103
West Bengal	9	11	13	39	88	78	238	113	79	81	89	97	100	95
GROUP A	9	16	17	42	88	71	243	113	114	106	95	97	91	97
Tamil Nadu		13	17	41	89	83	251	100	93	106	93	98	106	100
Kerala		17	14	47	88	84	258	100	121	88	107	97	108	103
Orissa	8	19	19	47	89	85	267	100	136	119	107	98	109	106
Assam	11	20	22	38	90	70	251	138	143	138	86	99	90	100
Karnataka	8	13	16	38	93	74	242	100	93	100	86	102	95	96
Andhra Pradesh	8	14	16	40	93	76	247	100	100	100	91	102	97	98
GROUP B	8	15	17	41	91	79	251	100	107	106	93	100	101	100
Uttar Pradesh	8	11	13	48	94	81	255	100	79	81	109	103	104	102
Rajasthan		15	18	46	92	72	251	100	107	113	105	101	92	100
Madhya Pradesh	7	14	16	45	93	83	258	88	100	100	102	102	106	103
Bihar	6	12	14	51	96	90	269	75	86	88	116	105	115	107
GROUP C	7	12	14	48	94	82	257	88	86	88	109	103	105	102
Himachal Pradesh	9	18	-	42	88	70	227	113	129	-	95	97	90	90
Jammu & Kashmir	12	31	45	63	90	72	313	150	221	281	143	99	92	125
Tripura	-	-	-	23	91	86	200	-	-	-	52	100	110	80
Manipur	-	-	-	22	92	78	192	-	-	-	50	101	100	76
Nagaland	11	21	99	44	99	65	339	138	150	619	100	109	83	135
Meghalaya	11	20	22	53	90	77	273	138	143	138	120	99	99	109
Sikkim	-	-	-	-	Neg.	5	6	-	-	-	-	Neg.	8	2
GROUP D	9	22	49	46	88	73	287	113	157	306	105	97	94	114
ALL STATES	8	14	16	44	91	78	251	100	100	100	100	100	100	100

Notes: Excise duty includes additional excise duties in lieu of sales tax.

for income tax sharing among the States despite its known regressive bias partly due to an erroneous understanding of the Constitutional provisions and partly due to the reluctance of each one of them to break with the tradition.[19]

States' Share in Excise Duty

Most of the Finance Commissions had relied on excise duty sharing as the principal instrument to bring about reduction in regional disparities. But during the first three Plan periods, even this instrument had failed to achieve the desired objective as may be seen from its positive though weak correlation with per capita income. In fact, during the Second Plan, the correlation was significant at 1% level. But during the later Plans governed by the awards of the Fifth, Sixth and Seventh Finance Commissions, the correlation coefficients have turned negative and significant at 5 per cent level. The increasing progressivity of excise sharing is seen from Table IV-4 which gives the State-wise flow of excise proceeds. The welcome change in excise sharing together with the increasing share of excise duty in the divisible pool of taxes, has helped to bring about greater progressivity in aggregate tax sharing though only by the Sixth Plan period.

Excise sharing exhibited a greater progressive bias than income tax sharing especially during the last three Plan periods because the Fifth, Sixth and the Seventh Finance Commissions had been increasingly introducing the

criterion of backwardness in the inter-State allocation of the divisible excise pool. The weight given to this factor has also been increasing.

It is true that in the sharing of additional excise duties in lieu of sales tax, the Finance Commissions employed the regressive criterion of consumption or the nearest approximate proxies like sugar despatches and per capita income. But the relative importance of additional excise duty proceeds in the total excise pool is still small.[20]

Grants-in-Aid

As seen earlier, the importance attached to grants in aid by all the Finance Commissions was relatively low. It varied from 7 per cent in the case of the Seventh Finance Commission to 25 per cent in the case of the Fourth Finance Commission. Of the total statutory grants, 88 per cent was contributed by grants under article 275.[21] Table IV-2 shows that the overall bias in dispensation of grants was more equitable than tax sharing. The group D States benefited the most and group A States the least from the dispensation of grants by all except the Fifth Finance Commission. Between the middle and low income groups of States, however, it was the middle income States which gained the maximum amount of grants. In fact, during the entire twenty five year period, group C States received only a little more than one third of what group B States received. All the low income States except Rajasthan received substantially lower amount of grants than

even West Bengal. This shows that in determining the 'States in need of assistance', the Finance Commissions had not followed any objective criteria with a definite bias towards the poorer States. It appears that the results achieved were not due to any conscious formula to redress the regional inequalities. It was more a random or accidental result of the sum total of the many ad hoc approaches of the Commission. If they were following any objective criteria, the present position of Uttar Pradesh, Madhya Pradesh and Bihar getting less grants than West Bengal, Kerala, Orissa, Assam, Karnataka and Andhra Pradesh would not have arisen. In fact, Uttar Pradesh did not get any Article 275 grants under the awards of any one of the first five Finance Commissions. Madhya Pradesh did not get any grant from the Fifth and even the Sixth Commission. Bihar did not get any grant from the Fourth and Fifth Finance Commissions.

This anomolous position of some of the richer States getting more grants which should have more properly gone to States in need of assistance while the poorer States getting less grants arose due to the defective concept of 'need' followed by the Finance Commissions. To most Finance Commissions, need meant budgetary need and was measured in terms of the deficit in the non Plan revenue budgets of the States. Their approach towards grants had been the 'gap filling' approach followed by Niemeyer in 1936. In assessing gaps, they had not taken into account either the fiscal capacity of States or the economies in the States' expenditure.

The existing level and disparities in the per capita expenditure of States also was not considered.

The practice of a few States getting large Central transfers by means of tax shares and others getting just enough by means of grants - just sufficient to fill their revenue gaps - tends to be disequalising. In reality, the grants had been found to be inadequate even to bridge the budgetary gaps, as their value gets eroded by price rise. While tax shares are expressed as percentages to the divisible pool, the grants are expressed in absolute amounts. While inflation increases the size of the divisible pool and consequently of the tax shares, it widens the revenue gaps and the grants provided to some States by the Finance Commissions, barely enough to cover the gaps even at the time of sanction, become inadequate leading to reduction of Plan Outlays and unauthorised overdrafts. All the delicate balancing mechanisms meticulously built by the Finance Commissions get upset even before their reports get into prints by the continuous rise in prices for which no provision has been made by any of the Finance Commissions so far. The Sixth Finance Commission, for instance, assumed price stability at 1971-72 level during the ensuing long eight years (1972-1979). But 60 per cent of the real worth of their grants was eroded even by 1974-75, the first year of the quinquennium to which their award applied.[22]

Revenue Surpluses

In the case of some States, the Finance Commissions' awards just covered their non Plan revenue budgetary deficits, by means of grants. But in the case of others, they left large surpluses as may be seen from Table IV-5. There is a positive and statistically significant correlation between the per capita non Plan budgetary surpluses left by the Finance Commissions and the per capita incomes. In fact, during the Fifth Plan, governed by the Sixth Finance Commission's award, correlation was perfect (the coefficient being +1.) During the Sixth Plan, covered by the Seventh Finance Commission award, the value of the coefficient came down; but it was still positive and high (0.521).

As a result of the surplus in non Plan revenue account, made possible largely by the inequitous tax sharing, some of the States could aim at a larger size for their Plans on the basis of higher resource 'mobilisation'. The larger Plans boost both the revenue raising capacity and the per capita non Plan revenue expenditure in the subsequent periods covered by the subsequent Finance Commissions. The rank correlation coefficient between the per capita Fourth Plan Outlay and the non Plan revenue expenditure during the Fifth Plan was + 0.589. The coefficient for Fifth Plan Outlay and the non Plan expenditure during the Sixth Plan ~~also~~ was + 0.517. Both were significant at 5 per cent level. Thus a vicious circle gets joined which no Finance Commission

Non Plan Revenue Surpluses under the awards of the Finance Commissions (1966-84) and Non Plan Revenue Expenditure

(Rupees Per Capita)

States	Finance Commissions				Non Plan Revenue Expenditure		
	IV	V	VI	VII	V (74-79)	VI (79-81)	Total
Punjab	27	87	252	597	960	504	1464
Haryana	--	80	223	676	922	468	1390
Maharashtra	55	83	149	596	932	504	1436
Gujarat		60	126	423	708	10	1118
West Bengal	4	-	-	157	585	310	895
GROUP A	-	-	-		787	425	1212
Tamil Nadu	-	-	45	159	652	357	1009
Kerala	-	-	-	112	791	399	1190
Orissa	-	-	-	15	582	297	879
Assam	-	-	-	74	591	261	852
Karnataka	-	-	79	343	710	371	1081
Andhra Pradesh	-	-	-	217	608	336	944
GROUP B	-	-	-	174	654	342	996
Uttar Pradesh	2	32	-	233	454	223	677
Rajasthan	-	-	-	85	686	307	993
Madhya Pradesh	-	4	27	282	520	264	784
Bihar	19	35	-	205	333	175	508
GROUP C	-	-	-	217	463	229	692
Himachal Pradesh	-	-	-	22	1096	555	1651
Jammu & Kashmir	-	-	-	40	1529	667	2196
Tripura	-	-	-	23	1011	540	1551
Manipur	-	-	-	93	1271	655	1927
Nagaland	-	-	-	84	4082	1642	5724
Meghalaya	-	-	-	48	1088	532	1620
Sikkim	-	-	-	31	1696	1134	2830
GROUP D	-	-	-	40	1394	665	2059
ALL STATES	-	-	-	259	631	328	959

had been able to break till now. In fact, the provision of huge surpluses on non Plan account with a few States leaves the size of the divisible pool for Central Plan assistance reduced correspondingly. So, even if the Planning Commission were to bring about a more equitable transfers, the funds available for doing that will get reduced.

This inequitous situation of some States being given huge surpluses and others made just to scrape through with the help of grants-in-aid (whose value gets eroded by inflation thus leading to a deficit in no time).is a result of the basic defect in the very approach of the Finance Commissions. This situation was inevitable as all the Finance Commissions relied primarily on tax sharing and not on grants. Besides, none of the Commissions had an integrated approach, taking into account the total pool of resources to be allotted among different States. As a corollary to this, none had any objective criteria governing the total transfers. Many of the criteria used had been inequitous. Even when the criteria of need was used their definition of need was a narrow one which varied over time. It differed for each streamlet of transfers.

Before going to the above reasons in greater detail, it is necessary to have a closer look at the inter-State pattern of these surpluses, the most revealing indicator of the overall effects of the Finance Commission's transfers on State finances". During the Fourth and the

Fifth ~~Plans covered by the Fifth and the Sixth~~ Finance Commission's awards, none of the middle income States had any surpluses. During the Fifth Plan, governed by the Sixth Finance Commission's award, only two middle income States had any surpluses. These were Tamil Nadu and Karnataka. The Seventh Finance Commission, for the first time, left surpluses with all States though the size of the surpluses of the developed States was larger as may be seen from the high value of the coefficient or correlation between per capita surplus and per capita income (+0.521). Even Raj Krishna's suggested distribution of statutory funds would not have led surpluses which are progressive, as may be seen from the positive though weak correlation with per capita income.[23] The per capita surplus of Haryana under the Seventh Finance Commission's award was 45 times more than that of Orissa. The surplus of Tripura and Himachal Pradesh was only 4 per cent that of Punjab and Maharashtra. All the developed States other than West Bengal had surpluses left by all the Finance Commissions. It is true that even without tax devolution, Punjab, Haryana, Maharashtra and Gujarat, four of the richer States would have had surpluses during the operative period of the Sixth Commission's award. Tamil Nadu and Karnataka were added to the list of such States during the Seventh Commission's period. But the Commissions added to the size of the surpluses of these States by their generous formulae of tax devolution which did not take into account the existing fiscal capacity of States.

The richer States got surpluses in spite of their larger non Plan revenue expenditure in per capita terms as may be seen from Table IV.5. In fact, the coefficient of rank correlation between per capita surplus according to the Seventh Finance Commission's award and per capita non Plan expenditure was as high as +0.95. In short, the richer States accumulated surpluses in spite of their having higher levels of per capita expenditure on account of their higher revenue raising capacity and higher Central transfers. Some of the poorer States too had surpluses, for exactly the converse reasons. Their own resources were lower, the per capita Central transfers too were lower. Still they accumulated surpluses because of their lower levels of non Plan revenue expenditure. This paradox will be resolved once the genesis of non Plan expenditure is traced.

The non Plan revenue expenditure now, as noted earlier is increasingly becoming a function of the size of the previous Plan Outlays, for, the committed Plan expenditure at the end of every Plan becomes a charge on the non Plan revenue account. Centrally sponsored schemes too become part of the non Plan revenue budgets after each Plan. Expenditure on maintenance of capital assets built up as part of previous Plan programmes becomes a non Plan liability of the States' revenue budget. Similarly, States which have built up higher standards of social and administrative services, become entitled to higher non Plan expenditure in subsequent Plans.

TABLE IV.6

Per Capita Revenue Expenditure 1974-81

States	Social			Administration			Total Revenue Expenditure		
	V	VI	Total	V	VI	Total	V	VI	Total
Punjab	464	233	697	154	80	234	1139	579	1718
Haryana	336	183	519	133	66	199	1070	566	1636
Maharashtra	367	199	566	237	126	363	1047	563	1610
Gujarat	382	204	586	168	85	253	864	493	1357
West Bengal	323	185	508	114	55	169	722	396	1118
GROUP A	363	198	561	172	88	260	924	501	1425
Tamil Nadu	329	162	491	113	55	168	771	421	1192
Kerala	473	249	722	119	58	177	903	475	1378
Orissa	274	153	427	109	59	168	707	385	1092
Assam	290	148	438	125	62	187	716	341	1057
Karnataka	313	159	472	101	50	151	839	450	1289
Andhra Pradesh	302	174	476	106	53	159	718	403	1121
GROUP B	327	173	500	110	55	165	773	416	1189
Uttar Pradesh	191	115	306	93	45	138	537	285	822
Rajasthan	322	149	471	115	53	168	802	388	1190
Madhya Pradesh	252	125	377	103	48	151	673	349	962
Bihar	162	97	259	77	42	119	392	218	610
GROUP C	211	116	327	93	46	139	545	293	838
Himachal Pradesh	533	317	850	223	121	344	1407	776	2183
Jammu & Kashmir	425	236	661	214	113	327	1702	785	2487
Tripura	508	327	835	263	155	418	1255	760	2015
Manipur	573	339	912	514	227	741	1603	855	2458
Nagaland	1513	614	2127	1400	608	2008	4872	1998	6870
Meghalaya	485	262	747	368	180	548	1589	787	2376
Sikkim	599	355	954	403	334	737	3058	1883	4941
GROUP D	531	300	831	312	161	473	1677	845	2522
ALL STATES	296	161	457	125	63	188	746	401	1147

Source: As in Table IV.1. The important social services are (1) Education (2) Health (3) Housing (4) Labour and employment (5) Social Security and Welfare (6) Natural Calamity Relief. Administration Services include (1) District Administration (2) Police (3) Public Works (4) Secretariat General Services. The classification followed is that of the Reserve Bank of India.

TABLE IV.7

Rank Correlation Coefficients with Per Capita Income

Rupees per Capita	II	III	AP	IV	V	VI
1. Per Capita Aggregate Statutory Transfers.	0.419	0.108	0.002	- 0.254	- 0.536	- 0.600
2. Per Capita Share in Taxes	0.713	0.775	0.831	- 0.100	0.074	- 0.631
3. Per Capita Share in Income Tax	0.643	0.822	0.671	0.567	0.449	0.607
4. Per Capita Share in Excise Duties.	0.822	0.249	0.384	- 0.654	- 0.583	- 0.701
5. Revenue Surplus ≠ Per Capita			0.586	0.857	+ 1.00	0.521 (0.471)*
6. Percentage Expenditure on Social Services					- 0.082	- 0.269

≠ Relates to the period of the Finance Commission Awards.

*Surplus according to Raj Krishna's suggested allocation. See Report of the (Seventh) Finance Commission, p. 146.

Note: Only values above 0.524 are significant at 5% level.

Larger State Plans involve larger borrowings for the States. Servicing of these loans becomes a charge on the non Plan revenue budget. Thus as noted by the Administrative Reforms Commission's Study Group, "it becomes more and more difficult to assess the budgetary gaps since the budgets themselves increasingly reflected Plan expenditure".[24] As a result, the poorer States which had lower Plan expenditure in the past become eligible for smaller admissible non Plan expenditure under the Finance Commission's approach of filling the gaps in the normative non Plan revenue budgets of States.

Need for a New Approach

For solving this problem of some States, managing to get huge surpluses while others barely managing with filling their non Plan revenue gaps, a fundamental break with the past approaches of the Finance Commissions becomes necessary. The new approach, should treat all taxes to be shared among States as feeder sources of a common divisible pool; and their distribution among the States *inter se* should be made on the basis of uniform principles serving the sole purpose of meeting the fiscal needs of each State. Ideally even funds available for grants-in-aid should be treated as part of the common pool. "Since both tax sharing and grants-in-aid have to be governed on the basis of need, it should be possible to evolve rational criteria of allocation applicable to the total resource transfer from the federal to the State Governments."[25] This scheme was in fact suggested by one of the States to the Fifth Commission which was rejected.[26]

In the absence of such integrated approach, none of the Commissions except the Seventh could even present, in their reports, the quantum of aggregate transfers, recommended by them to different States.[27] The continued reliance on the present practice on account of the erroneous interpretation of the constitutional provisions and partly out of the desire not to depart from the practice established by the previous Finance Commissions, has helped the richer States in getting large sums by way of tax sharing which boosted their surpluses while some of the poorer States did not get any surplus at all. The reluctance of the Finance Commissions to break with the past is surprising. As pointed out strongly by Sastri,

> "It is pointless to adopt the whole gamut of means of adjustment discussed above and indulge in ingeneous arithmetical exercise for making up the total financial transfers to each State in what is practically an infinite number of possible alternative combinations among them, all the more so when a basic principle such as fiscal need is accepted as the bedrock of the adjustments. Money being homogeneous, any given State can hardly be expected to take an interest in the proportions of the total revenue devolution to it constituted by the several heads of shared revenues and revenue assignments when the degree of its financial dependence is in no way affected by changes in these proportions."[28]

One reason adduced by the Finance Commissions for their piecemeal approach is the constraints imposed on them by the wording of the constitutional provisions which supposedly compel them to give differential treatment to different items of transfer. According to this argument,

Constitutional sanction for tax sharing is derived from separate articles viz., Articles 269, 270 and 272. The sanction for grants-in-aid is derived from Article 275. The wording of these provisions differs from one another and, therefore, a separate treatment of each sharable tax and grants is essential. This view does not appear to follow from the interpretation of the Constitutional provisions.[29] It is true that transfer of the entire tax proceeds under Article 269 is mandatory and these proceeds do not form part of the Consolidated fund of the Government of India. Sharing of income tax under Article 270 is also mandatory. Excise duties under article 272 form part of the Consolidated Fund, the sharing of which is only permissive. But even under the mandatory provisions of Article 269, the _inter se_ allocation among the States was left entirely to be determined "in accordance with such principles of distribution as may be formulated by Parliament by law", but on the recommendations of the Finance Commission. The only restriction placed by the Constitution is that taxes should be assigned only "to the States within which that duty or tax is leviable in that year".[30] As for Article 270, the share of the Centre and States on the one hand and among the States on the other, has to be determined in such manner and form as may be prescribed by the Finance Commission. The only limitation, as with Article 269, is that States in which the income tax is not leviable are not entitled to a share in its proceeds. As for sharing the Union Excise

duties, as per Article 272 it is purely permissive and the distribution among the States should be in accordance with such principles of distribution as may be formulated by such law by Parliament on the basis of the Finance Commission's awards. As for grants-in-aid, the eligibility of States in terms of need of assistance is to be determined by Parliament according to Article 275. The Constitution also permits the fixation of different sums for different States. In short, the Constitution does not stipulate any rigid principles, but gives ample freedom to the Finance Commissions.

Even assuming, for the sake of argument that the Constitutional provisions require differential and separate treatment to tax sharing and grants-in-aid on the one hand and among the different taxes on the other, the objective of equalisation could still have been achieved by increasing relatively the importance of grants-in-aid. The *inter se* importance of the sharing of permissive and mandatory taxes could also have been similarly adjusted. Such an approach was suggested by Swaminathan, a member of the Sixth Commission.[31] But this was not accepted by other members. Surprisingly, all the Finance Commissions adopted just the opposite approach. They had been progressively raising the share of taxes instead of grants and among the taxes the States' share in the mandatorily sharable income tax (from 55 per cent to 90 per cent).

In short, the Finance Commissions, despite the freedom and importance given to them by the Constitution preferred to follow the beaten track of Otto Niemeyer and other British appointed advisory committees.[32] Although these committees had done a thorough job, as Hanson points out, they were "even less conscious than the Constitution makers of 1948-1950 of the financial implications of a planned economy."[33] Though the Second Finance Commission was eloquent on the "fundamental changes in the scope of governmental functions resulting in the widening of the content of fiscal need as a result of the transition from a police State to a welfare State, they found, like the First Commission that the "basic overall approach of Niemeyer, still remains valid; the States and the Union have to balance their budgets within their available resources and the needs of the States which cannot be met by devolution of shares of taxes have to be covered by grants-in-aid".[34] All the Commissions shared Niemeyer's concern for financial equilibrium and assigned only a residuary role to grants-in-aid which to repeat is specifically earmarked under the Constitution for States' in need of assistance'.

The gap filling approach of the Finance Commission is not suggested by the Constitution. According to Rajamannar, "ex facie, there is nothing in the Article (275) which confines its operations to filling up of any gap".[35]

Criteria for Transfer

A corollary to the compartmentalised approach of the Finance Commissions is that the criteria used by them for allocating resources among States varied from grants to tax sharing, from income tax to excise duty sharing and from time to time. Some of these criteria had a progressive bias while some others had an opposite bias. The sum total of the effects was any body's guess including that of the Finance Commissions. For sharing of income tax, variations of the population collection formula was used by all the Finance Commissions as seen by us earlier. As for Union excise duties, the major ingredient of the formula is population which is supposed to represent both contribution and need, depending on which way the Commission prefers to project its approach. A small weightage has been given to the factor of backwardness, for the measurement of which a large number and wide variety of indicators have been used. As for grants-in-aid, the criteria was formerly the size of the revenue budget deficit. From the Fourth Finance Commission onwards, the criterion had been narrowed further to non Plan revenue budgetary gap.

Collection, as a principle of tax sharing, is clearly regressive as was briefly noted earlier. It is not a Constitutional requirement either, as is sometimes suggested. The constitutional provisions do not stipulate collection as a principle for inter-State allocation. Unlike in the

Canadian and Australian federations, the right to tax income is not derived by the Union government by any tax rental arrangement.[36] Historically, the Provinces of the Indian federation had never enjoyed the right of concurrent taxation [37] Collection principle, tends to favour the richer States.[38] Besides, as pointed out by Justice Kaushalendra Rao in the First Finance Commission's report, the doctrine of economic allegience which lies behind the principle of contribution has no constitutional validity in India.[39] The need-based twist given to the argument by the developed States that the urban agglomerations necessitate provision of larger funds from the State revenues is again not fully valid as incomes generated strengthen the resource base of the States too as is evident from the larger resources of the developed States.[40] Similarly, in a highly integrated economy, the contribution of each State to the tax revenue realised by the Centre cannot be clearly attributed.[41] In fact, the Second Commission was very emphatic that collection should be completely abandoned in favour of population as the basis of distribution. Still, the Commission did no more than reducing the weightage of collection from 20 per cent to ten per cent as they did not desire to break the continuity of policy suddenly. The desire not to upset Niemeyer's applecart was at the back of the recommendation made by the First Commission to give a 20 per cent weightage to collection after an elaborate and substantial argument, both on constitutional and economic grounds against it.

And according to Otto Niemeyer, substantial justice would be done by fixing the scale of distribution 'partly on residence and partly on population'.[42] The Third and Fourth Commissions increased the weightage of contribution to 20 per cent from 10 per cent fixed by the Second Commissi[on]. The Fifth, the Sixth and the Seventh Commissions reduced it again to 10 per cent.

The principle of contribution has been accepted for inter-State distribution of not only income tax, but also of Estate duty (location and assessment) and additional excise duty (per capita income and consumption). It is also made use of for making grants in lieu of railway fares and wealth tax on agricultural property. However, the amounts transferred under these heads are of small magnitudes and therefore may not be of much significance, in bringing about regressivity in aggregate statutory transfers Besides, as seen earlier, sanction for Centre's mobilisation of resources under these heads is derived from some sort of tax rental arrangements with States. And therefore the principle of contribution cannot be totally ruled out in the inter-State allocation of these taxes and duties.

The single most important criterion used in tax sharing among States is population. As seen earlier, the importance of this factor varied from 80 to 90 per cent for income tax sharing. Its importance varied from 75 to 100 per cent in the sharing of excise duty. This criterion

bestows equal benefits to people in all the States irrespective of their per capita income levels. We have earlier noted an agrument that when taxes are progressive, equal per capita transfer of the tax porceeds has a built-in redistributive bias about it. But this argument is not acceptable, firstly because the progressiveness of the India tax system as a whole is not yet beyond doubt despite its progressiveness in appearance, inter alia due to the extensive tax evasion.[43] Secondly, equal resource transfers will continue to permit unequal budgetary expenditure levels as a result of the unequal fiscal capacity of States. In other words, equal treatment of unequals is only bound to increase inequalities.

From the third Finance Commission onwards, apart from population, certain additional criteria of backwardness were also used in sharing excise duties. Weightage to this factor of backwardness however did not exceed 20 per cent except under the Sixth Commission which raised it to 25 per cent. The Seventh Finance Commission raised it significant to 50 per cent. The Third Commission did not even specify the weightage to this factor. In their attempt, "to bring all the States as far as possible, to a comparable level of financial balance" the Third Commission considered along with population the "relative financial weaknesses of the States, the disparity in the levels of development reached, the per centage of Scheduled Castes and Tribes and backward classes in their population, etc."[44] The weightage given

to these individual indicators of backwardness is not made clear. Nor is it clear what the Commission means by disparities in levels of development. The Fourth Commission excluded the criterion of financial weakness, but adopted certain others like economic and social backwardness as indicated by an arrayof seven factors like per capita value of agricultural and industrial production, labour participation rates, share of rural,Scheduled Caste and Scheduled Tribe population, enrolment in scho ls and hospital beds per population. Twenty per cent weightage was given to all these seven factors together.[45] The individual weightages given t these factors are not known. Nor is it known how they were combined.[46] The Fifth Commission also assigned 20 per cent weightage to backwardness. The Commission sought to measure economic backwardness both in terms of per capita income and a composite index of socio-economic backwardness. It may be said to the credit of the Fifth Commission that they introduced for the first time State income as an indicator of backwardness though its relative importance was still very small. Two thirds of twenty per cent of divisible pool of excise duty was to be shared exclusively with States having per capita income below the national average "in proportion to the shortfall of the States' per capita income from all States' average, multiplied by the population of the State. The remaining one-third was to be distributed according to the composite index, constructed with six indicators, giving equal

weightage.[47] The indicators were, Scheduled Tribes population, factory employment, road and railway mileage, enrolment in schools and hospital beds and net irrigated area. All these are partial indicators unlike the per capita income which is an overall indicator. As the Sixth Commission pointed out, these are either the causes or the effects of per capita income. Besides, these indicators reflect very much the particular pattern of allocation of resources by different States.[48]

The Sixth Commission, therefore, took into account only per capita income as the sole indicator of backwardness. They also assigned 25 per cent weightage to this factor in the sharing of the Union excise pool. But they allowed all the States except Punjab to partake in this common pool divisible according to the criterion of backwardness. The States with per capita income above the national average who were excluded by the Fifth Commission from sharing this part of the pool were now made eligible on the ground that the criterion "affected most adversely those States whose per capita income happened to be just above the dividing line".[49] The known margins of errors in national income data also made the Commission to adopt this approach. So the common pool available for sharing according to the criterion of backwardness was distributed according to the "distance of a State's per capita income from that of the State with the highest per capita income multiplied by the population

weightage.[47] The indicators were, Scheduled Tribes population, factory employment, road and railway mileage, enrolment in schools and hospital beds and net irrigated area. All these are partial indicators unlike the per capita income which is an overall indicator. As the Sixth Commission pointed out, these are either the causes or the effects of per capita income. Besides, these indicators reflect very much the particular pattern of allocation of resources by different States.[48]

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of the State concerned".[50] What the Commission stated about the marginal States is true. However, for protecting the interests of the border-line States, the Commission could have adopted a sub-classification of States above the national income. This has been done in the present study. To restore the old balance between the States above and below average per capita income, the new definition adopted by the Sixth Commission for relative backwardness would have required the population weightage to be reduced to 30 and relative backwardness to be given the weightage of 70 per cent.[51]

The Seventh Finance Commission has adopted poverty ratio too in addition to the inverse of per capita income. The drawback of introducing poverty ratio in addition to per capita income is that poverty ratio is not independent of the way resources have been allocated by different States. It is also not independent of the per capita income level as is seen from the high negative value of the coefficient of rank correlation between per capita income and poverty ratio noted in Chapter I.[52]

The criteria selected by the successive Finance Commissions in allocating the quantum of grants-in-aid which was explicitly meant by the Constitution to take care of the States "in need of assistance" were also defective, though the Commissions had a free hand in selecting these criteria. "All the Finance Commissions have hitherto

continued the legacy of the earlier period where statutory grants were small compared to the divisible pool and have not added greately to their importance."[53] Here again, all that all the Commissions did was to slavishly follow the footsteps of Otto Niemeyer, who treated grants-in-aid as a residuary factor meant to 'fill the revenue budget gaps'.[54] The basic defect is in the very approach of all the Finance Commissions to use grants-in-aid "to cover what a State was committed to and not what a State ought to be committed to. The so called norms (of expenditure) were applied to the rates of growth and not to the level of commitments under various heads".[55]

It was not that the possible divergence between the financial weakness as reflected in the budgetary gap and the socio-economic backwardness did not occur to the Finance Commissions. The Second Commission noted: "In a Union in which the Centre and the States co-operate for planned development, priorities and provisions in the Plan itself should determine the fiscal need for development for the period of the Plan".[56] But this lofty principle was not followed in their scheme of grants. The Fourth Commission was more explicit: "it is possible that a State may be economically backward and poor in social services and yet it may have fairly comfortable position on revenue account. There are States of this type".[57] But this awareness influenced the Commission's thinking on excise

sharing only and not on grants. Similarly, the Fifth Commission too felt that as a broad measure of needs of different States, due regard should be had to criteria like population and suitable indicators of backwardness, rather than the relative financial weakness or budgetary deficits of the States.[58] But all the Commissions failed to take into account their own broad norms of needs and preferred to follow financial weakness as measured by non Plan budget gaps as the criterion for selecting States in need of assistance.

Conditional Grants and Provision for Upgradation of Services

In addition to the unconditional grants under article 275, the First and Third Finance Commissions tried t to give conditional grants for upgradation of standards in primary education and communications respectively. (The Third Commission's recommendation regarding conditional grants for financing the revenue component of Plans was not accepted by the Union Government.) But even the conditional grants did not have an equalisation bias. While Punjab did qualify for primary education grants, the old princely States like Travancore and Cochin did not. While Gujarat got communication grants, under the Fourth Commission's award, Uttar Pradesh did not get any. This is because the Commissions considered only the weakness of a State in the particular sector for alloting these grants. The States' fiscal capacity had not been taken into account by the Commissions in this context.

The Sixth and the Seventh Finance Commissions in tune with the new emphasis on social consumption and Minimum Needs Programme and in response to their terms of reference, made provision for upgradation of administrative and social services to national standards while computing the revenue gaps. These provisions are in fact concealed forms of grants-in-aid, since, in the absence of these provisions in the normative expenditure budgets drawn up by the Finance Commissions, many States would not have qualified for grants in aid under Article 275 at all or would have qualified for lesser amounts. These 'indirect grants' for specific purposes had a broad equalisation tendency: but they also had benefitted a few of the richer States like West Bengal and Haryana while some of the poorer States like Madhya Pradesh and Rajasthan benefited only marginally. Under the Sixth Commission's award, all but two States got provisions for upgradation of the standards of essential administrative services irrespective of either their per capita income levels or their per capita expenditure levels. The per capita resource raising capacity and per capita revenue surplus also was not considered. Of the two States which did not get upgradation provisions one belonged to the middle income group (Tamil Nadu) and the other to the special category (Himachal Pradesh).

The upgradation grants actually helped those States which had in the past diverted their own resources for purposes other than social consumption. Our own

analysis confirms the findings of the earlier studies that, as compared to the richer States, the poorer States are spending larger proportion of their expenditure on social services, in conformity with the conception of modern States and also for compelling forces to catch up with advanced States.[59] For achieving the most minimum levels, larger proportion of revenue has to be spent on these services by the backward States. Our analysis for the Fifth and Sixth Plan shows that the rank correlation between the share of expenditure on social services to the total revenue expenditure and the per capita income was negative though weak. Some of the States like Kerala had therefore represented before the Finance Commissions that the adoption of these criteria for the measurement of relative backwardness "would place at a disadvantage those States which despite a poor resource base have assigned high priority for these services in the past."[60] In their concern for the upgradation of social standards, the Finance Commissions interfere with the order of preference of the States in the wrong way by penalysing those States which in the past had given high priority to these services presumably out of their greater concern for the weaker sections of society. Instead of helping even the developed States from the national pool of resources, the States which had neglected these services in the past should have been compelled to spend from their own resources. This problem can be solved if only the Finance Commission takes the proportion of States' expenditure

on these items to either the total expenditure or the per capita income, instead of taking per capita expenditure alone in deciding the qualifying criterion.

The upgradation grants despite its appearance do not ensure equity, as in certain cases it serves only to widen the disparities in total expenditure on social services itself. The upgradation grants or provisions are given to all States irrespective of their non Plan budgetary surpluses. The only exception was the Seventh Finance Commission. But even this Commission excluded only those States which would have got surpluses even without devolution. Others who got surpluses after devolution were still given upgradation provisions.

This concern of the Finance Commissions for upgradation of social consumption is borrowed from the mature federations where attempts are made to equalise only social and administrative standards. But the inequalities in income as also consumption are relatively less in these federations than in India. The social security schemes including unemployment relief financed by the federal government ensure that destitution does not prevail in any of their constituent units. It may be remembered that per capita food consumption in India as also poverty ratios show considerable inter-State variations.[61] The concern of the Finance Commission for equalisation of administrative and social standards without assuring any corresponding responsibility for ensuring a floor level of income and consumption

is at best a superficial concern. "The Basic Minimum Needs Programmes are aimed at providing a floor standard for certain development indicators. But basic minimum need for food is not included in the basic minimum requirements."[62]

Equalisation of social and administrative services may be enough in mature federations where the range of disparities in income and consumption is less. But as compared to some of the mature federations, the disparity in per capita income is higher in India. As against 0.09 in Australia, the coefficient of variability in per capita income in India was 0.22 in 1960-61. As seen earlier in Chapter I it has increased since then. The per capita income in the least developed Australian unit was 79.5 per cent that of the richest, as against 47.1 per cent for India in 1960-61.[63] As the Sixth Commission rightly pointed out, when the per capita income levels are very low, the tolerance limit for inequalities is also lower.[64]

Again, it is perhaps enough for the federal government in a loose federation with more powers to States to limit its responsibility to equalisation of social and administrative standards. But this is clearly not adequate for a federal government in a tight federation which has reduced the constituent units to the State of abject dependence acquiring near monopoly over the financial resources. Similarly, what is adequate for federations with free enterprise economies is not adequate for a country which has assumed the responsibility for national planning and with

its commitment for reduction in inter-State disparities in development. It is to be noted that in the process of planning, the Union government had virtually taken over the responsibility for planning in sectors originally included in the State and Concurrent Lists. As a result making of crucial economic decisions has come to be centralised. After three decades of such comprehensive planning, an attempt to envisage the role of the Union Government as merely to equalise social and administrative standards in the constituent units is perhaps defeatist and unrealistic.

In assessing the criterion of need for determining the quantum of statutory transfers, the Finance Commissions should not confine themselves to partial indicators like the ones discussed earlier. They should radical. depart from their traditions and take per capita income as their sole criterion. If for any reason this is not possible, they should at least try to equalise the per capita revenue expenditure by leaving surpluses to those States showing shortfalls from national average. Though equalisation of revenue expenditure may not be a big contribution to the problem of regional disparities, it may give at least a desirable first break from the past traditions.

Tax and Expenditure Norms

The Finance Commissions prepare, before deciding the distribution of grants-in-aid under Article 275, normative budgets in which unnecessary and unproductive expenditure are excluded while computing the revenue gaps to be filled by grants-in-aid. Similarly they also suggest certain revenue norms before computing the revenue gaps. But both

these norms, relating to tax efforts and expenditure economy are far from satisfactory. These unsatisfactory norms also have helped the developed States' for the laxity in the discipline of tax efforts and economy in expenditure is tolerated more in those States which have surpluses before or after tax devolution and who do not require grants-in-aid. This violates the canon of equity which requires that benefit-sacrifice levels should be equalised in the different constituent units of the federation.

In India, as May notes, "the Finance Commissions have been able to take account of States' tax efforts and economy of administration only in a superficial way".[65] As for tax efforts, the principle of tax effort was deemed unexceptionable by all Finance Commissions. But as the First Commission observed: it is only in clear cases of inadequate taxation that this (lack of tax effort) should affect the quantum of assistance a State would otherwise be qualified to get".[66] According to the Second Commission, clear cases of inadequate taxation are difficult to determine. The Commission therefore made the untenable assumption that "if a State raised additional revenue which it has promised for the Plan, it will have done its part".[67] The ball thus was pushed to the Planning Commission's court. But the latter also does not appear to have hit upon any more scientific norms. The best they could think of was the ratio of tax revenue to per capita income without taking into account either the structure or the distribution of income.[68]

The Sixth Finance Commission gave up its effort or improving the tax norms:

> "on the practical consideration that the application of a formula based on relative tax effort, however designed, would place at a disadvantage to some of the States faced with big gaps on non Plan revenue accounts. To leave such gaps uncovered on this ground of their poor tax performance, however defensible on theoretical considerations, would jeopardise maintenance of essential administrative and social services for want of adequate resources."[69]

The absence of norms or unscientific norms help the richer States as their tax efforts are magnified unduly which entitles them to more statutory and Plan funds. According to Rao's study, about 91 per cent of the variation in per capita tax between different States is explained by the variation in per capita SDP.[70]

The absence of scientific norms for tax efforts and expenditure economy in India is understandable. The Indian Finance Commission unlike the Commonwealth Grants Commission in Australia is handicapped in making a thorough study as it is not a permanent one with continuity of membership and a permanent secretariat.[71] In spite of the recommendations of successive Commissions for establishing a permanent secretariat, all that the Indian Finance Commissions have managed to get is a dormant cell in the Finance Ministry which goes to sleep as a Finance Commission presents its report and awakens at the first sign of the appointment of a new Finance Commission. And the Fourth Finance Commission lamented: "no data except the conspectus of the

Central and State budgets has been made available to us by this cell".[72] This is understandable as the cell consisted of only s ministerial staff! The position has not changed much since then and the cell continues to be small and ineffective as noted by the Seventh Commission.[7]

Conclusion

In summing up, it may be seen that the successive Commissions did not have an integrated approach to the total statutory transfers. Their approach was adhoc and piecemeal They relied more on tax sharing than on grants. Their approach was more judicial than economic. The criteria chosen for allocation of grants varied from those for tax sharing. In fact, the criteria varied from sharing of one tax t another. And even the best of criterion evolved by them had only scratched the surface of the problem of ever-widening regional disparities. One may conclude that the awards of the successive Finance Commissions as a whole had only served to widen the inter-State disparities in economic growth.

It is true that even with the best of criterion, the present role of the Finance Commissions (self imposed as also imposed by their terms of reference) in reducing inter-State disparities is a limited one. As seen earlier, during the last quarter century of planning (1951-1976), the Finance Commission's awards covered only less than two fifths of the total budgetary transfers from the Union Government

to States. Thus [illegible] ven i[illegible] Finance Commissions are possessed of a magical [illegible]ormula, they can only produce half a rabbi[illegible] out [illegible] the hat.[74] [illegible] the next two Chapters we pr[illegible]ose t[illegible] examine [illegible]ow well the other half was produced by the Planning Commission and the Union Ministries.

Notes and References

1. For the Constitutional provisions relating to Finance Commission and the Statutory Transfers, see Report of the (Seventh) Finance Commission, Government of India, New Delhi, 1978, Annexure p.1-9.

2. Santhanam, K., Transtition in India, Asia Publishing House, Bombay, 1964, p.116,. Shri Santhanam was the Chairman, of the Second Finance Commission.

3. Wheare, K.C., Federal Government, Oxford University Press, London, 1963, Chapter VI.

4. See the Constitutional provisions referred to in Foot-note 1.

5. Report of the (Fourth) Finance Commission, Government of India, p.88.

6. The Union Government is under no obligation to accept the recommendations in full of the Finance Commissions and in fact rarely does." See Hicks, U.K., "Federal Finance Problems in India and Australia," Public Finance Hague, Vol.23, 1968, p.221.

7. "Centre-State Financial Relations, Economic and Political Weekly, 13 May, 1973.

8. Chanda, A.K., "Financial Aspects of Union-State Relations in India", in ed. Kashyap, S.C., Union-State Relations in India, Institute of Constitutional and Parliamentary Studies, New Delhi, 1969, p.143-149.

9. Report of the (Third) Finance Commission, Government of India, New Delhi, 1961, p.35.

10. Quoted in the Report of the (Second) Finance Commission Government of India, New Delhi, 1957, p.92.

11. Report of the (First) Finance Commission, Government of India, 1962 p.8.

12. Report of the (Fifth) Finance Commission, Government of India, New Delhi, 1969, p.7.

13. Report of the (Sixth) Finance Commission, Government of India, New Delhi, 1973, p.8.

14. Ibid. p.7.

15. May, R.J., Federalism and Fiscal Adjustment, Oxford Clarendon Press, London, 1969, p.123.

16. Hanson, A.H., The Process of Planning, Oxford University Press, London, 1966, p.351.

17. See also Footnotes to Table IV.1.

18. For the inequitous nature of the Collection Criterion, see the Note of Dissent by Raj Krishna in the Report of the (Seventh) Finance Commission, op.cit. p.150

19. See Report of the (Second) Finance Commission, op.cit. p.40.

20. Moreover, there is a case for using collection as a criterion here as Centre's authority to levy and collect this duty is derived from tax rental arrangement with the States.

21. The other statutory grants are (1) Grants in lieu of tax on railway passenger fares, (2) Grants in lieu of Wealth tax on agricultural property (3) States' reorganisation grants (4) Grants under proviso to Article 275 and (5) Grants under Article 278.

22. See Gulati, I.S., "Sixth Finance Commission's award," Economic and Political Weekly, Bombay, February 1977.

23. Raj Krishna, Note of Dissent, Report of the Seventh Finance Commission, op.cit. p.146.

24. Administrative Reforms Commission (ARC) Report on the Study Team on Financial Administration, Government of India, New Delhi, 1967, p.81.

25. See Report of the (Fifth) Finance Commission, 1969, p.13.

26. See also Bhatt, V.V., "On the Magnitude and Allocation of Federal Assistance for States in India: Some Rational Criteria", Public Finance, Vol.XXIV, 1969, p.567.

27. Report of the (Seventh) Finance Commission, op.cit.p.146.

28. Sastri, K.V.S., Federal State Financial Relations, Oxford University Press, London, 1966, p.76.

29. See "Centre-State Financial Relations," Economic and Political Weekly, Bombay, 12 May, 1973. op.cit. p.823.

30. Ibid, p.823.

31. See Minute by Swaminathan, C., Report of the (Fifth) Finance Commission, op.cit. .102.

32. Hanson, A.H., op.cit. .32 . . . When it came to taking decisions about the devolution of Centrally levied taxation and the making of grants, and loans by the Centre to the States, the Government of Independent India was heavily dependent on the Studies produced by a series of British appointed advisory bodies such as the Meston Committee of 1920, the First Peel Committee of 1931, the Percy Committee of 1932, the Second Peel Committee of the same year and the Niemayer Mission of 1935".

33. Ibid, p.324.

34. Report of the (Second) Finance Commission, op.cit. p.23.

35. Minute by Rajamannar P.V., Report of the Fourth Finance Commission, op.cit. p.87. Justice Rajamannar was the Chairman of this commission.

36. See Wheare, K.C., op.cit. Chapter VI.

37. See Eapen, A.T., Critique of Indian Fiscal Federalism", Public Finance, Vol.24, 1969, p.543.

38. See Swaminathan, C., Minute to theFifth Finance Commission, See also Hanumantha Rao, C.H., Growth, Poverty and Tax Effort, Institute of Economic Growth, Delhi, 1979 (mimeo).

39. For a brilliant exposition of the view, see the Minute by Justice Kaushalendra Rao, Report of the First Finance Commission, op.cit. p.112-113.

40. See Raj Krishna, op.cit. p.150.

41. See Nanjundappa, D.M., Inter-Governmental Financial Relations in India, Sterling, New Delhi, 1974, p.46.

42. Quoted in the Report of the (First) Finance Commission, op.cit. p.20.

43. See (1) Toye, JFJ,"How Progressive Are Indian Consumption Taxes?" Economic and Political Weekly, Bombay, March 20, 1976. (2) Gupta, Anand. P.,"Central Government Taxes: Have they reduced Inequalities"? Economic and Political Weekly, Bombay, Jan. 22, 1977.

44. Report of (Third) Finance Commission, op.cit. p.22.

45. Report of the Fourth Finance Commission, op.cit. p.22.

46. Unlike t Australian Grants Commission, the Indian Finance Commissions do not take the public fully into confidence especially on its arithemetical adjustments. All the rking papers are destroyed after the Commission finalised their report for the reason that the Commission's reports amount to awards and to document showing how the awards are arrived at need be kept. See Jayanta Sarkar, permanent Finance Commission", Economic and Political Weekly, 9 Aug. 1969 On the other hand, the Australian Grants Commission "has always taken the public into its confidence and this has not been misplaced". The Commission has deri ed both assistance and prestige not only from its accumulated experience, but also from the reactions to its published hearings, Hicks, U.K., op.cit. p.221.

47. Report of the (Fifth) Finance Commission, op.cit. p.36.

48. Report of the (Sixth) Finance Commission, op.cit. p.16.

49. Ibid. p.17.

50. Ibid, p.17.

51. Gulati, I.S.,"Sixth Finance Commission's Award", Economic and Political Weekly, February 1977.

52. For an exposition of this view, see the majority observations on Raj Krishna's dissenting note: Report of the (Seventh) Finance Commission, op.cit. p.162.

53. Lakdawala, D.T., 'Union-State Financial Relations, Lalvani Publishing House, Bombay, 1967, p. 64.

54. Quoted by the Second Finance Commission, op.cit. p.22.

55. Nambiar, K.V., "Task before the Seventh Finance Commission, Economic Times, March 18-19, 1977.

56. Report or the (Second) Finance Commission, op.cit. p.22.

57. Report of the (Fourth) Finance Commission, op.cit. p.23.

58. Report of the (Fifth) Finance Commission, op.cit. p.36.

59. Nanjundappa, D.M., op.cit. p.42.

60. Report of the (Sixth) Finance Commission, op.cit. p.16.

61. Panikar, P.G.K., Inter-Regional Variations in Calorie intake, Economic and Political Weekly, Oct. 1980, p.1803.

62. See Kamal Salih, in Growth Pole Strategy and Regional Development Planning, U.N., Centre for Regional Development, Nagoya, 1965, p.39.

63. May, R.J., op.cit. p.170.

64. Report of the (Sixth) Finance Commission, op.cit. p.8.

65. May, R.J., op.cit. p.50.

66. Report of the (First) Finance Commission, op.cit. p.96

67. Report of the (Second) Finance Commission, op.cit. p.25.

68. For a Critque of these tax norms, See Reddy, K.N., "Inter-State Tax Effort," Economic and Political Weekly, Dec. 13, 1975.

69. Report of the (Sixth) Finance Commission, op.cit. p.52.

70. Hanumantha Rao, C.H., op.cit. p.7.

71. Hicks, U.K., op.cit. p.223.

72. Report of the (Fourth) Finance Commission, op.cit. p.62.

73. Report of the (Seventh) Finance Commission, op.cit. p.119.

74. Venkataraman, K., States' Finances in India, Allen & Unwin, London, 1968, p.94.

CHAPTER V

PLAN TRANSFERS

Role of Plan Transfers

Central assistance for financing State Plans accounted for one half of the non-statutory transfers and nearly one third of the aggregate budgetary transfers during the period 1951-1981. During the Second and Third Plan periods, the role of Plan transfers exceeded the role of even the statutory transfers. During the Annual Plan period (1966-69) Plan transfers were only slightly smaller than the statutory transfers. During the Second, Third, Fifth and Sixth Plans, Plan transfers exceeded discretionary transfers also. In absolute amounts, the Plan transfers totalled Rs.22,350 crores during the last thirty years[1] (1951-1981). Such massive transfers apart from their direct effect, also influence the amounts transferred through the Finance Commissions. This is because the non Plan budgets of States which the Finance Commissions now seek to balance are increasingly becoming dependent on the Plan expenditure of the previous quinquennium.

Central Plan transfers financed 46.3 per cent of the State Plan Outlays during the 25 years covered by this study. This proportion was much higher during the earlier

Plans. It was 50.8 per cent during the Second Plan and went up to 60.4 per cent during the Third Plan. From the three Annual Plan period onwards, the importance of Central Plan assistance in financing State Plans has been steadily coming down, partly due to the large surpluses left by the Finance Commissions on non-plan revenue account which added to the States' 'own' resources position.

The proportion of States' Plan Outlays financed by Union funds varied considerably among States. This may be seen from Table V-1. Generally speaking, dependence of the less developed States on the Centre was greater than that of the richer States. This can be seen from the negative correlation between per capita income and proportion of Central Plan assistance to total Plan Outlays during all Plan periods as may be seen from Table II-5. In the case of the special category States in Group D, more than four fifths of their Plans were financed by Central transfers. More than one half of the Plan outlays of both the low and middle income States were financed by the Centre. The dependence on the Centre was less in the case of all Group A States, except West Bengal. The low dependence of the developed States, it may be added, was not due to any substantial difference in the per capita Plan funds received by them. It was more due to their larger 'own' resources as may be seen from Table V-4.

TABLE V.1

Proportion of Central Assistance to State Plan Outlays

In Percentages

States	Plan Periods						
	II	III	AP	IV	V	VI	Total
Punjab	58.5	52.9	44.1	33.1	24.7	19.1	30.3
Haryana	58.5	52.9	61.0	32.7	25.5	26.6	33.3
Maharashtra	34.7	38.5	26.7	26.6	19.9	25.0	25.2
Gujarat	33.8	46.9	35.9	33.7	24.6	22.0	29.2
West Bengal	46.8	51.6	67.6	65.9	38.8	32.4	44.3
GROUP A	42.2	46.1	40.2	35.4	25.7	25.5	31.3
Tamil Nadu	51.0	54.6	47.6	37.9	55.2	40.3	48.0
Kerala	47.9	67.0	62.7	65.9	52.3	35.6	52.7
Orissa	73.8	61.0	59.3	69.7	55.2	67.3	62.2
Assam	48.6	75.4	96.1	65.4	68.8	67.5	69.4
Karnataka	8.6	62.4	59.6	47.7	34.4	30.1	41.4
Andhra Pradesh	53.1	63.9	68.5	55.2	41.2	47.5	49.4
GROUP B	53.3	62.4	62.0	53.8	48.0	46.1	51.8
Uttar Pradesh	52.9	63.6	56.4	64.2	48.0	44.0	50.4
Rajasthan	59.4	76.6	86.6	95.7	41.4	9.5	50.2
Madhya Pradesh	56.2	76.2	81.1	90.2	34.7	38.5	51.1
Bihar	47.4	65.1	68.6	39.7	53.4	56.6	51.9
GROUP C	55.4	68.6	67.7	77.7	43.7	39.9	52.6
Himachal Pradesh	58.5	52.9	--	82.4	78.8	85.1	78.4
Jammu & Kashmir	72.1	100.0	91.8	105.8	86.9	84.2	90.0
Tripura	--	--	--	179.4	60.2	71.6	88.4
Manipur	--	--	--	78.2	54.5	83.2	66.7
Nagaland	48.6	71.3	85.6	97.9	75.9	92.9	83.1
Meghalaya	48.6	75.6	96.1	84.6	81.2	86.0	82.2
Sikkim	--	--	--	--	92.1	95.4	93.4
GROUP D	64.2	84.2	90.9	99.7	78.6	84.4	84.1
ALL STATES	50.8	60.4	57.8	51.6	41.1	39.4	46.3

For Notes and References, See Tables 2 and 3.

The dependence of the States on the Centre for execution of their Plans will facilitate better the attainment of all Plan objectives including the objective of reduction of regional imbalances as noted earlier.

In this Chapter, it is proposed to examine how far the massive Plan funds deployed by the Centre for financing State Plans have served to meet the equalisation objective that the Planning Commission has set for itself in the various Plan documents.[2] It may be recalled that the National Development Council which oversees the working of the planning process, particularly those with a bearing on State's Plans and their financing, was charged specifically, at the time of its setting up in August 1952 with the task of "ensuring the fullest development of the less advanced regions and sections of the community through sacrifices borne equally by all citizens, build up resources for national development".[3] In short, the National Development Council had fully accepted the principle of equalisation, not only of benefits but also of sacrifices.

State-wise Flow of Plan Funds

But the rank correlation coefficients of Plan transfers with per capita State incomes show that there has been no significant correlation between the two during any Plan periods.

Table V-2 brings out the State-wise flow of Plan funds during different Plan periods. The table shows

TABLE V.2

Plan Transfers, 1956-81

States	Rupees per Capita							Index Numbers						
	II	III	AP	IV	V	VI	All	II	III	AP	IV	V	VI	All
Punjab	51	62	45	72	149	64	443	170	107	110	82	104	80	101
Haryana	51	62	58	76	157	94	498	170	107	141	86	110	118	113
Maharashtra	23	42	28	47	89	62	291	77	72	68	53	62	78	66
Gujarat	31	54	36	58	114	62	355	103	93	88	66	80	78	81
West Bengal	28	45	32	48	104	57	314	93	78	78	55	73	71	71
GROUP A	31	48	34	54	108	63	338	103	83	83	61	76	79	77
Tamil Nadu	32	55	35	48	122	58	350	107	95	85	55	85	73	80
Kerala	28	72	52	80	145	68	445	93	124	127	91	101	85	101
Orissa	45	78	45	71	169	128	536	150	134	110	81	118	160	122
Assam	35	86	72	117	230	135	675	117	148	176	133	161	169	153
Karnataka	35	66	45	57	113	58	374	117	114	110	65	79	73	85
Andhra Pradesh	31	61	44	53	152	86	427	103	105	107	60	106	108	97
GROUP B	33	66	45	64	146	82	436	110	114	110	73	102	103	99
Uttar Pradesh	19	48	35	70	143	75	390	63	83	85	80	100	94	89
Rajasthan	37	80	58	112	145	19	451	123	138	142	127	101	24	103
Madhya Pradesh	37	68	43	83	114	89	434	123	117	105	94	80	111	99
Bihar	22	47	33	79	113	69	363	73	81	80	90	79	86	83
GROUP C	25	55	39	80	130	69	398	83	95	95	91	91	86	90
Himachal Pradesh	51	62	--	286	613	393	1405	170	107	--	325	429	491	319
Jammu & Kashmir	60	172	160	363	902	401	2058	200	297	390	413	631	501	468
Tripura	--	--	--	472	368	285	1125	--	--	--	536	257	356	256
Manipur	--	--	--	255	600	476	1331	--	--	--	290	420	595	303
Nagaland	35	209	388	759	1663	842	3896	117	360	946	863	1163	1053	885
Meghalaya	35	86	72	334	771	466	1764	117	148	176	380	539	582	401
Sikkim	--	--	--	--	2062	1209	3271	--	--	--	--	1442	1511	743
GROUP D	54	128	164	354	769	433	1902	180	221	400	402	538	541	432
ALL STATES	30	58	41	88	143	80	440	100	100	100	100	100	100	100

Notes and References.

For data on Plan transfers for the Second, Third and the three Annual Plan Periods, See "Distribution of Central Assistance for the Fourth Plan" - Paper submitted to the National Development Council at its meeting dated the 26th December 1970 -- Statement III A quoted by Grewal, B.S. in "Centre-State Financial Relations in India," Punjab University 1975, p.235. Data for the Fourth Plan are taken from an unpublished document of the Planning Commission. For the Fifth and the Sixth Plans, data have been taken from "Finances of State Governments, R.B.I. Bulletin, different issues.

that large amount of Plan funds were received by the special category States (Group D). This group had received the highest per capita Plan transfers which was far higher than that of any other group. The deviation from all States average in their case during all Plans was substantial. Large assistance to such States was, of course, inevitable in view of their slender resource base and their near total dependence on the Central transfers for their Plans. The equitable bias of the Planning Commission may also be seen from the fact that unlike under the Finance Commission's awards, the top income States as a group received less Plan assistance than the low income States except during the Second Plan.

Against this apparent progressiveness of Plan transfers, one has to take note of the fact that next to the Group D States, it was the middle income States and not the low income States which received more per capita Plan transfers during all Plan periods except the Fourth. The low income States received only less than the national average during all Plans. Besides, though the Group A States as a whole received less amounts of Plan funds than all other groups, two out of the five States in this group received amounts higher than the national average. These two States ranking first and second in per capita income, viz., Punjab and Haryana, received more Plan transfers than three of the four low income States put together. In fact, Haryana received more funds than Rajasthan too. Three of

these four low income States got less than the all States' average during the twenty five years period as a whole. The above as also the low value of the correlation coefficient only shows that the Planning Commission also was none too successful in using Central Plan assistance as a corrective to regional isparities. Of course, it has to be admitted that the comparable performance of the Commission was a shade better than that of all Finance Commissions, especially during the early Plan periods. But during the Fifth and Sixth Plans, statutory transfers were more equitable

Plan Outlays

A more serious criticism against the Planning Commission is that it failed to ensure a progressive regional pattern in the Plan Outlays. Unless the resource transfers from the Centre take into account the need for progressive Plan Outlays among the States, the problem of regional disparities cannot be solved especially now when the share of Central transfers in Plan Outlays is coming down. It may be noted that progressiveness in the resource transfers in itself cannot correct the existing regional disparities. It is in this context that the Planning Commission's limited success in achieving even the limited objective of progressiveness in the Plan transfers has to be evaluated.

Table V-3 shows that the per capita Plan Outlays are highly regressive. This is also seen from the high

TABLE V.3

State Plan Outlays, 1956-81

States	Rupees per Capita: Plan Periods II	III	AP	IV	V	VI	Total	Index Numbers: Plan Periods II	III	AP	IV	V	VI	Total
Punjab	88	118	102	216	604	335	1463	151	122	145	171	174	165	162
Haryana	88	118	96	225	615	353	1495	151	122	137	178	177	174	166
Maharashtra	67	109	103	178	447	248	1152	115	113	147	141	128	122	128
Gujarat	90	115	101	170	462	276	1214	155	119	144	134	133	136	135
West Bengal	59	86	47	73	268	176	709	101	89	67	57	77	87	79
GROUP A	72	105	85	151	421	247	1081	124	109	121	119	121	122	120
Tamil Nadu	62	102	74	126	221	144	729	106	106	105	100	64	71	81
Kerala	58	107	83	129	277	191	845	100	111	118	102	80	94	94
Orissa	61	128	75	102	306	190	862	105	133	107	81	88	94	96
Assam	71	114	75	179	334	200	973	122	118	107	142	96	99	108
Karnataka	72	106	76	120	328	193	895	124	110	108	95	94	95	99
Andhra Pradesh	58	96	64	97	369	180	864	100	100	91	77	106	89	96
GROUP B	63	106	73	118	304	178	842	108	110	104	93	87	88	93
Uttar Pradesh	36	76	62	109	321	169	773	62	79	88	86	92	83	86
Rajasthan	63	104	67	117	351	197	899	108	108	95	92	101	97	100
Madhya Pradesh	56	89	53	92	329	231	850	96	92	75	73	95	114	94
Bihar	46	72	48	199	212	122	699	79	75	68	157	61	60	78
GROUP C	45	81	57	103	297	173	756	77	84	81	81	85	85	84
Himachal Pradesh	88	118	--	347	778	462	1793	151	122	--	275	224	228	199
Jammu & Kashmir	83	172	174	343	1038	476	2286	143	179	248	272	298	234	254
Tripura	--	--	--	263	611	398	1272	--	--	--	208	176	196	141
Manipur	--	--	--	326	1100	572	1998	--	--	--	258	316	282	222
Nagaland	71	293	453	775	2190	906	4688	122	305	647	615	629	446	520
Meghalaya	71	114	75	395	949	542	2146	122	118	107	313	273	267	238
Sikkim	83	152	180	355	2238	1266	3500	143	158	257	281	643	624	389
GROUP D	58	96	70	126	978	513	2261	100	100	100	100	281	253	251
ALL STATES	58	95	70	121	348	203	901	100	100	100	100	100	100	100

Notes & References

1. Source for the second, Third and Annual Plans, draft Fourth Five Year Plan, p.75. For other Plans, Finances of State Governments, op.cit.

2. Fourth Plan figures of Meghalaya, Tripura and Manipur for the years when they had not beca   States are repetitions of the figures for the first ensuing year for which data are available.

3. For other notes, see footnotes to Table V.1

degree of positive correlation between per capita income and per capita Plan Outlays. During all the plans except the Third and the Fourth, these correlations were significant statistically. Disparities in Plan Outlays were far greater than in Plan transfers. During the two and half decades covered by our study, the top income States managed to get higher Plan Outlays than the States in all other groups except group D. This was true of all Plan periods except the Third Plan when Group B States had a slight edge over Group A States The low income States as a group had only the smallest Outlays during all Plan periods except the latest when their Plan size was marginally more than that of the group B States. During the entire two and half decades taken as a whole, Punjab, Haryana, Gujarat and Maharashtra had the highest per capita Plan Outlays. The Outlay of Bihar was the lowest. During the entire period, per capita Outlay of Bihar was less than one half that of Punjab and of Haryana. The Outlay of Uttar Pradesh was only a little more than half that of Punjab and Haryana.

The skewness of State Plan Outlays is brought out by the fact that only five out of the 15 non special category States had a Plan Outlay higher than the all States' average. Of these, four belonged to Group A, and only one belonged to Group B. None of the low income States could manage to have a Plan, the size of which was at least equal to the national average. As Gadgil puts it correctly,

> "there is a lot of discussion about regional backwardness. Yet about the basic problem of Plan Outlays in a federal polity, there is very little thinking. But I think it is important that there is a debate, a much wider debate than at present on these questions".[4]

The call of Gadgil was taken up a decade later by Raj Krishna too, but to no avail. The discussions on resource transfers still centre around Central Plan assistance whose importance in Plan financing is steadily coming down.[5]

Internal Resources of States

The difference in Plan outlays between the richer and the poorer States is due to the failure of the Planning Commission and other resource allocating agencies to counteract the influence of the widely different resource bases of the States in allocating the Plan and other Central funds. The differences in resource base arise due to the existing disparities in the levels of development, especially industrial development which in turn are due to historical reasons, compounded by the failure of the earlier Plans to correct them.

Table V-4 gives the per capita resources other than the Central funds available to each State to finance its Plan Outlays during each of the Five Year Plans. It is seen that the 'own resources'[6] of Group A States were much larger than those of other Groups including Group D. The own resources of Group C and D were less than half that of Group A. The Plan resources of Jammu and Kashmir were less

TABLE V.4

States' Resources for Plans

(States' Plan Outlays - Central Plan Transfers)

States	Rupees per Capita							Index Numbers						
	Plan Periods									Plan Periods				
	II	III	AP	IV	V	VI	Total	II	III	AP	IV	V	VI	Total
Punjab	36	56	57	144	455	271	1019	132	147	196	236	222	220	210
Haryana	36	56	38	149	358	259	996	132	147	131	244	223	211	205
Maharashtra	44	67	75	131	358	186	861	157	176	258	214	175	151	177
Gujarat	59	61	65	112	34	214	859	210	160	224	103	170	174	177
West Bengal	31	41	15	25	164	119	395	110	107	51	41	80	97	[illegible]
GROUP A	[illegible]2	57	[illegible]1	98	313	184	743	150	144	175	159	153	150	1[illegible]3
Tamil Nadu	30	47	39	78	99	86	379	107	123	134	127	48	70	78
Kerala	30	35	31	49	130	123	398	107	92	106	80	63	100	82
Orissa	16	50	30	31	137	62	326	57	131	103	50	67	50	67
Assam	37	28	3	60	104	65	297	128	73	10	98	51	53	61
Karnataka	37	40	31	63	215	135	521	132	105	106	103	105	110	107
Andhra Pradesh	27	35	20	44	217	94	437	96	92	69	72	106	76	90
GROUP B	30	40	28	55	158	96	406	107	105	396	88	77	78	84
Uttar Pradesh	17	28	27	39	178	95	383	60	73	93	83	87	77	79
Rajasthan	26	24	9	5	206	178	448	92	63	31	55	100	145	92
Madhya Pradesh	19	21	10	9	215	142	416	67	55	34	50	105	115	86
Bihar	24	25	15	120	99	53	336	85	65	51	231	48	43	69
GROUP C	20	25	19	23	167	104	358	71	68	62	67	81	85	74
Himachal Pradesh	36	56	-	61	165	69	388	132	147	-	98	80	56	81
Jammu & Kashmir	23	Nil.	14	- 20	136	75	228	82	-	44	70	66	61	47
Tripura	-	-	-	-209	243	113	147	-	-	-	116	119	92	30
Manipur	-	-	-	71	500	96	667	-	-	-	134	244	78	137
Nagaland	37	84	65	16	527	64	792	128	205	103	206	257	52	163
Meghalaya	37	28	3	61	178	76	382	128	73	10	39	87	62	79
Sikkim	-	-	-	-	176	57	229	-	-	-	-	85	46	46
GROUP D	30	24	16	1	209	80	359	135	36	55	103	102	65	74
ALL STATES	29	38	30	61	205	123	100	100	100	100	100	100	100	100

Notes: 'Own' resources of States include their market borrowings as well as loans taken directly from the financial institutions.

than a quarter that of Punjab. The resources of Assam and Bihar were only one third that of Haryana. That the own resources of States are positively related to the per capita income is borne out by the positive and significant value of the coefficients of correlation.

The higher level of own resources of the developed States was not due to greater exploitation of their resource as was noted earlier.[7] This is confirmed by Vithal for the Fourth Plan. The rank correlation between per capita income and percentage increase in per capita additional taxation in the Fourth Plan worked out by him was negative though weak.[8] This is not surprising if we disaggregate further the States' Own Plan funds. The major items of States' resources are: (i) Balances from current revenues at the base level of taxes and rates; (ii) Contributions of public enterprises, (iii) Market and other institutional borrowings; (iv) Miscellaneous capital receipts; and (v) Additional resource mobilisation.

The wider and more elastic resource base of the richer States enables them to have higher balance of current revenues. In fact, the balance of current revenues now is determined largely by the Finance Commissions which had allowed larger surpluses to the developed States and lower or nil surpluses to the poorer States. Unlike in the case of developed States the meagre surpluses of the poorer States are provided to them in the form of grants, the value of

TABLE V.5

Rank Correlation Coefficients with Per Capita State Income

	II	III	AP	IV	V	VI
Aggregate Plan Transfers	0.111	-0.353	0.066	-0.315	-0.113	-0.354
Plan Outlays	0.626	0.355	0.626	0.477	0.589	0.636
Proportion of Plan Transfers to State Plan Outlays	-0.438	-0.722	-0.700	-0.454	-0.679	-0.792
States' Own Resources	0.802	0.690	0.593	0.654	0.769	0.754

which gets eroded even before the Commissions' reports get into print. Contribution of public enterprises is not solely dependent on the rates charged or the efficiency of management. It is also a function of the volume and pattern of investments made in the earlier plans. This resource too, thus favours the developed States. Miscellaneous net capital receipts in recent Plans are negative and lead to net outflow depending on the debt outstanding which again is a consequence of the regressive 'patterns of assistance' and the resultant grant-loan composition of previous Plan and non-plan transfers. Thus the inequities of the past Plans haunt the current Plans. The market loans and other institutional borrowings have favoured in the past the developed States more than the underdeveloped States, as was brought out in Chapter II.

Criteria for Plan Transfers and Plan Outlays

For ascertaining how the declared equalisation objective was scuttled in the process of allocation of Plan funds and Plan Outlays, one has to examine the criteria which governed these allocations. For this, the Plan era can be divided into two periods viz., the pre and post Fourth Plan periods. During the earlier period, there were no definite criteria governing either the Plan Outlay or the Plan assistance. During the second period, the objective Gadgil formula to determine States' Plan assistance was implemented.

Looking at the process of planning prior to 1965, Hanson noted that

> "The principles on which Central assistance to State Plans is allocated have never been made clear. . . At present, no one knows and even if the Commission has this all worked out, no one is likely to be told, at least just yet. But if the whole complex process were laid bare, existing complaints of inequity, serious enough already, would be redoubled[9].

Gadgil confirmed it later. "As matters developed, the Planning Commission had to advise on Plan finance in an ad hoc way. The Commission had itself no firm criteria which it had developed and which it could put to the States .[10] And in the absence of definite criteria, as the Administrative Reforms Commission's study group on Financial Administration noted "all sorts of devices and subterfuges are devised by the States with a view to obtaining as large a quantum of Central assistance as possible".[11] One of the subterfuges adopted to get their Plan Outlays boosted was to play off the Planning Commission against the Finance Commission. "For the Third Plan period, figures presented by some of the States to the Finance Commission underestimated revenue resources while those to the Planning Commission overestimated them. For the Fourth Plan, the States were unable to use this device as the Fourth Finance Commission had completed its work before the Plan was formulated. But some of them, it is understood, managed to attain their objective, viz., a larger Plan, by presenting an over-optimistic picture of their capital resources".[12]

Prior to the Fourth Plan, Central assistance, it is believed, was being allocated after taking into account the States' Plan Outlay and the States' own resources determined during bilateral discussions. "The States' First Five Year Plan included projects/programmes which were in progress before the commencement of planned economic development. A broad view was taken about the development efforts that were envisaged in the different States and after assessing the resources to be raised by individual States, the quantum of Central assistance was fixed for each State for the entire Plan period During the Second Plan, the quantum of Central assistance was not predetermined. It continued to change from year to year in the light of the financial position of States and the Centre and the requirements of projects taken up in both the States' as well as the Central sector The National Development Council it may be mentioned, <u>did not specifically consider the principles for allocation of Central assistance to States either in the Second or the Third Five Year Plans</u>. (emphasis added) The main emphasis had been on the principles which should govern the determination of the States' Plan Outlays".[13]

As the Administrative Reforms Commission (ARC) study team noted, "After the Plan outlays and financial resources to be raised have been determined for the Centre on the one hand and the States on the other, the gap filling between the States' resources and their Plan outlays is left to be met by assistance from the Centre".[14]

There was no definite criteria in the formulation of State Plan outlays either. Hanson commented caustically, "the criteria for judging the Plans which the Commission has publicly proclaimed are at best vague and at worse ambiguous" He quotes an intelligent and experienced informant in Maharashtra as saying, "The extent to which the Planning Commission agrees to accept the States' own targets and to supplement the States' own resources depends on a process of haggling in which a great deal of cunning but very little science is displayed on both sides".[16] The criteria for determining the size and pattern of States' Plan Outlay were too numerous, diverse and often contradictory to have any operational significance. In the process, the relative bargaining power, more than any rationale came to have dominance.

For instance, the Second Plan is supposed to have taken into consideration the following factors in determining the Plan Outlay: (i) Population, (ii) Commitments on account of the First Plan, (iii) Expected achievement of development at the end of the First Plan, (iv) Expected revenue contribution of the States and programmes for irrigation and power".[17] The Third Plan seems to have taken into account a still larger numberand variety of factors including "needs, problems, past progress and lags in development, likely contribution to achievement of the major national targets, potential for growth and the

contribution in resources which the State could make toward its dev lopment programmes. In assessing needs and problem such factors as population, area, levels of income and expenditure, availability of certain services, for example roads, schools, hospitals, extent of commitments carried ov from the Second Plan, commitments on account of large projects or special programmes and the State of technical and administrative service available were taken into account. Care was also taken to see that States whose resources were unavoidably small did not have to limit development to scal which was altogether insufficient merely because of paucity of resources. At the same time, States which were able to make larger efforts in mobilizing their own resources could undertake development on an appropriate scale".[18] How and why these criteria were selected, in what fashion they were combined and what weightage was given to each of them are anybody's guess including the Planning Commission's. One can only judge by the results that followed.

Patterns of Assistance

There were no definite criteria for determining the grant-loan composition of the Central Plan transfers prior to the Fourth Plan. This proportion depended on the 'patterns of assistance' of individual schemes included in the State Plans. Not all schemes in the State Plans were eligible for Central financing. Even for the eligible schemes, the grant-loan composition of Central financing varied. At one time, the patterns numbered 200. "The

ultimate grant-loan break-up therefore does have an element of mystery" and was not known till the plan was completed.[19] The patterns of assistance are made known not at the time of determining the State Plan outlays and the Plan transfers. "The loan and grant portions of the total Central assistance for a State Plan are arrived at by adding up the loan and grant components in the patterns of schemes included in the Plan. If the sumtotal falls short of the total assistance assured to the State, the balance is made up through what is called a miscellaneous development loan".[20] "The patterns which had become a maze" were both inefficient and inequitable.[21] The net result "would therefore appear to be needless, voluminous and complicated work, a distortion, of priorities, vexation to the States without ensuring effectiveness for the Centre, a dilution nevertheless of the initiative and judgement of the States and a fettering of their operational flexibility".[22] From the equity angle, the richer States with larger revenue resources could opt for schemes with a larger grant component than the poorer States. This was confirmed by Gadgil. The grant component "would be as large as 40 per cent or more in the case of developed States which had resources; it would get 40 per cent as grants. On the other hand, an underdeveloped State which had no resources could get only 12 per cent as grants though the average was about 22 per cent".[23] For these reasons, the State governments had demanded the abolition of patterns of assistance and the Administrative Reforms Commission concurred with this suggestion.

Gadgil Formula

This uncertain and inequitous pattern of Central assistance was replaced by the Gadgil formula, during the Fourth Plan. According to this formula, accepted by the National Development Council in 1968, States like Jammu and Kashmir, Nagaland and Assam were given special consideration. The balance available in the divisible pool of Plan resources was to be distributed according to five criteria. Population was the major criterion which was assigned a weightage of 60 per cent. The second criterion was per capita State income with a weightage of ten per cent. Only States below the all States' average of per capita income were eligible to claim this part of the divisible pool. Another 10 per cent was to be distributed according to tax efforts in relation to per capita income. Yet another 10 per cent of the divisible pool was set apart to meet the special needs arising out of commitments on major continuing, power and irrigation projects. The remaining 10 per cent was to be allotted taking into account the special problems arising out of metropolitan areas, floods, chronically drought affected areas and tribal areas.[24]

The uncertainty regarding the grant-loan component also was removed. Seventy per cent of the transfers was to be given as loans and the balance as grants. For the States of Jammu and Kashmir, Assam and the hill States of the North East, the proportion of grants was however, 90 per cent.

The formula underwent some changes in 1978-79. The weigtage given to special factors was reduced which is now added to the weightage for per capita income.

The formula had to a great extent, removed the rigidity and delays involved in the schematic patterns of assistance. It had also reduced the uncertainty regarding the quantum and composition of Central Plan transfers. Thus it increased considerably the autonomy of the States in their allotted spheres.

The formula did have a better equalisation bias, but interestingly the effect was felt only during the Fourth and the Sixth Plans. During the Fifth Plan, the coefficient of rank correlation between per capita Plan transfers and per capita income was only the same as in Second Plan. It was in fact lower than in the Third Plan. Even during the Fourth Plan when the formula showed greater equalisation bias the rank correlation was less than during the Third Plan. During the Sixth Plan, the value of coefficient was only the same as in Third Plan. In any case, none of the correlation coefficients was significant at 5 per cent level. Besides, the formula was not adequate to countervail the disequalising trends in Plan Outlays.

During the Fourth Plan, after the implementation of the Gadgil formula, the group D States, no doubt, improved their relative position at the expense of all other groups of States.

The formula also reduced the relative share of Group A States. But it also reduced the share of group C States. The low income States did not receive even average volume of funds under the Gadgil formula. Among the non special categories, only two States - Assam and Rajasthan - had received above average Plan transfers during the Fourth Plan. During the Fifth Plan, eight States managed to get equal or more than the all States' average sums. Of these, two belonged to Group A, four to Group B, and only two to Group C. Of these, Uttar Pradesh's receipt was just equal to the all States' average. During the Sixth Plan, under the modified Gadgil formula with increased weightage to per capita income, only five States received above average quantum of funds. Of these, only one belonged to the low income group.

It is worthwhile to examine how even the Gadgil formula with a ten per cent weightage to per capita income failed to bring about any substantial degree of equalisation. What is more, how is it that this same 'objective' formula had different impact during different Plan periods? The reason is, except for the weightage of 10 per cent (raised to 20 per cent during the Sixth Plan) given to the per capita income of backward States, there is no other equalising factor in the formula. The role of population as an equalising factor is limited as was noted earlier in Chapter IV. The weightage given to tax norm is unexceptional in principle. But a norm which is not progressive with State income enables the richer States with their larger component

of industrial income to show better tax performance and thus to corner more of the Central Plan funds. The high ratio of tax revenue to per capita income does not by itself reflect the degree of utilization of tax potential.[25] In the absence of a per capita norm progressive with State income, the cannon of equity-equalisation of benefits and sacrifices - is not likely to be satisfied. The remaining factors which had been given 20 per cent weightage cut both ways and dilute the objectivity of the formula. These give some elbow room for the Planning Commission to manoeuvring. This may explain the changes in the relative position of States during the Fourth and the Fifth Plans under the same 'objective' formula. The criterion of commitments on major continuing power and irrigation projects is a shifting one. The weightage given to special problems like metropolitan areas actually benefits the urbanised States which are more industrialised and therefore have larger resource potential. Chronically flood and drought affected areas and tribal belts exist in all the States, irrespective of their income status. Central assistance according to these criteria would benefit both the rich and poor States depending upon their barga-ining power and the degree of patronage of the Centre enjoyed by them at any given time. If past experience is any guide, developed States with their better administrative machinery manage to appropriate to themselves more resources on these bases.[26]

Not all the Plan funds are brought under the Gadgil formula. For example, of the Rs.7,900 crores of Plan funds that were available for distribution among States during the last four years of Sixth Plan (original verseion under the Janata rule) it was decided by the National Development Council that only Rs.4,200 crores (53.2 per cent) were to be brought under the Gadgil formula. Of the remaining, 22.8 per cent was set apart for Special Category States, 10 per cent for hill areas and 7.6 per cent for special problem areas. Funds from IDA Credit (6.3 per cent) also was not added to the divisible pool[27]. If past experience is any guide, the funds meant for the last three purposes are likely to be cornered by the more developed States with their better oiled administrative machinery.

The criterion of uniform grant loan proportion of Central assistance applicable to all States except for the special category States and Assam, irrespective of their developmental status, is equitable only on the face of it. By its treatment of unequals as equals, it does not take care of the principle of vertical equity.

Thus, Gadgil, the then Vice-Chairman of the Planning Commission with his thorough understanding of the regional problems in India (as seen earlier) was also not able to bring about greater progressivity in his formula for Central Plan assistance. The explanation is that the conflicts of interests between the rich and the poor States represented in the National Development Council could have been resolved

only by political compromises based on expediency rather than principles of equity.[23] Of course, an illusion of equity was provided by the ten per cent weightage given to per capita State income of the backward States. This should lead us to a discussion of few larger questions regarding the fundamental problems of Indian federal polity. This however, we postpone to Chapter X.

Summing up, during the first eighteen years of Planning, the poorer States suffered in the absence of an objective formula to determine the Central transfers for Plan purposes. During the next twelve years, these States continued to suffer, inspite of the implementation of an objective formula which was not sufficiently progressive in itself. In any case the degree of progressivity was not enough to bring about progressivity in States' Plan Outlays. In fact, what is desired is not merely progressivity in Plan transfers but progressivity in Plan Outlays. In retrospect, it would appear that the approach of the Planning Commission before the Gadgil formula, viz., to determine first the size of the Plan outlays and then to treat the Plan assistance as a residual factor, was more sound. But the failure of the earlier Plans was in translating this sound approach to objective and equitable criteria in determining both the size of the Plan Outlays and the Central Plan assistance. In its anxiety to clear the above drawbacks of the earlier approaches the new Gadgil formula seems to have thrown the baby too with the bath water.

The Gadgil formula treats the Plan Outlay as a residuary factor. Once the quantum of Plan assistance is determined, the States are free to decide the size of their Plans, depending on the volume of additional resource mobilised by them. These efforts depend as much or more on the States' resource potential as on the degree of its exploitation. It is also dependent on the amount of surpluses left behind by the Finance Commissions. A change in attention to Plan Outlays from Plan assistance once again is therefore called for urgenctly in view of the decreasing role of Central assistance in financing State Plans, which is more pronounced in the case of developed States. // As seen at the outset, the Central Plan assistance discussed in this Chapter does not include all Plan funds from the Centre routed to the States through the Planning Commission. Financing of Central and Centrally sponsored schemes in the States are excluded in this discussion$. Despite stiff resistance from all the States, Centre is unwilling to reduce the importance of these schemes, partly because, in the dispensation of funds for these pet schemes of different Union Ministries, the Union government - Planning Commission, the different Union Ministries, particularly the Union Finance Ministry - enjoys considerable discretion. Any study of the regional pattern of the flow of Plan funds will be complete only after a study of the financing pattern of these schemes. This is done in the next Chapter.

Notes and References

1. Throughout this study, the term Plan transfers is used to include only transfers to finance State Plans. It excludes transfer for Central and Centrally sponsored schemes; for data see Report of the (Seventh) Finance Commission, Government of India, New Delhi, 1978, p.172.

2. Nair, K.R.G., Regional Experience in Developing Economy, Wiley Eastern, New Delhi, 1982, p.132.

3. Quoted by Grewal B.S., Centre-State Financial Relations in India, Punjabi University 1975, pp.50-52.

4. Gadgil, D.R., "Some aspects of Centre-State Financial Relations" in ed., Kamat, A.R., Planning and Development, 1967-77, Gokhale Institute of Politics and Economics, Pune, 1973 p.339. Gadgil even suggested that the size of the Plan Outlays may be determined by the Finance Commissions.

5. Raj Krishna, "The Centre and the Periphery", Social Action, New Delhi, Jan-March 1982, p.8.

6. Own resources include market borrowings as well as direct loans obtained by StateGovernments from financial institutions.

7. Reddy, K.N., "Inter-State Tax Efforts", Economic and Political Weekly, Bombay, 13 Dec. 1975.

8. Vithal, B.P.R. "Central Assistance for State Plans", How Equitable is it"? Economic and Political Weekly, Bombay, June 14, 1969, p.469.

9. Hanson, A.H., Process of Planning, Oxford University Press, London, 1968, p.321.

10. Gadgil D.R., op.cit. p.339.

11. Administrative Reforms Commission, Report of the Study Team on Centre-State Relationships, Government of India, New Delhi, 1968, p.74. The Chairman of the Study Team was M.C. Setalvad, former Attorney General of India.

12. Ibid. p.27

13. Summary record of the 24th Meeting of the National De lopment Council, 1-2, December 1967, quoted by Grewal, D.S., op. cit. p.58.

1 Administrative Ref rms Commission, op.cit. p.49.

15. Hanson, A.H., op.cit. p.370.

16. Ibid p.370.

17. Quoted by Chatterjee Amiya, The Central Financing of State Plans in the Indian Federation, U.K. Mukhopadhya, Calcutta, 1971, p.38.

18. Planning Commission, Third Five Year Plan, Government of India, New Delhi, (1960), p.60.

19. Venkataraman, K., States' Finances in India, George Allen and Unwin, London, 1968, p.21.

20. Administrative Remofrms Commission, op.cit. p.108. The grant content of Plan transfers does not take into account the revenue component of Plan Outlays. As a result, loans were used to finance even revenue expenditure, See ibid, p.55.

21. Venkataraman, K., op.cit. p.100.

22. Ibid, p.113.

23. Gadgil D.R., op.cit. p.338. See also, Planning Commission, Fourth Five Year Plan, Government of India, New Delhi, 1969, p.59.

24. Fourth Five Year Plan, op.cit. p.56.

25. Reddy, K.N., op.cit.

26. For instance, some of the developed States managed to get considerably more Central funds meant for relief of natural calamities as we will be seeing shortly in the next Chapter.

27. The Economic Times, Bombay, Jan.2, 1979.

28. The casual way in which such important subjects like Central Plan transfer are handled by the Council was brought out by the Study Team Report of the ARC. The Working paper on Determination of the principles of allocation of Central assistance to States in the Fourth Plan discussed on the 20-21 August, 1966, was circulated only on the 19 August. See ARC, op.cit. Vol.III. p.75.

CHAPTER VI

DISCRETIONARY TRANSFERS

The importance of Discretionary Transfers

Discretionary transfers constitute an area of darkness in the Union-State financial relations scene in India, though, these non statutory, non-plan transfers amounted to nearly one third of the aggregate budgetary transfers during the first three decade of planning, (1951-1981)[1]. In sbsolute terms the discretionary transfers amounted to Rs.22,300 crores which was only Rs.60 crores less than the Plan transfers. During three Plan periods (First, Fourth and Annual Plan periods) discretionary transfers exceeded both statutory and plan transfers. It is only during the recent Plan periods that the importantce of discretionary transfers is coming down. This is partly due to the increasing role played by the recent Finance Commissions and partly due to the concerted opposition put up by the State Governments against the increasing importance of these transfers. But even during the Fifth and the Sixth Plans, discretionary transfers accounted for more than a quarter of the aggregate budgetary transfers. Apart from their direct effects, the discretionary transfers affect the statutory transfers in the following Plan period, by boosting the non Plan expenditure.

State-wise discretionary transfers are estimated by us indirectly by deducting the amounts of statutory and Plan transfers from the aggregate budgetary transfers (sum of loans, grants and share of taxes.) As noted earlier only the transfers meant to finance the State Plans are included in this study under Plan transfers. In other words, Centre's contribution to Central and centrally sponsored schemes are included under discretionary transfers and not under Plan transfers as is sometimes done. Such a categorisation is partly due to reasons of data availability noted earlier in Chapter V.

Categories of Discretionary Transfers

Broadly discretionary or non statutory non Plan transfers can be classified into (i) 'schematic' transfers, (ii) overdraft, gap and special accommodation loans and ways and means advances (iii) small savings loans and (iv) assistance for meeting relief expenditure. The relative importance of each of these items changes over time. During the Fifth and the Sixth Plan periods, for which alone break-up of data is available, the schematic transfers accounted for 66 per cent and 61 per cent respectively of the total discretionary transfers. Next in importance was the small savings loans (23.8 per cent and 27.6 per cent) followed by ways and means advances (9.7 per cent and 7.3 per cent). Central relief for natural calamities formed only a small proportion during this period, particularly during the Fifth Plan period. But assistance to finance relief expendi-

ture was very large during the Fourth Plan and the three Annual Plan period. The overdrafts, gap, and special accommodation loans were also very important during the Fourth Plan.

The most serious objection to the discretionary transfers from the angle of this study however, is that the principle of equity has been ignored in discretionary transfers. That this has actually happened may be seen from the rank correlation between discretionary transfers that went to different States and the per capita income of States. During all but two Plan periods, (the Second and the Annual Plan period) the correlation was positive though weak as may be seen from Table VI-7. During none of the Plan periods, the correlation was statistically significant.

State-wise Discretionary Transfers

The absence of progressiveness is confirmed by the State-wise flow of discretionary funds given in Table VI-1. It would, in fact, seem that it had served only to widen the inter-State disparities. During the two and a half decades covered by the study, the low income States among the non special category States received less funds than both the high income and the middle income States. Even among the latter two groups, it was the middle income States which received less than the high income States except during the three Annual Plans (1966-69) and the Fourth Plan. The low income States, fared better than the top income States,

Discretionary Transfers, 1956-81

States	Rupees per Capita							Index Numbers						
	Plan Periods							Plan Periods						
	II	III	AP	IV	V	VI	All	II	III	AP	IV	V	VI	All
Punjab	18	50	67	99	293	77	604	82	143	163	109	240	112	159
Haryana	18	50	11	172	164	75	490	82	143	27	189	134	109	129
Maharashtra	20	38	34	125	109	71	397	91	109	83	137	89	103	104
Gujarat	13	39	41	100	135	70	398	59	111	100	110	111	101	105
West Bengal	38	41	29	124	169	85	486	173	117	71	136	139	123	128
GROUP A	23	42	35	120	153	76	449	105	120	85	132	125	110	118
Tamil Nadu	12	34	35	82	73	38	274	55	97	85	90	60	55	72
Kerala	26	46	23	116	91	33	335	118	131	56	127	75	48	88
Orissa	36	39	52	137	128	84	476	164	111	127	151	105	122	125
Assam	28	100	92	240	109	90	659	127	286	224	264	89	130	173
Karnataka	7	23	46	140	108	60	384	32	66	112	154	88	87	101
Andhra Pradesh	20	45	57	124	83	52	381	91	129	139	136	68	75	100
GROUP B	19	42	47	127	94	57	386	86	120	115	140	77	83	102
Uttar Pradesh	13	16	25	46	111	53	264	59	46	61	51	91	77	69
Rajasthan	31	53	89	241	133	187	734	141	151	217	265	109	271	193
Madhya Pradesh	23	30	39	25	91	40	248	105	86	95	27	75	58	65
Bihar	37	28	45	42	116	50	318	168	80	110	46	95	72	84
GROUP C	23	26	41	65	110	67	332	105	74	100	71	90	97	87
Himachal Pradesh	18	50	--	178	124	128	498	82	143	--	196	102	186	131
Jammu & Kashmir	70	137	155	500	397	207	1466	318	391	378	549	325	300	386
Tripura	--	--	--	12	172	197	381	--	--	--	13	141	286	100
Manipur	--	--	--	229	400	296	925	--	--	--	252	328	429	243
Nagaland	28	--	487	758	1067	418	2758	127	--	1188	833	875	606	726
Meghalaya	28	100	92	368	164	93	845	127	286	224	404	134	135	222
Sikkim	--	--	--	--	763	308	1071	--	--	--	--	625	446	282
GROUP D	45	75	145	317	308	196	1086	205	214	354	348	252	284	286
ALL STATES	22	35	41	91	122	69	380	100	100	100	100	100	100	100

Sources: Reserve Bank of India, Finances of State Governments. R.B.I. Bulletins, Different issues.

paradoxically, only during the three years of the Plan holidays. Even during these annual Plan years, their position was worse than that of the middle income States. The special category States, of course, received the highest per capita discretionary transfers. This was perhaps unavoidable in view of their special problems including defence and internal security problems.

Of the five States which got less than all States average during the 25 year period, two belonged to group B, three to group C and none to group A. In other words, only one among the four poor States, recei ed more than the all-States average amounts while all the five States belonging to the richest category received more than that amount. Uttar Pradesh and Madhya Pradesh received the lowest while Assam and Rajasthan received the largest amounts per capita. Punjab received the third largest amount.

Identification of the reasons for the regressiveness of discretionary transfers requires analysis based on its further disaggregation into its components. The most important category of discretionary transfers is schematic transfers.

(i) Schematic Transfers:- The schemes for which Central funds are made available outside the State Plan framework are of three types. They are: Central Plan Schemes, Centrally sponsored schemes and the non Plan Schemes proper.[2] The Central and centrally sponsored schemes accounted for

53 per cent and 58 per cent respectively of the total schematic transfers during the Fifth and the Sixth Plans. The difference between the State Plan schemes and some of the above schemes are only marginal. There are instances of schemes which are included both under the State Plans and outside. These are other instances of schemes started as non-plan, but included in later Plans. As Venkataraman observes, "Empirically the only definition of centrally sponsored scheme is that the centrally sponsored schemes are those for which assistance is given over and above the assistance assured for the State as a whole."[3] There are schemes which are "sometimes converted from State Plan schemes to Centrally sponsored schemes with no intent other than the obvious one of getting the State better financial assistance as noted by the ARC study group.[4] These schemes relate to subjects in the State list, Central list and the concurrent lists of the Constitution.

Generally speaking the states are not happy with the increase in the schematic transfers. These schemes are mostly thrust upon the State Governments against their own order of preferences at the behest of the interested Union Ministries. It may be noted that in several meetings of the National Development Council, the Chief Ministers of States have argued for substantial reduction in the number of Central and Centrally sponsored schemes.[5]

Secondly, discretionary transfers as the name suggests are not governed by any objective criteria. The

large scale discretionary transfers effected by the Planning Commission and different Union Ministries undermine the importance of the criteria adopted by the Finance Commission[6] and the National Development Council. Thirdly, these transfers reduce the pool of funds available for distribution on the basis of the National Development Council (Gadgil) formula. Fourthly, some of the criteria used for discretionary transfers are the ones rejected by the Finance Commissions. Fifthly, discretionary transfers tend to undermine the autonomy of States by entering the State subjects in the Constitution through fiscal backdoors. The States' priorities are often ignored in the allocation of funds by the different Ministries at the Centre. Sixthly, large scale discretionary transfers leave the area of fiscal transfers open for political bargaining and horse-trading.[7]

All the above objections of the State Governments could perhaps have been ignored if only the Schematic transfers were equitable. During the Fifth Plan, assistance under all the three types of Schemes showd a positive though weak correlation. But during the Sixth Plan, the trend was slightly reversed as is seen from the emergence of negative, though still weak correlation between per capita income and different types of schematic assistance.

If we go beyond the general trends and carry our analysis in per capita terms, we are confronted with our usual finding that the three low income States - Uttar

Schematic Transfers, 1974-81

Rupees Per Capita

States	Central Plan Schemes			Centrally sponsored Schemes			Others			Total Schematic		
	V	VI	Total	V	VI	Total	V	VI	Total	V	VI	Total
Punjab	23	7	36	25	11	37	121	21	143	176	41	217
Haryana	25	1	26	29	25	55	51	16	68	106	42	149
Maharashtra	21	10	32	22	9	32	12	7	20	56	28	85
Gujarat	20	4	25	40	15	55	19	6	25	80	26	107
West Bengal	7	2	10	18	7	26	57	11	69	84	21	105
GROUP A	17	6	24	25	11	37	40	10	51	84	28	112
Tamil Nadu	17	4	22	18	8	26	10	3	13	46	15	62
Kerala	15	2	17	27	17	44	25	4	30	68	23	92
Orissa	21	25	47	29	13	43	59	19	79	110	58	169
Assam	27	18	45	18	17	36	17	1	58	63	77	140
Karnataka	33	13	47	28	11	40	12	7	20	75	32	107
Andhra Pradesh	17	14	31	24	12	37	30	10	41	73	37	110
GROUP B	22	12	34	24	15	37	24	13	38	71	39	110
Uttar Pradesh	10	1	24	16	11	27	42	10	53	69	36	105
Rajasthan	3	19	53	37	21	58	38	112	150	110	152	263
Madhya Pradesh	20	9	30	24	11	36	30	8	38	76	29	105
Bihar	11	5	16	13	15	28	37	6	43	62	27	89
GROUP C	15	11	27	20	13	33	38	21	60	73	47	121
Himachal Pradesh	--	--	--	56	82	138	6	6	13	62	88	151
Jammu & Kashmir	21	10	31	74	29	104	287	148	436	384	188	572
Tripura	104	19	123	31	63	94	27	108	136	162	191	353
Manipur	74	41	116	57	45	103	260	207	467	392	294	686
Nagaland	--	124	124	312	19	332	526	205	732	839	349	1188
Meghalaya	49	3	52	62	39	102	34	25	60	146	68	214
Sikkim	--	--	--	370	118	489	392	188	581	763	307	1070
GROUP D	31	16	47	76	51	127	165	104	270	273	172	445
ALL STATES	18	10	29	24	13	37	37	17	55	80	41	122

Sources: As in Table VI.1.

Pradesh, Madhya Pradesh and Bihar - got only less than the national average and much less than the averages for some of the most developed States like Punjab and Haryana. This is brought out in table VI-2. Bihar received only 41 per cent of the funds which Punjab got. Uttar Pradesh and Madhya Pradesh also got less than half of what Punjab received.

Discretionary transfers to finance various schemes initiated by the different Central Ministries had a higher grant content than the Central assistance for State Plans. During the seven year period covering the Fifth Plan and the first two years of the Sixth Plan, the grant content of schematic discretionary transfers was 63 per cent as against 38 per cent for Plan assistance. The grant content of Central Plan schemes was higher at 72 per cent. For centrally sponsored schemes, the grant content was still higher at 88 per cent. The grant-loan component of schematic transfers varied among the States according to the nature of the schemes as in the case of 'patterns of assistance' for the State Plans followed by the Planning Commission, prior to the Fourth Plan. As with the Central Plan assistance before the Fourth Plan, the proportion of transfers by way of grants was the highest for the developed States as may be seen from Table VI-3. The proportion of grants was 66 per cent for group B States, 63 per cent for group A States and only 59 per cent for group C States.

Among the special category States, the grant component was the second highest for Haryana, (after Orissa)

TABLE VI.3

Share of Grants in Schematic Transfers (1974 - 1981)

(Figures in percentages)

States	Central Plan Schemes	Centrally sponsored Schemes	Others	Total
Punjab	85	86	47	60
Haryana	81	95	64	81
Maharashtra	67	90	67	76
Gujarat	77	89	34	80
West Bengal	69	71	19	39
GROUP	73	86	39	63
Tamil Nadu	44	87	59	69
Kerala	40	78	17	55
Orissa	80	89	73	86
Assam	40	96	40	54
Karnataka	46	88	27	58
Andhra Pradesh	77	91	34	72
GROUP B	56	85	48	66
Uttar Pradesh	87	91	28	62
Rajasthan	95	96	26	70
Madhya Pradesh	76	87	20	59
Bihar	87	91	18	55
GROUP C	86	91	24	59
Himachal Pradesh	--	130	98	122
Jammu & Kashmir	100	59	51	55
Tripura	42	75	92	78
Manipur	74	68	56	61
Nagaland	100	64	63	67
Meghalaya	85	98	84	92
Sikkim	--	77	100	90
GROUP D	82	87	59	70
ALL STATES	72	88	36	63

Source: As in Table VI.1.

and the third highest for Gujarat. The grant component for Bihar and Madhya Pradesh, on the other hand was less than the national average. The overall trend may be seen from the correlation of grant content of all these schematic transfers with per capita income. The correlation was positive though weak during the Fifth Plan period. During the first two years of the Sixth Plan, there was a welcome change leading to a negative and statistically significant correlation.

The same trends are visible even when we analyse the discretionary grants in per capita terms. The rank correlation between per capita grants and per capita income was positive during the fifth plan and negative during the Sixth Plan. During both Plans, the correlation was weak. However some of the figures for individual States strike discordant notes. For example, Punjab, Haryana and Gujarat received larger grants per capita during the seven year period (1974-81) than the three low income States, viz., Uttar Pradesh, Madhya Pradesh and Bihar. Bihar's per capita grants during the seven year period was only 37.7 per cent that of Punjab. Per capita grants of Uttar Pradesh and Madhya Pradesh were just half that of Punjab. The distortions introduced in federal financial relations by the discretionary transfers not supervised by any federal body like the Finance Commission and the National Development Council may be seen from the fact that three States, viz., Punjab, Haryana and Rajasthan received more discretionary

grants than Plan grants during the Fifth and the Sixth Plans. Again, except for Kerala, West Bengal, Assam and the special category States, the discretionary non Plan grants exceeded the Statutory grants.

(ii) Loans towards Share in Small Savings:- The second most important item of discretionary transfers is the loans representing States' share in Small Savings. From the Fourth Plan onwards, they are treated as non Plan loans, meant to meet the overall non Plan gaps. At present, following the recommendations of the Seventh Finance Commission two-thirds of the net collection of small savings in each State is given back to it as loans 'in perpetuity'.[8] As an incentive to States for larger collection, the States are also offered half of every five per cent over and above the national average of net to gross collections. The small savings loans are in addition to the non Plan grants given for meeting half the expenditure on State staff employed for popularising small savings.

The sharing formula adopted by the Union Government implicitly amounts to the acceptance of a principle already rejected by all the Finance Commissions, both on constitutional and economic grounds, namely the principle of contribution. The present arrangement for sharing of small savings collections, in the name of giving incentives to States, leaves some of the poorer States badly off. The high weightage given to collection serves only to perpetuate

TABLE VI.4

Small Savings Loans, 1974-81

Rupees per Capita

States	Outstanding on 31.3.1974	Plans		Total
		V	VI	
Punjab	33	22	27	50
Haryana	43	31	20	51
Maharashtra	43	40	42	82
Gujarat	24	35	35	71
West Bengal	36	62	41	103
GROUP A	36	44	37	81
Tamil Nadu	15	27	14	41
Kerala	8	11	5	17
Orissa	13	18	9	27
Assam	23	31	9	41
Karnataka	14	22	14	37
Andhra Pradesh	6	9	7	16
GROUP B	13	19	10	29
Uttar Pradesh	19	31	13	45
Rajasthan	8	18	-1	16
Madhya Pradesh	12	14	10	25
Bihar	17	29	20	50
GROUP C	16	26	13	39
Himachal Pradesh	21	61	36	98
Jammu Kashmir	21	12	19	31
Tripura	3	9	6	15
Manipur	3	9	1	10
Nagaland	-	14	3	17
Meghalaya	-	16	8	25
Sikkim	-	—	--	--
GROUP D	17	25	18	44
ALL STATES	20	28	19	47

Source: For outstanding loans, Report of the Sixth Finance Commission op.cit.
For others, Finance of State Governments, op.cit.

the existing regional disparities, as may be seen from Table VI-4. The rank correlation coefficient between share of small savings and per capita income is positive during both the Fifth and Sixth Plans. But during both the Plan periods, it was not significant at 5 per cent level.

The reasoning behind the present sharing formula is fallacious. As the Sixth Finance Commission pointed out, "Small Savings collections in recent years have shown a sharp spurt mainly because of the Provident Funds, particularly subscriptions under Employee's Provident Fund Act have been permitted to be invested in post office Time Deposits. Nearly 60 per cent of the net collections of Small Savings are attributable to the investments made by the Provident Funds. In the mobilisation of funds from this source at any rate, the State Governments cannot claim to play an active part".[9] For the contributions made by the non institutional investors the scale of the other two incentives being granted at present to the State Governments must be considered adequate.

(iii) Gap loans and Ways and Means Advances :- Gap loan was a major component of the discretionary loans during the Fourth Plan. Such loans, comprising of loans for clearance of overdrafts, loans for meeting gaps in resources and special accommodation loans, had assumed massive proportions during the Fourth Five Year Plan period. Together, such loans outstanding at the end of the Fourth Plan

amounted to Rs.1,270 crores.[10] However, its importance declined considerably during the Fifth and the Sixth Plans as a result of the massive debt rescheduling recommended by the Sixth and the Seventh Finance Commissions.

During the Fourth Plan period, most of the States ran into large overdrafts with the Reserve Bank of India which were cleared at the end of March 1972 by the loans given by the Centre. Many States faced, even in subsequent years, serious Ways and Means difficulties, which would have led them to resort again to heavy overdrafts, but for the loans given by the Centre to avoid overdrafts. Such loans given to avoid overdrafts have come to be known as gap loans. Several States had taken these two types of loans even after receiving special accommodation loans, for the purpose of covering non Plan gaps in their resources. These loans were given at the time of finalisation of the States' Fourth Plan, so that the States can fill their non Plan gaps without taking recourse to Central Plan funds and the additional resources mobilised by them for financing their Plan. Resort to overdrafts and gap loans reflects to some extent the financial mismanagement of States. But to a greater extent it is also a commentary of the approaches of the Finance Commissions which do not provide for escalation of price rise. Gadgil, the then Vice Chairman of the Planning Commission explains the then prevailing position, "Examining the post Finance Commission position, we found that all States had to carry on their administration and for this they

Gap Loans and Ways and Means Advances

Rupees per Capita

States	Gap Loans as on 31.3.1974	Ways and Means Advances		
		V	VI	Total
Punjab	--	93	9	102
Haryana	.15	26	7	24
Maharashtra	--	11	Neg.	11
Gujarat	--	18	--	18
West Bengal	25	22	18	40
Tamil Nadu	11	--	6	6
Kerala	55	9	--	9
Orissa	69	--	--	--
Assam	109	--	2	2
Karnataka	39	10	13	23
Andhra Pradesh	22	--	Neg.	Neg.
Uttar Pradesh	2	8	--	8
Rajasthan	85	3	32	36
Madhya Pradesh	Neg.	--	--	--
Bihar	2	22	1	24
Himachal Pradesh	46	--	--	--
Jammu & Kashmir	361	--	--	--
Tripura	--	--	--	--
Manipur	27	--	--	--
Nagaland	--	213	64	277
Meghalaya	73	--	15	15
Sikkim	--	--	--	--
GRAND TOTAL	23	11	5	16

Sources: For Gap Loans, Report of the (Sixth) Finance Commission 1973, p.340
For others, Finances of State Governments, R.B.I. Bulletin op.cit.

will have to run into overdrafts. What we said to the Finance Ministry was, 'If you have any resources, these resources must first be earmarked for meeting the deficits of these States. It is only after you meet them that you really have surplus resources for adding to Central assistance.' "[11]

All these gap loans assisted the middle income States more than the poorer States. These loans were given to all States except Punjab, Maharashtra and Gujarat among the high income States, and Tripura and Nagaland among the special category States. States like Haryana, Assam, Orissa and Kerala which received relatively large amounts as statutory Plan funds, managed to get large amounts as gap loans too. Among the group C States, Rajasthan which was the largest beneficiary of Plan and statutory transfers during the Fourth Plan, received the maximum amount of gap loans too. Uttar Pradesh, Madhya Pradesh and Bihar received the lowest amounts. Among the special category States, Jammu and Kashmir and Maghalaya benefited the most from gap loans.

During the Fifth and the Sixth Plans, resort to gap loans on such a massive scale as during the Fourth Plan has not been made for the reason referred to earlier. But the States still take recourse to ways and means advances from the Centre. During the Fifth Plan, such loans amounted to Rs.637 crores and during the first two years of the Sixth Plan, Rs.340 crores. Unlike during the Fourth Plan, the

States which availed themselves of the maximum ways and means loans were Punjab followed by West Bengal, Rajasthan, Haryana and Karnataka. Except Rajasthan and West Bengal, all the others in the list of States had large revenue surpluses awarded by the Finance Commissions. The ways and means loans availed by the low income States on the other hand was low. While all the high income States took ways and means loans, Madhya Pradesh did not take any during both the Fifth and Sixth Plan periods.

(iv) Relief for Natural Calamities:- The fourth major component of discretionary transfers is the Centre's contribution for relief from natural calamities. Transfers of this nature which amounted to Rs.271 crores during the four year period ended in 1968-69 went up to Rs.530 crores during the next four years.[12] During 1973-74 alone, the total amount transferred on this count amounted to Rs.239 crores.[13] Thus during the Fourth Plan period as a whole, Central transfers to finance relief expenditure added upto Rs. 769 crores.

It may be recalled that the Central assistance discussed here is to finance expenditure over and above the provisions for famine relief made by the Finance Commissions while computing the normative non Plan revenue budgetary gaps for the purpose of determining the quantum of grants under Article 275. Funds provided for relief by the Finance Commissions which are in the nature of concealed grants were used by the States during normal years, for meeting their ways and means requirements. The recommendations made by

the successive Finance Commissions that funds provided by them for financing relief should be appropriated in normal years towards a famine relief fund for use in the lean years went unheeded by the States. Nor did the Centre implement the suggestion of the Finance Commissions that in determining the Central transfers for relief, the accumulated provisions made by the Finance Commissions and not merely the annual provisions relating to the particular year in which the natural calamity occurs, should be taken into account.

The Sixth Finance Commission had taken note of the possibility of the constraint of resources for developmental programmes in the Plans, in a few cases, leading to pressures by the States on the Centre for larger assistance in the form of drought relief. According to the Commission, while it could be argued that utilisation of relief funds on works of permanent value that should normally be accommodated within the Plan is in national interest, the distribution of Central assistance for drought relief, outside the framework of Central assistance for Plans, tends to set at naught the formula (Gadgil formula) for distribution of Central assistance evolved according to the criteria approved by the National Development Council. The present system of assistance for natural calamities has thus introduced serious distortions in the scheme of allocation of Central funds among the States and if continued any longer, will accentuate inter-State jealousies and rivalries."[14]

The Sixth Finance Commission, therefore, recommended that transfers for relief over and above the provisions made by the Finance Commissions should be adjusted against the Central Plan assistance. In fact, the implementation of the Commission's suggestions during the Fifth Plan, reduced not only the quantum of such non Plan expenditure but also the possibilities of diversion of relief funds to other purposes. During the Fifth Plan, Central assistance for relief expenditure came down to a meagre sum of Rs.6 crores, as against Rs.769 crores during the Fourth Plan. Only very few States received any Union funds for relief from natural calamities during the Fifth Plan, as against all except three States during the Fourth Plan.

There is evidence to show that with the Sixth Finance Commission's recommendations that bulk of Central assistance for natural calamities should be set off against State Plan assistance, the demand for funds for relief expenditure has tapered off. As the Seventh Finance Commission noted, the advance Plan assistance for relief released during the first four years of the Fifth Plan formed less than fifty per cent of the total relief expenditure intimated to it by the States.[15] The Seventh Finance Commission has loosened the purse strings again and this accounts for the sudden jump in relief assistance to Rs.198 crores within the first two years of the Sixth Plan. Apparently even weather gods respond to the tightening or loosening of the purse strings by the Union Government.

During the period of bountiful Central assistance, political bargaining is believed to have had a hey-day in allocation of relief funds. For, allotment of relief "was almost the only element for which no clear guidelines have been laid down for State-wise distribution and therefore in respect of which there is considerable room for exercise of discretion."[16]

Data for the Fourth Plan presented in Table VI-6 show that the lavish transfers made in the name of relief from natural calamities benefited a few of the high income States with more resources of their own. Three States in group B also received substantial relief funds. Rajasthan, the biggest beneficiary of Central relief funds belonged of course, to group C. It is also true that Rajasthan is a drought prone State. But Rajasthan also happens to be the one poor State which benefited the most from all types of transfers, statutory, Plan and discretionary.

The major drawback of all Central schemes for financing relief expenditure is that Union Government funds are given irrespective of the budgetary position of States or past accumulation of relief provisions with them. Some of the States which received massive assistance from the Centre were the ones with large revenue surpluses on non Plan account.

Summing up, it is often argued that a tight federation, in which resources are centralised with the Union and the Union Government which has the maximum discretion in their

TABLE VI.6

Central Assistance for Relief Expenditure, 1965-1981

Rupees per Capita

States	1965 - '69	IV Plan	V Plan	VI Plan	Total
Punjab	--	--	--	--	--
Haryana	--	--	--	3	3
Maharashtra	4	35	--	--	39
Gujarat	8	37	--	7	52
West Bengal	7	13	--	2	22
Tamil Nadu	2	4	--	2	8
Kerala	1	4	--	4	9
Orissa	14	18	Neg.	16	48
Assam	7	12	Neg.	--	19
Karnataka	6	19	--	--	25
Andhra Pradesh	5	24	--	7	36
Uttar Pradesh	Neg.	4	--	4	8
Rajasthan	19	41	--	3	63
Madhya Pradesh	11	2	--	Neg.	13
Bihar	14	7	1	--	22
Himachal Pradesh	--	7	--	2	9
Jammu & Kashmir	1	6	--	--	7
Tripura	--	3	--	--	3
Manipur	--	4	--	--	4
Nagaland	--	2	--	--	2
Meghalaya	--	--	2	--	2
Sikkim	--	--	--	Neg.	Neg.
GRAND TOTAL	6	14	Neg.	3	23

Sources: For data upto and including '72-73, Report of the Sixth Finance Commission, op.cit. p.175.

For later years, Finances of State Governments, op.cit.

allocation, is better suited for achieving effective re-distribution of resources from the richer to the poorer States. But our analysis, covering one quarter of a century, only goes to prove that centralisation in itself is no guarantee for regional equity in resource allocation.

TABLE VI.7

Coefficients of Rank Correlation with Per Capita Income

Types of Transfer	Plan Periods					
	II	III	AP	IV	V	VI
1. Per Capita Aggregate Discretionary Transfers	- 0.146	+ 0.352	- 0.111	+ 0.229	+ 0.363	+ 0.229
2. Per Capita Transfers for Central Plan Schemes					+ 0.307	- 0.504
3. Per Capita Transfers for Centrally sponsored Schemes					+ 0.468	- 0.186
Per Capita Transfers for other Non-Plan Schemes					+ 0.061	- 0.039
5. Per Capita Transfers for all Non-Plan Schemes (2-4)					+ 0.350	- 0.136
6. Per Capita Transfers for Total Discretionary Grants					+ 0.411	- 0.236
7. Per Capita Transfers for Small Savings Loans					+ 0.175	+ 0.451
8. Percentage share of Grants in total Schematic Transfers					+ 0.071	- 0.632

Notes and References

1. Report of the (Seventh) Finance Commission, 1978, p.173.

2. For a discussion on these schemes see (1) Grewal, B.S., Centre-State Financial Relations in India, Punjabi University, Patiala, 1975, p.238. (2) Administrative Reforms Commission, Report of the Study Team on Centre-State Financial Relationships, Government of India, New Delhi, 1968, pp.71-121.

3. Venkataraman, K., States' Finances in India, George Allen & Unwin, London, 1968, p.79.

4. Administrative Reforms Commission, op.cit. p.128.

5. Ibid, Chapter VIII.

6. Gadgil formula referred to in Chapter V. The distribution of small savings loans among States however is overseen by the Finance Commissions while reviewing the non Plan gaps.

7. See Administrative Reforms Commission, op.cit. Chapter VIII.

8. Report of the (Seventh) Finance Commission, op.cit., p.127.

9. Report of the (Sixth) Finance Commission, Government of India, New Delhi, p.87.

10. For a description of these loans as well as for data, see Ibid, p.93, 339 and 340.

11. Gadgil, D.R., "Some Aspects of Centre-State Financial Relations" in ed. Kamat A.R., Selected Writings and Speeches of Prof. D.R. Gadgil on Planning and Development (1967-71), Gokhale Institute of Politics and Economics, Poona, 1973, p.343.

12. Report of the (Sixth) Finance Commission, op.cit. p.175.

13. "Finances for State Government", Reserve Bank of India Bulletin, Bombay, August 1976.

14. *Report of the* (Sixth) *Finance Commission*, op.cit. p.64.

15. *Report of the* (Seventh) *Finance Commission*, op.cit. p.52.

16. *Report of the* (Sixth) *Finance Commission*, op.cit. p.65.

CHAPTER VII

INSTRUMENTS OF BUDGETARY TRANSFERS

In the earlier Chapters, we had examined the allocation of budgetary funds according to different agencies. However, the agency-wise allocation is much less important than the composition of budgetary transfers. In this Chapter, therefore it is proposed to examine the aggregate budgetary transfers to different States according to its components - viz., tax shares, grants and loans.

Constitutional Provisions

There are differences in the constitutional sanction for different forms of transfers. Taxes are shared among the States according to Articles 268, 269, 270 and 272 of the Constitution, whereas grants are effected under Article 275 and 282. Loans are granted under Article 293.[1]

While transfers by way of tax sharing are effected solely by the Finance Commission, grants are disbursed by all the three agencies such as the Planning Commission, different ministries of the Government of India and the Finance Commission. Loans are sanctioned by the Planning Commission and the Ministry of Finance.

Importance of Instruments of Transfers

An analysis of the instruments of budgetary flows assumes importance not primarily because of the differences in Constitutional sanction noted above or because of the differences in the type of agencies through which such flows take place. Forms of transfer assume importance mainly because of the differences in the impact of each form of transfer on the State budgets at a later date. While loans create debt servicing problems, transfers by way of tax sharing and grants do not give rise to these problems.

If there were assurances that fresh loans would always exceed the sums due as repayment instalments and interests on past loans, there would not have been any reason for the States to worry about the composition of budgetary transfers. In fact, the States were little worried of the forms of transfers till the end of the Third Plan, till when fresh loans used to exceed the debt servicing amounts. This was taken note of by the Study Group of the Administrative Reforms Commission. "This had bred in the States a degree of indifference as a result of which, when receiving assistance from the Centre they need worry little whether the assistance is in the form of a loan or a grant".[2] But the situation has changed in subsequent Plan periods when reverse flow of funds in the form of debt servicing started exceeding fresh loans in the case of many States.[3]

Again, States need not have bothered about patterns of assistance, provided all loans were productive enough to generate sufficient revenues to repay the principal and interest during the maturity period of the loans themselves. But in India, the debt servicing obligations used to be fixed independent of the capacity of the project to generate repayment potential. Loans are used to finance projects which should in the normal course have been financed by capital grants. Loans are used even to finance revenue component of Plans.

The loan:grant composition of Central Plan assistance in India used to be determined by the 'patterns of assistance' which were more often a reflection of the Centre's priorities and preferences for different projects. It was very often determined independent of the financial productivity, gestation period and the life span of the projects. Miscellaneous development loans and loans for flood control and anti-sea erosion works are examples.

Between taxes and grants, the States prefer to receive funds by way of tax shares as noted by us in Chapter IV. This is because, by sharing taxes they are able to partake in the buoyancy of Centre's tax revenues. While tax sharing expressed in fixed percentages of divisible pool provides for escalation in prices, inflation erodes the real worth of grants as the amounts are fixed in absolute terms more than five years ahead of their disbursements.

Another reason adduced for the preference of the States for tax sharing is its unconditional nature. While all tax shares are unconditional, some grants - both statutory and non statutory - are conditional.[4]

Components of Transfer - Plan-wise and State-wise

Table No.VII-1 gives the pattern of aggregate budgetary transfers during the three decades ending March 1981. During this period, loans constituted the largest single component of Central budgetary transfers accounting for two fifths of the aggregate transfers. This was the position during all Plans except the Sixth. Tax sharing was the second most important form of transfers accounting for little less than one third of the total. Grants of all varieties together accounted for only 28 per cent of the total transfers. As between tax sharing and grants, their relative importance varied among the different groups of States and over time. The relative importance of grants was more during the Second, Third and the Annual Plan periods. From the Fourth Plan period onwards, the relative importance of tax sharing has picked up thanks to the increasing role played by the Fifth, Sixth and Seventh Finance Commissions.

This pattern of assistance was not the one envisaged by the Constitution. According to Santhanam, the Constitution envisaged "that the main assistance required from the Centre would be in the nature of share in taxes and grants towards recurring revenue expenditure of the States

TABLE VII.1

Composition of Budgetary Transfers (1951-1981)

(Figures in percentages)

Plans	Tax	Grants	Tax & Grants	Loans
1st Plan	24.0	20.1	44.1	55.8
2nd Plan	23.3	27.5	50.8	49.2
3rd Plan	21.4	23.3	44.7	55.4
Annual Plans	24.0	26.0	50.0	50.0
4th Plan	30.2	25.4	55.6	44.4
5th Plan	33.0	32.2	65.2	34.8
6th Plan	40.3	27.0	67.3	32.7
All Plans	32.1	28.0	60.1	40.0

Source: Report of the Seventh Finance Commission, 1978 p.172 for 1st to 5th Plans. For the 6th Plan, Finances of State Governments, Reserve Bank of India Bulletin, Aug. 1981.

Though under Article 293, the Government of India is empowered to make loans to States or give guarantees in respect of loans raised by them, it was contemplated that normally the capital needs of a State would be met by its own borrowing".[5]

It may be interesting to note that the loan component of Centre-State budgetary flows in India was more than that of the official assistance granted by 15 members of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD).[6] In 1964, the share of loans in their assistance was much less (40 per cent) than the share of loans in the Central assistance to States in India, during the first three Plans, which varied from 49 to 55 per cent. In 1968, the share of loans in the official assistance of the above 15 OECD countries increased to 50 per cent. Even then, it was only equal to the share of loan in the Central transfers during the three Annual Plans period. In fact, the Development Assistance Committee had recommended that the loan component of the member countries' official assistance should not exceed 30 per cent.[7]

Loan Component

Loan component was the largest single component of aggregate budgetary transfers for all States, barring Orissa and the group D States. Even in this group, Jammu and Kashmir is an exception. There is however a welcome

Pattern of Budgetary Transfers among States, 1956-81

Figures in Percentages

States	Tax	Grants	Tax & Grants*	Loans
Punjab	27.4	23.9	51.3	48.6
Haryana	27.8	22.7	50.5	49.4
Maharashtra	39.9	19.4	59.3	40.7
Gujarat	37.2	23.4	60.6	39.4
West Bengal	33.1	20.6	53.7	46.3
GROUP A	35.0	21.2	56.2	43.8
Tamil Nadu	40.2	18.9	59.1	40.9
Kerala	30.6	28.6	59.2	40.8
Orissa	24.4	38.0	62.4	37.6
Assam	19.4	38.4	57.8	42.1
Karnataka	33.3	21.5	54.8	45.2
Andhra Pradesh	31.2	25.7	56.9	43.1
GROUP B	30.6	27.7	58.3	41.7
Uttar Pradesh	37.6	22.9	60.5	39.5
Rajasthan	23.2	29.3	52.5	47.5
Madhya Pradesh	37.3	22.9	60.2	39.8
Bihar	37.2	21.1	58.3	41.7
GROUP C	35.0	23.4	58.5	41.7
Himachal Pradesh	12.0	67.3	79.3	20.7
Jammu & Kashmir	9.6	42.9	52.5	47.5
Tripura	9.9	80.5	90.4	9.7
Manipur	6.2	76.2	82.4	17.6
Nagaland	5.9	81.8	87.7	12.3
Meghalaya	10.0	76.8	86.8	13.2
Sikkim	1.0	92.1	93.1	7.0
GROUP D	9.4	61.3	70.7	29.3
ALL STATES	31.6	27.2	58.8	41.2

Sources: Reserve Bank of India, Finances of the State Governments, various issues.

trend of declining share of loans from the Fourth Plan period mainly because of the increasing role played by the Finance Commission.

States at the lower levels of development are required to invest a larger proportion of their budgetary funds in the development of infrastructure and other social overheads. Investments in these sectors are not immediately productive. Their productivity is therefore not immediately reflected in increased revenues. It is therefore necessary that the less developed States must get more of the budgetary transfers in non-repayable forms as compared to the more developed States which can invest a higher proportion of budgetary transfers in directly productive activities. It may be remembered that even in international financial assistance, the principle that grant component should vary in favour of hard core developing countries is quite accepted.[8]

Devolution in Non Repayable Forms

But this principle has not been consistently and systematically followed in India. In fact, the rank correlation between per capita income and the percentage share of the non repayable type (tax and grants) in the aggregate transfer amounts shows divergent trends. It was positive during the three Plan periods (i.e. between 1961 and 1974) and negative during the three other Plan periods, i.e., the Second, Fifth and Sixth Plans. Even during the Sixth Plan, the correlation was not statistically significant.

As ma be seen from Table VII-2 during the entire period, Maharashtra and Gujarat received a higher proportion of Central funds in non repayable forms than Rajasthan, Bihar, Assam and Jammu and Kashmir. The redeeming feature, however is that the special category States received 71 per cent of funds in the form of taxes and grants.

Tax Sharing and Grants

The share of taxes exceeded that of grants in case of all groups other than group D. Orissa and Assam in group B and Rajasthan in group C, however were exceptions.

The importance of tax sharing in the aggregate budgetary transfers was the same for group A and C States. This amounted to 35 per cent each, followed by the group B States which come to 30.6 per cent. For group D States, tax sharing was the least important form of resource transfer, accounting for less than one-tenth of the aggregate. In their case, grants were of the highest importance accounting for 61.3 per cent of the total. The only exception was Jammu and Kashmir. For the low income group C States, the relative share of grants (23.4 per cent) was lower than that of the middle income States (27.7 per cent). The share of grants for high income group A States was the lowest (21.2 per cent).

It was noted in Chapter III that the low income States received the lowest quantum of Central funds among

non special category States, while the middle income States received the maximum.[9] The shortfall of group C States in aggregate transfers was contributed by all forms of transfer as may be seen from Table VII-3. But the deficiency was the maximum in the case of grants where the deviation from the national average was 23 per cent. In tax sharing, the group C States more or less levelled off with the national average. In loans, the deficiency was by ten per cent.

The high income group as a whole too, had received less budgetary funds than the all States average. But their shortfall was relatively small. It was only six per cent. But this shortfall was contributed by the shortfall in grants which was by 27 per cent. In tax sharing they had received more while in loans they received average sums.

The group B States received above average sums of loans as also grants. Their shortfall, although marginal, was in tax sharing.

Grants Per Capita

In Chapter IV it was noted that the Plan-wise and State-wise distribution of the share in taxes among States was not progressive except in the Sixth Plan.[10] A Plan-wise analysis of total grants shows relatively more progressive bias than tax sharing as may be seen from Table VII-6. The correlation between per capita income and per capita grants was negative during all Plans except the Fourth. During none of the Plan periods,

Pattern of Budgetary Transfers Among States, 1956-81

States	Rupees per Capita					Index Numbers				
	Tax	Grants	Tax & Grants	Loans (Gross)	Total	Tax	Grants	Tax & Grants	Loans (Gross)	Total
Punjab	399	347	746	706	1452	95	95	95	128	109
Haryana	383	313	696	681	1377	91	86	89	124	103
Maharashtra	458	223	681	468	1149	109	61	87	85	86
Gujarat	453	285	738	481	1219	107	78	94	87	91
West Bengal	438	273	711	613	1324	104	75	90	111	99
GROUP A	441	266	707	551	1258	105	73	90	100	94
Tamil Nadu	430	202	632	438	1070	102	55	80	80	80
Kerala	426	398	824	567	1391	101	109	105	103	104
Orissa	420	653	1073	647	1720	100	179	137	118	129
Assam	404	797	1201	875	2076	96	219	153	159	155
Karnataka	407	263	670	553	1223	96	72	85	101	92
Andhra Pradesh	410	337	747	565	1312	97	93	95	103	98
GROUP B	417	378	795	569	1364	99	104	101	103	102
Uttar Pradesh	414	252	666	434	1100	98	69	85	79	82
Rajasthan	403	510	913	825	1738	95	140	116	150	130
Madhya Pradesh	414	254	668	442	1110	98	70	85	80	83
Bihar	423	240	663	474	1137	100	66	84	86	85
GROUP C	416	280	696	493	1189	99	77	89	90	89
Himachal Pradesh	361	2023	2384	621	3005	86	556	303	113	225
Jammu & Kashmir	462	2072	2524	2294	4828	109	569	322	417	361
Tripura	299	2434	2733	292	3025	71	669	348	53	226
Manipur	284	3474	3758	800	4558	67	954	478	145	341
Nagaland	750	10414	11164	1570	12734	178	2861	1420	285	953
Meghalaya	431	3311	3742	569	4311	102	910	476	103	323
Sikkim	48	4663	4711	353	5064	11	1281	599	64	379
GROUP D	443	2873	3316	1373	4689	106	789	422	250	351
ALL STATES	422	364	786	550	1336	100	100	100	100	100

Source: As in Table VII.2

however, the correlation was significant at 5 per cent level.

It is true that during the whole 25 year period, it was the low income States which received more grants than the top income States. But the grants that they received were considerably less than what the middle income States received. Besides, all but Rajasthan in group C received less than the national average of grants. The per capita grants received by Uttar Pradesh, Madhya Pradesh and Bihar were less than three fourths that of national average.

Statutory and Non Statutory Grants

As may be seen from Table VII-4, statutory grants constituted only 25.8 per cent of the total grants. The remaining grants were disbursed by the Planning Commission and the Union Ministries under Article 282. The importance of statutory grants was the highest for middle income States. Next in importance was it for the low income States. Statutory grants formed only a small share of the total grants that went to the high income States. Of course, the importance of statutory grants was considerably more for special category States.

The high income States, with the exception of West Bengal, did not receive much statutory grants. But three of the low income States - Uttar Pradesh, Madhya Pradesh and Bihar also did not receive much statutory grants. In fact these three States received less than the national

Statewise Distribution of Total Grants, 1956-81

Rupees per Capita

States	II	III	AP	IV	V	VI	Total	Statutory	Non Statutory	% share of Statutory grants in Total
Punjab	10	30	25	88	150	44	347	6	341	1.7
Haryana	10	30	22	60	123	68	313	6	307	1.9
Maharashtra	6	21	22	63	67	44	223	3	220	1.3
Gujarat	6	41	29	64	100	45	285	13	272	4.6
West Bengal	21	23	17	54	122	36	273	86	187	31.5
GROUP A	11	27	22	62	101	43	266	30	236	11.3
Tamil Nadu	6	25	28	43	65	35	202	16	186	7.9
Kerala	16	35	58	69	178	42	398	185	213	46.4
Orissa	24	53	70	99	267	140	653	288	365	44.1
Assam	45	80	96	164	326	86	797	338	459	42.6
Karnataka	18	34	45	51	76	39	263	58	205	22.1
Andhra Pradesh	13	28	29	62	143	62	337	94	243	28.1
GROUP B	16	36	45	70	149	62	378	125	253	33.1
Uttar Pradesh	7	20	20	39	105	61	252	32	220	12.7
Rajasthan	14	35	41	95	230	95	510	150	360	29.4
Madhya Pradesh	1	26	23	47	85	59	254	14	240	5.5
Bihar	29	22	15	38	90	46	240	33	207	13.8
GROUP C	15	23	22	47	112	61	280	43	237	15.7
Himachal Pradesh	0	30	--	294	1072	617	2023	741	1282	36.
Jammu & Kashmir	51	129	191	399	931	371	2072	842	1230	40.6
Tripura	--	--	--	533	1224	677	2434	1220	1214	50.2
Manipur	--	--	--	649	1908	917	3474	2018	1456	58.1
Nagaland	45	80	962	2775	4525	2027	10414	5330	5084	51.2
Meghalaya	45	80	96	710	1611	769	3311	127	2040	38.4
Sikkim	--	--	--	--	2907	1756	4663	674	3989	14.4
GROUP D	55	84	236	525	1329	664	2873	1268	1605	44.1
ALL STATES	15	29	31	69	149	71	364	94	270	25.8

Source: As in Table VII.2

average. They received less than West Bengal. Madhya Pradesh's statutory grants were only 15 per cent of the national average. Statutory grants of Uttar Pradesh and Bihar were only one third of the national average.

The large share of non statutory grants raises some interesting constitutional questions as well. The Article 282 of the Constitution which was used to give large volume of grants by the Planning Commission and the Union Ministries falls outside the purview of the substantive provisions relating to 'Distribution of Revenue between Union and the States' and finds a place only under 'Miscellaneous Financial Provisions'. The constitutional assumption was that "the discretionary paragraph under Article 282 would be used only for special emergencies like famines or floods or other natural calamities" as noted by us in Chapter IV. It was assumed by the framers of the Constitution that Article 275 was the channel through which grants will be routed from the Centre to States.[11] The use of the Articles for effecting substantial transfer of resources is not unconstitutional. But, it can still be argued that it is really stretching the constitutional provisions too far. Though not unconstitutional, the present excessive use of Article 282 is not constitutionaly 'neat'.[12]

All these aberrations would have been tolerable if only the cause of equality was upheld by the dispensers of non statutory grants. But this is not so. Even in the distribution of non statutory grants, the low position of the

Per Capita (Gross) Loans, 1956-81

States	II	III	AP	IV	V	VI	All
Punjab	64	83	87	83	292	97	706
Haryana	64	83	47	188	198	101	681
Maharashtra	37	59	40	112	131	89	468
Gujarat	38	62	48	95	151	87	481
West Bengal	53	64	44	134	211	107	613
GROUP A	46	65	47	118	179	96	551
Tamil Nadu	38	68	48	93	130	61	438
Kerala	43	98	54	151	162	59	567
Orissa	67	97	77	160	144	102	647
Assam	40	130	111	254	200	140	875
Karnataka	36	69	72	152	145	79	553
Andhra Pradesh	43	89	83	131	142	77	565
GROUP	43	86	70	142	147	81	569
Uttar Pradesh	25	44	44	77	174	70	434
Rajasthan	60	110	116	279	148	112	825
Madhya Pradesh	51	77	61	63	120	70	442
Bihar	34	55	63	84	164	74	474
GROUP	36	61	61	101	157	77	493
Himachal Pradesh	64	83	--	255	131	88	621
Jammu Kashmir	116	211	179	624	787	377	2294
Tripura	--	--	--	190	51	51	292
Manipur	--	--	--	302	261	237	800
Nagaland	40	129	151	253	734	263	1570
Meghalaya	40	130	111	152	81	55	569
Sikkim	--	--	--	—	176	177	353
GROUP D	87	137	167	375	397	210	1373
ALL STATES	42	71	61	125	165	86	550

Source: As in Table VII.2

low income States continued. Bihar got only three fourths of the national average of non statutory grants. It received only three fifths of what Punjab got. West Bengal which received more statutory grants than the other group A States received the second lowest quantum of non statutory grants.

The general direction in the inter-State flow of loan funds was towards the developed States as may be seen from Table VII-5. This is also borne out by the positive correlation between per capita income and per capita loans during all Plans other than the Third Plan and the Annual Plans as may be seen from Table VII-6. However, during none of the Plans, the correlation was statistically significant.

Summing up, it may be seen that the pattern of financial flows from the Centre to the States which has emerged during the last 30 years, with its high content of loan and non statutory grants, is not the one visualised in the Constitution. Further the pattern had no definite and consistent progressive bias. The pattern of financing, in which loans predominated, has generated serious debt servicing problem. This is being discussed in the next Chapter.

TABLE VII.6

Coefficients of Rank Correlation with per Capita Income

Types of Transfers	Plan Periods					
	II	III	AP	IV	V	VI
Tax shares (Per Capita)	0.713	0.775	0.831	- 0.100	0.074	- 0.631
Grants (Per Capita)	- 0.274	- 0.048	- 0.105	+ 0.236	- 0.154	- 0.417
Tax plus Grants (Per Capita)	- 0.036	+ 0.158	+ 0.035	+ 0.254	- 0.154	- 0.746
Loans (Per Capita)	+ 0.302	- 0.088	- 0.282	+ 0.082	+ 0.146	+ 0.238
Share of non repayable forms in total Transfers (%)	- 0.244	+ 0.076	+ 0.290	0.071	- 0.431	- 0.542

Note: Only values above 0.524 are significant at 5% level.

Notes and References

1. Relevant clauses of Article 293 read as under:

   (2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or so long as any limits fixed under Article 292 are not exceeded, give guarantees in respect of loans raised by any State and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

   (3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of loan which has been made to the State by the Government of India or by its predecessor Government or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

   (4) A consent under clause 3 may be granted subject to such conditions if any as the Government of India may think fit to impose.

2. Administrative Reforms Commission, Report of the Study Team on Centre-State Relationships, Government of India, New Delhi, Vol.I, p.4.

3. These aspects are discussed in greater detail in Chapter VIII.

4. All discretionary grants are conditional. Finance Commission gives both conditional and unconditional grants. From the Fourth Plan onwards, most of the Plan grants are unconditional 'block grants'.

5. Santhanam, K., Transition in India, Asia Publising House, Bombay, 1964, p.116.

6. The Organisation for Economic Development unlike its its predecessor, European Economic Co-operation, has a membership outside Europe. Countries like U.S.A., Canada, New Zealand, and Turkey, in addition to the non Socialist European nations, are its members. One of the objectives of the Organisation is "to stimulate and harmonise its members' aid efforts in favour of the developing countries". Development Assistance Committee is one of its important Committees.

7. *Partners in Development*, (Report of the Commission on International Development - Chairman, Lester B. Pearson, Pall Mall Press (London), 1969 p.385.

Ibid. p.163.

9. Table III.2 Chapter III.

10. Table IV.2. Chapter IV.

11. Santhanam, K., op.cit. p.116.

12. Administrative Reforms Commission, op.cit. p.74.

CHAPTER VIII

STATES' INDEBTEDNESS AND THE REVERSE FLOW OF FUNDS TO THE CENTRE

Magnitude of the Problem

In the previous Chapter, it was examined how far the federal financial relationship in India has been transformed to a Creditor Debtor relationship as a result of the 'pattern of assistance' adopted by the Planning Commission and the different Union Ministries. The high loan component in Central assistance, especially in the earlier Plans has led to reverse flow of funds in the form of debt servicing payments, from the States to the Centre.

The Indian States' debt per capita has been ever on the increase. From Rs.10.4 per capita in 1951, it has reached Rs.366.5 in 1981.[1] In 1951, Central loans accounted for only 52.2 per cent of the outstanding debts whereas in 1981 it accounted for 72.9 per cent. As a result, the per capita Central loans to States which amounted to Rs.5.4 only in 1951 increased nearly 50 times to Rs.267 in 1981.(Table VIII.1)' absolute terms, the volume of central loans increased from Rs.196 crores in 1951 to Rs.18,000 crores in 1981. As a result, the per capita debt servicing payments increased from Rs.17.7 during the Second Plan to Rs.111 crores during the Fifth Plan as may be seen from Table VIII-2.

TABLE VIII.1

States' Outstanding Debt

Rs. in Crores

Types of Debt	As on 31st March of						
	1951	1956	1961	1966	1969	1974	1981
I. a) Market Loans	111	222	410	720	950	1543	--
b) Others	12	45	182	458	539	612	--
Total Internal Debt (a b)	123	267	592	1178	1489	2155	4133
II. Loans from the Centre	196	943	2014	4103	5569	8578	18007
III. Unfunded Debt	56	86	133	231	367	857	2554
Total Debt (I-III)	375	1296	2739	5512	7425	11590	24694

Sources: For the year 1981, Reserve Bank of India, Report on Currency & Finance, 1980-81, Bombay, Vol. II, p.126. For other years, Report of the (Seventh) Finance Commission, Government of India, New Delhi, 1978. p.110.

Debt Servicing Payments of States, 1956-81

Rs. per Capita

States	II	III	AP	IV	V	VI	Total
Punjab	40.7	56.8	76.4	104.0	223.3	70.3	571.5
Haryana	40.7	56.8	76.0	152.7	172.2	58.0	556.4
Maharashtra	14.2	26.2	32.9	80.3	104.2	31.3	289.1
Gujarat	13.3	25.9	35.0	75.3	119.1	29.5	298.1
West Bengal	17.1	29.7	27.0	100.0	131.4	69.6	374.8
GROUP A	19.7	32.3	38.6	92.6	131.1	48.1	314.3
Tamil Nadu	21.4	36.5	45.3	87.7	74.3	35.6	300.8
Kerala	16.9	48.1	41.4	104.1	124.0	32.8	369.3
Orissa	25.3	49.3	61.1	119.6	111.4	47.0	371.4
Assam	11.7	54.6	77.0	170.4	128.2	41.1	483.0
Karnataka	14.9	35.6	48.4	122.6	110.6	53.5	385.6
Andhra Pradesh	27.4	50.9	57.5	117.7	97.1	44.2	394.8
GROUP B	21.5	44.5	53.0	114.4	101.8	42.5	377.7
Uttar Pradesh	9.8	22.3	29.4	64.4	87.1	37.7	250.7
Rajasthan	17.1	54.5	74.5	188.7	148.2	97.7	580.7
Madhya Pradesh	20.7	33.5	44.2	80.2	69.6	30.9	279.1
Bihar	7.7	25.0	31.5	60.2	108.8	35.6	268.8
GROUP C	12.0	28.9	38.0	81.5	96.8	43.5	300.7
Himachal Pradesh	40.7	60.7	--	94.9	192.0	37.1	425.4
Jammu & Kashmir	75.9	80.8	7.5	397.2	392.5	122.6	1076.5
Tripura	--	--	--	113.9	96.0	10.0	219.9
Manipur	--	--	--	130.7	248.5	128.0	507.2
Nagaland	10.8	54.6	30.6	121.5	451.3	86.9	755.7
Meghalaya	11.7	55.0	77.9	83.8	68.0	26.4	322.8
Sikkim	--	--	--	--	23.8	25.9	49.7
GROUP D	54.8	68.0	20.1	214.7	257.2	74.6	689.4
ALL STATES	17.7	35.3	42.3	97.9	111.3	45.2	349.7

Note: (1) Only debt servicing payments actually made on Central Loans are included.

(2) Debt servicing includes both payment of interest and repayment instalment of principal.

Source: Reserve Bank of India, Finances of State Governments, different issues.

The mounting debt servicing payments, have progressively reduced the net loans given to the States into a trickle as may be seen from Table VIII-3. Most of the States in India have fallen into 'debt traps', a situation wherein fresh loans are necessary to service old loans. During the Annual Plan period, the ratio of net loans to gross loans come down to 31.1 per cent from 59 per cent during the third Plan. During the Fourth Plan, it came down further to 21.6 per cent. This trend was arrested to some extent by the debt rescheduling made during the Fifth and the Sixth Plans on the basis of the recommendations of the Sixth and the Seventh Finance Commissions. But for these rescheduling, the net loans would have been negative for ten States during the Fifth Plan and for one State during the Sixth Plan. This situation in which debt service payments exceeded the fresh loans arose in Haryana as early as the Annual Plans period. The problem of negative loan 'assistance' was faced by Punjab and Madhya Pradesh during the Fourth Plan. Despite massive debt relief, three States - Rajasthan, Himachal Pradesh and Tripura faced this problem of negative loans even during the Fifth Plan.

In the case of other States too, the percentage of debt servicing payments to gross loans was steadily going up as may be seen from Table VIII-3. This mounting problem is being faced by all groups of States. During the Second Plan, the problem was most acute for the special category States. During the Fourth and the Sixth Plan, the problem was

Ratio of Debt Servicing Payments to Gross Loans from the Centre, 1956-81

In Percentage

States	Plan Periods						
	II	III	AP	IV	V	VI	Total
Punjab	64	73	87	125	76 (80)	72 (87)	81
Haryana	64	73	162	83	87 (104)	57 (69)	82
Maharashtra	38	44	83	71	80 (90)	35 (47)	62
Gujarat	34	42	73	79	79 (88)	34 (49)	62
West Bengal	32	47	61	75	62 (78)	65 (78)	61
GROUP A	43	50	83	79	73 (85)	50 (63)	66
Tamil Nadu	55	54	94	95	57 (73)	58 (65)	69
Kerala	44	49	76	69	77 (108)	56 (86)	65
Orissa	37	51	79	75	77 (127)	46 (60)	64
Assam	30	42	69	67	64 (120)	29 (45)	55
Karnataka	42	52	67	81	76 (106)	68 (73)	70
Andhra Pradesh	63	57	70	90	68 (99)	57 (71)	70
GROUP B	51	52	76	80	69 (106)	52 (65)	67
Uttar Pradesh	40	50	66	82	50 (60)	54 (73)	58
Rajasthan	28	50	65	68	100 (168)	87 (102)	70
Madhya Pradesh	41	44	72	127	58 (75)	44 (60)	63
Bihar	24	45	51	71	66 (81)	48 (62)	57
GROUP C	33	48	62	81	62 (81)	56 (73)	61
Himachal Pradesh	64	73	-	38	147 (223)	42 (75)	69
Jammu & Kashmir	66	38	4	64	50 (87)	33 (56)	47
Tripura	-	-	-	60	188 (369)	20 (50)	75
Manipur	-	-	-	43	95 (150)	54 (68)	64
Nagaland	30	-	14	48	61 (77)	33 (70)	48
Meghalaya	30	42	69	55	84 (177)	48 (81)	57
Sikkim	-	-	-	-	14 (14)	15 (19)	14
GROUP D	53	42	12	57	65 (108)	36 (61)	50
ALL STATES	43	49	69	79	67 (90)	53 (67)	63

Figures in brackets are inclusive of debt relief suggested by the Sixth and Seventh Finance Commissions. Figures of debt relief for Sixth Plan are pro rate figures for the first two years.

Source: 1. Reserve Bank of India, Finances of State Governments, op.cit.
2. For debt relief data (a) Reports of the Seventh Finance Commission, op.cit. p.116.
(b) Reports of the Sixth Finance Commission, op.cit. p.95.

most intense for the low income States. During the Third, and the Fifth Plan periods, the problem was more serious for the middle income States. During the Annual Plan periods, the problem was more grave for the top income States. Judged by the ratio, the overall picture is that of the burden varying according to per capita income. This may be seen from the positive though weak correlation between this ratio and per capita income (see Table VIII-15).

The debt servicing payments in per capita terms. were the highest for Group D States during the entire period as may be seen from Table VIII-2. Group B came second and group A third. In per capita terms, group C came only fourth. There was a positive though weak correlation between per capita debt service payments and per capita income.

The per capita loans outstanding at the end of the Fourth and the Fifth Plans also show the same pattern, of the special category States having the highest and the group C States having the lowest burden.[2] Again, there was a positive though weak correlation between outstanding loans and per capita income.

But neither these per capita figures nor the ratio of debt servicing payments to fresh loans give the correct picture of the debt burden as they do not take into account the ability of the States to bear the debt burden. During the two and a half decades studied here, debt servicing accounted for about eleven per cent of the States' combined

(Capital and Revenue) Expenditure, 1956-81

In Percentage

States	Plan Periods						
	II	III	AP	IV	V	VI	Total
Punjab	17.6	16.1	17.5	11.8	12.5	7.6	12.4
Haryana	17.6	16.1	27.5	18.0	10.1	6.5	13.1
Maharashtra	6.6	7.6	9.5	10.4	6.8	4.0	7.3
Gujarat	6.3	8.8	12.0	11.3	9.0	4.0	8.4
West Bengal	7.8	12.8	11.6	18.1	13.1	12.5	13.2
GROUP	9.0	10.8	12.6	13.2	9.6	6.6	10.0
Tamil Nadu	11.4	12.2	15.2	14.3	7.0	6.0	9.8
Kerala	9.8	16.2	13.9	16.4	10.4	5.3	11.4
Orissa	15.5	18.0	22.3	22.1	17.1	8.4	14.4
Assam	5.0	15.6	22.0	25.8	12.6	8.1	15.4
Karnataka	7.5	11.3	15.3	17.4	9.0	8.3	11.3
Andhra Pradesh	14.8	20.5	23.2	21.7	9.0	7.8	13.6
GROUP B	11.4	15.4	18.3	18.8	9.3	7.3	12.3
ttar Pradesh	7.7	11.1	14.7	14.9	10.3	11.1	11.2
Rajasthan	8.7	16.7	22.8	26.5	12.9	16.0	17.4
Madhya Pradesh	11.3	14.8	19.5	18.0	7.5	5.8	10.9
Bihar	6.1	14.2	17.9	16.5	16.7	9.8	14.4
GROUP C	8.3	12.8	16.9	18.0	11.4	9.6	12.8
Himachal Pradesh	17.6	16.1	--	10.9	9.7	3.4	9.4
Jammu & Kashmir	21.4	15.0	1.4	27.2	14.0	10.2	15.5
Tripura	--	--	--	11.6	5.7	1.0	6.4
Manipur	--	--	--	11.3	9.5	0.7	9.7
Nagaland	5.0	--	3.5	3.6	6.7	3.2	5.5
Meghalaya	5.0	15.6	22.0	7.9	3.2	2.3	6.2
Sikkim	--	--	--	--	--	1.0	0.7
GROUP D	15.7	11.3	3.9	17.6	10.2	5.0	11.0
ALL STATES	9.8	13.5	16.2	16.7	10.1	7.6	11.0

Source: As in Table VIII.3.

revenue and capital expenditure as may be seen from Table VIII-4. The ratio of debt servicing payments to the aggregate expenditure of the States was steadily on the rise till the Fifth Plan. The ratio which was only 9.8 per cent in Second Plan rose progressively to 16.7 per cent during the Fourth Plan period. During the Fifth and the Sixth Plans, this ratio however came down, thanks to the debt rescheduling done according to the recommendations of the Sixth and Seventh Finance Commissions.

The burden of debt as indicated by this ratio is not being felt uniformly by all the States. During the 25 year period, the poorer States felt this burden more as may be seen from the consistently negative though weak correlation between this ratio and the per capita income during all the Plans except the Second. During the whole 25 year period surveyed in this study, the burden was the highest for Rajasthan followed closely by Jammu and Kashmir, Assam, Orissa and Bihar. Among the non special category States, it was the lowest for Maharashtra, Gujarat and Tamil Nadu. Speaking of groups, the debt burden as indicated by the ratio of debt servicing to aggregate expenditure, was the highest for low income States and lowest for top income States, lower than that of even the special category States. The middle income State's debt burden was the second highest. Again, it may be qualified that there were considerable intertemporal and inter-State differences in

the debt servicing burden, within the groups and among them. During the Second Plan, the problem was most acute, for the Special category States. In fact, the ratio was the highest for Jammu and Kashmir. During all subsequent Plans, except the Fifth and the Sixth, the debt servicing ratio was the highest for the middle income States. During the Fifth and the Sixth Plans, in spite of debt relief, the burden was the highest for the low income group C States.

The intensity of the debt service burden is highlighted by the ratios of repayment instalments due to total capital disbursements given in Table VIII-5. These ratios also highlight the circumstances which compelled the Sixth and the Seventh Finance Commissions to recommend a massive debt rescheduling. But for the rescheduling, 97.5 per cent of the States' total non Plan capital disbursements would have gone only for meeting the repayment obligations on the previous Central loans to them, during the Fifth Plan. In spite of the debt rescheduling recommended by the Sixth Commission, repayment obligations would still have accounted for 86.8 per cent of the non Plan capital expenditure of States during the Sixth Plan period (1979-1984). The State-wise position given in Table VIII-5 shows that during both the Plans, it was the ratio of the special category States which was the highest. Among the non special category States, the burden was the highest for middle income States during the Fifth Plan and for low income States during the Sixth Plan. The range of inter-State differences however was small.

Ratio of Loan Repayments to Non Plan Capital Disbursements, 1974-84

(In percentages)

States	Plan Periods	
	V	VI
Punjab	98.14	93.66
Haryana	98.28	90.32
Maharashtra	99.22	89.28
Gujarat	98.16	66.97
West Bengal	89.20	85.22
GROUP A	95.21	84.30
Tamil Nadu	97.80	72.94
Kerala	99.04	85.21
Orissa	98.90	89.50
Assam	99.77	87.85
Karnataka	99.13	74.49
Andhra Pradesh	99.18	86.82
GROUP B	99.00	82.10
Uttar Pradesh	93.75	99.66
Rajasthan	98.75	90.12
Madhya Pradesh	99.42	79.26
Bihar	97.38	89.18
GROUP C	97.02	91.60
Himachal Pradesh	98.99	89.44
Jammu Kashmir	99.40	96.43
Tripura	98.28	99.44
Manipur	99.46	87.12
Nagaland	99.48	93.08
Meghalaya	99.11	92.28
Sikkim	--	73.22
GROUP D	99.24	94.40
ALL STATES	97.54	86.80

Sources: 1. Report of the (Sixth) Finance Commission, op.cit. p.83.
2. Report of the (Seventh) Finance Commission, op.cit. p.262.

A still better indicator of the debt servicing burden is the ratio of debt service payments to States' own resources - capital and revenue. The ratios given in Table VIII-6 show that the States' ability to service the debts (if it were to service the debts out of its own resources and not out of Central funds) was steadily on the increase till the Fifth Plan. These ratios for all the Plans, were highly regressive as may be seen from its negative and significant correlations with per capita income. Among the groups, the debt burden was the highest for special category States during all Plan periods except the Annual Plan period. Among the non special category States, the burden was the highest for the low income States from the Fourth Plan onwards. During the Second, Third and Annual Plans, debt servicing burden was the highest for middle income States. During all the plans, except the Annual Plans, the burden was the lowest for high income States. For the period as a whole, the burden was the highest for Manipur, Tripura, Nagaland and Jammu and Kashmir. For these States and Assam, debt servicing during the Fourth Plan exceeded their own resources indicating an insolvency position. To them, debt servicing payments could be met only out of additional Central loans or Central transfers in the form of tax sharing and grants. And if the Centre for some reason were to tighten its purse strings, the States could not have been able to spend any money at all even for their maintainance. A financial 'emergency' would have been certainly on the cards as the State administration would have ground to a halt.

TABLE VIII.[illegible]

Debt Servicing to States' Own Resources, 1956-81
(Revenue and Capital)

In Percentage

States	II	III	AP	IV	V	VI	All
Punjab	31	28	28	18	19	12	20
Haryana	31	28	43	30	15	10	20
Maharashtra	11	13	15	17	9	6	11
Gujarat	11	17	21	20	13	6	14
West Bengal	15	21	21	41	25	25	26
GROUP	16	18	21	23	14	11	16
Tamil Nadu	18	22	27	25	11	10	16
Kerala	19	35	29	34	18	10	21
Orissa	44	42	73	65	28	26	40
Assam	10	54	93	103	37	31	51
Karnataka	14	24	27	31	13	14	19
Andhra Pradesh	28	36	53	46	16	15	26
GROUP B	22	32	40	39	17	14	24
Uttar Pradesh	15	22	29	29	19	21	22
Rajasthan	18	43	58	78	26	36	41
Madhya Pradesh	23	31	38	33	12	11	20
Bihar	13	34	46	42	41	25	36
GROUP C	17	30	39	40	22	22	27
Himachal Pradesh	31	28	-	41	33	12	29
Jammu & Kashmir	81	43	7	126	49	34	57
Tripura	-	-	-	380	44	10	70
Manipur	-	-	-	141	172	67	119
Nagaland	10	54	-	74	62	43	58
Meghalaya	10	54	94	88	24	20	40
Sikkim	-	-	-	-	4	6	5
GROUP D	50	47	20	103	46	26	50
ALL STATES	19	27	32	34	18	15	22

Source: As in Table VIII.3

The Sixth Finance Commission found it objectionable to assess the debt servicing capacity by relating the debt burden to own revenues of States as it puts to disadvantage those States which exploited their revenue potential more fully. They had therefore related the burden of debt with per capita income. Our own analysis on similar lines is given in Table VIII-7. The ratios given in the Table differ from the Sixth Finance Commission's ratios in four ways. Firstly, the interest payments have also been included in the total debt burden. Secondly, the data on burden in the study are those of actuals unlike those of the Finance Commission which are only estimates. Thirdly, the burden data in this study are annual averages. Fourthly, the per capita income figures are those of the middle year of each Plan, except those of the Fifth and Sixth Plans. In the case of these two Plans, the 1975-76 data had to be used as they are the latest available.

The analysis shows that except during the Annual Plan period, the burden was the highest for special category States. Except during the Fifth Plan, the burden was lowest for high income States. During the Third, the Fourth and the Annual Plans periods, the burden was the highest for middle income States. During the Fifth and the Sixth Plans, the burden in relation to per capita income was the highest for the low income States.

TABLE VIII.7

Ratio of Per Capita Annual Debt Servicing Payments to Per Capita Income

In Percentage

States	Plan Periods				
	III	AP	IV	V	VI
Punjab	2.7	1.7	1.9	2.6	2.1
Haryana	3.0	1.9	3.0	2.3	1.9
Maharashtra	1.0	1.0	1.9	1.4	1.1
Gujarat	1.3	1.0	1.8	1.9	1.2
West Bengal	1.4	0.8	2.6	2.4	3.2
GROUP	1.5	1.1	2.1	2.1	2.0
Tamil Nadu	2.0	1.7	2.5	1.5	1.8
Kerala	3.2	1.6	3.3	2.5	1.6
Orissa	3.8	2.7	4.5	2.7	2.8
Assam	3.1	2.5	6.1	3.0	2.4
Karnataka	2.2	1.9	3.5	2.1	2.6
Andhra Pradesh	3.0	2.2	3.7	2.2	2.5
GROUP B	2.7	2.0	3.6	2.0	2.1
Uttar Pradesh	1.7	1.2	2.6	2.4	2.6
Rajasthan	3.8	3.0	6.6	3.4	5.6
Madhya Pradesh	2.4	1.9	3.0	1.8	2.0
Bihar	2.2	1.5	2.8	3.3	2.7
GROUP C	2.2	1.5	3.2	2.6	2.9
Himachal Pradesh	3.5	--	2.6	3.3	1.6
Jammu Kashmir	6.1	0.4	14.0	9.5	7.4
Tripura	--	--	4.0	2.2	0.6
Manipur	--	--	5.8	5.5	7.1
Nagaland	--	1.5	4.6	9.5	4.6
Meghalaya	--	--	3.0	1.5	1.5
GROUP D	4.7	0.8	7.1	5.5	4.0
ALL STATES	2.2	1.6	3.0	2.3	2.3

<u>Notes</u>:

1. Debt Servicing Payments are inclusive of interest payments.
2. Per Capita Income estimates are those of Central Statistical Organization.
3. Income estimates for the Third Plan relate to 1962-63, for Annual Plans to 1967-68, for Fourth Plan to 1971-72. For Fifth and Sixth Plans they relate to 1975-76, the latest year for which C.S.O. estimates are available. Source of State Income Data: Majumdar Grace & Kapoor, J.L., "Behaviour of Inter-state Income inequalities in India", *Journal of Income and Wealth*, Jan. 1980, p.6.

For Data relating to annual debt servicing payments, *Reserve Bank of India Bulletin*, op.cit.

Commenting on the [illegible] t servicing problems of the develo ing nations, the Pearson Commission Report observ

> The accumulation of excessive debt is usually the combined result of errors of borrower governments and of their foreign creditors. Failure on the part of the debtors will be obvious. The responsibility of foreign creditors is more rarely mentioned."[3]

Without forgetting that there is a definite distinction to be made between loans from international development agencies or the developed nations to the less developed ones and the loans from the Central Government to the States in a developing country, it can still be noted that in the ever increasing burden of debt servicing faced by the Indian States, especially the poorer among them, the role of the creditor Central Government cannot be minimised. It should be noted that in a vast country like India, the Central Government bears a special obligation to the less developed States as per the objectives of development laid down by the Planning Commission and the philosophy of planning adopted by the National Development Council. To quote the Pearson report again:

> ". Economic growth in many developing countries calls for large and sustained investment in areas where increased productivity is not immediately reflected either in increased revenue (e.g., education, roads, agriculture, public health, research etc.) or a sufficient improvement in balance of payments."[4]

Therefore, they had urged that future development assistance be extended on highly concessional terms.

> The terms of official development assistance loans should provide for interest of no more than 2 per cent, a maturity of between 25 and 40 years and a grace period from 7 to 10 years. It is to be understood that while the length of the maturity and grace period may vary according to the circumstances of the borrowing country, developing countries with very low income per head should receive the most favourable terms".[5]

The World Bank group is already implementing this policy. While the International Finance Corporation (IFC) and the International Bank for Reconstruction and Development (IBRD) charge near commercial rates, the International Development Association (IDA), the soft loan associate of the IBRD makes only a service charge of 0.75 per cent and the poorer among the developing countries share most of these loans. Even International Monetary Fund has its Trust Facility under which hard core developing countries are given loans on very concessional rates. Even in bilateral credit, this principle has been implemented to a large extent. The weighted average interest rate on official bilateral commitments of DAC countries in 1968 was 3.3 per cent. In fact, many DAC countries like Canada, Norway, Sweden and United Kingdom charged less than 3 per cent.[6] The principle of differential interest rates and differential maturity has been accepted by the commercial Banks and the term lending institutions under the Union Government ownership in India too.

Interest Rate Structure

As against the trend for the softening of the terms of official multilateral and bilateral aid, particularly to hard core developing countries, the lending rates of the Central Government's loans to States in India have been going up.[7] What is more, the Centre, till recently, was charging more on its loans than it was paying for its borrowed funds as may be seen from Table VIII-8. Even now the Central Government charges more interest rates on IDA funds lent to the States which it has received on concessional terms. It may also be noted that the Centre's interest rates have been very regressive, as may be seen from the negative correlation between the per capita State income and the rates of interest given in table VIII.15. In 1960-61, the first year of the Third Plan, it was the high income States which were paying more than all the other groups of States. In the final year of the Third Plan, the first year of the Fourth Plan and the second year of the Sixth Plan, the low income States were paying higher interest rates on Centre's loans than both the high and middle income States. In the final year of the Fourth Plan, the low income States were still being charged higher interest rates than the high income States, though lower than the middle income States. The rates of interest on loans to special category States, however were generally lower (see Table VIII-9).

TABLE VIII.8

Comparative Interest Rate Structure of Centre and States

(in percentages)

Years	On Centre's Liabilities	On Centre's Loans to State Governments
1960-61	1.2	2.8
1965-66	3.3	3.7
1969-70	3.1	5.0
1973-74	3.6	4.7
1975-76	4.1	4.5
1978-79	4.6	4.2
1980-81	4.7	.3

Sources: 1) "Finances of Central Government", Reserve Bank of India Bulletin, different issues for different years.

2) "Finances of State Governments", op.cit. for various years.

3) "Report on Currency and Finance" op.cit. various years.

TABLE VIII.9

Estimated Rates of Interest on States' Loans from Centre

In Percentage

States	1960-61	1965-66	1969-70	1973-74	1980-81
Punjab	4.2	2.4	4.5	4.7	5.0
Haryana	--	--	4.9	4.3	5.6
Maharashtra	3.9	3.8	4.8	4.5	4.2
Gujarat	2.9	3.8	4.9	4.2	4.7
West Bengal	2.0	3.2	3.4	4.1	4.2
GROUP	3.2	3.2	4.3	4.3	4.5
Tamil Nadu	3.1	3.6	4.8	4.8	4.3
Kerala	3.0	3.4	5.1	4.9	3.4
Orissa	1.2	3.5	4.7	4.2	3.9
Assam	2.5	3.3	4.8	6.5	2.7
Karnataka	2.8	3.9	4.9	4.8	4.5
Andhra Pradesh	2.3	3.5	5.0	4.9	4.1
GROUP B	2.4	3.5	4.9	5.0	3.9
Uttar Pradesh	3.4	3.7	5.0	4.4	4.3
Rajasthan	3.2	5.5	5.0	5.3	4.1
Madhya Pradesh	2.7	3.8	4.9	4.9	4.0
Bihar	2.4	5.4	5.0	4.4	5.9
GROUP C	3.0	4.5	5.0	4.7	4.6
Himachal Pradesh	--	--	--	4.3	2.4
Jammu Kashmir	0.4	0.	11.3	4.3	5.0
Tripura	--	--	--	3.9	1.6
Manipur	--	--	--	4.1	2.2
Nagaland	--	--	5.5	4.9	0.3
Meghalaya	--	--	--	9.1	1.8
Sikkim	--	--	--	--	3.2
GROUP D	0.4	0.4	13.5	.3	3.2
ALL STATES	2.8	3.8	5.0	.7	3.9

Sources: 1. Finances of State Governments, op.cit.
2. Report on Currency and Finance, op.cit. for various years.

It may be conceded that the interest rates paid by the States on Central loans were lower than those paid for its market borrowings or institutional borrowings or unfunded debts. But the cost of market borrowings to the States was much more than for the Centre. This is seen by the running yield of State Government securities which was higher than that of Central Government securities during the last seven years ending 1980-81. Similar differences were seen in the redemption yields too till 1978-79.[8]

The interest rates were higher for the State Government securities though the maturity periods of their loans were shorter than those of Central Government loans. The weighted average maturity period of Central Government securities issued in 1980-81 was 20 years, whereas the maturity period of all State Government securities was only 12 years.[9] Taking into account the fact that it is the Reserve Bank of India which is the Manager to the issue for both tiers of government and the principal subscribers are (mostly or all) all public sector financial institutions, the additional costs incurred by the State Governments are difficult to justify.

The Centre was borrowing long from the market and lending short to the States. What is more, the Centre was charging higher rates on the States, for these relatively short-term loans.

Maturity of Loans

It would be difficult to arrive at a weighted average maturity period for the 12,000 and odd individual loans advanced by the Centre to the States. So the ratio of repayment instalments to the aggregate debt servicing payments has been adopted in this study as an approximate indicator for the change in the maturity pattern. This indicator has been used by others in the international context.[10]

The ratio of repayment instalments to aggregate debt servicing of the Centre has steadily come down from 61.8 per cent during the Second Plan to 21.4 per cent during the Sixth Plan as may be seen from table VIII.10. The ratio for State loans from the Centre on the other hand went up from 64.8 per cent in the Second Plan to 69.3 per cent during the Fourth Plan. This ratio went up, inspite of the hardening of the interest rates. It came down during the Fifth and the Sixth Plans, thanks to the debt rescheduling effected on the recommendations of the Sixth and the Seventh Finance Commissions. But for this debt rescheduling, this ratio would have been 70.2 per cent during the Fifth Plan and 65.3 per cent during the Sixth Plan.

Details of the maturity period of some of the loans extended during the Fourth Plan are available. The block loans under the Gadgil formula extended during the Fourth Plan were repayable in 15 years, starting from the first anniversary of the loan. Loans for relief of distress

TABLE VIII.10

Ratio of Repayment Instalments to Aggregate Debt Servicing Payments - 1956-81

(In percentages)

Plan	Centre	States
Second Plan	61.8	64.8
Third Plan	47.7	66.1
Annual Plans	44.7	66.2
Fourth Plan	44.9	69.3
Fifth Plan	28.5	60.5
Sixth Plan	21.4	55.5

Sources: 1) "Finances of the Central Government," op.cit.
2) "Finances of State Governments," op.cit.

caused by natural calamities were repayable within ten years. The special accommodation loans extended to the States during the Fourth Plan were repayable in ten equal instalments. The overdraft loans and loans for meeting gaps in resources were repayable in six years.[11]

In contrast, it may be noted that the weighted average maturity level of official bilateral loan commitments of DAC countries who are members of the Organization for Economic Cooperation and Development in 1968 was 25 years with a weighted average grace period of 6.5 years.[12] The Pearson Commission as also the DAC have recommended further softening of the period of repayment of these bilateral loans The period of repayment of IDA loans for which India is the major beneficiary is still longer.[13]

There was no weightage in favour of the poorer States in the Centre's loan operations. In fact, during the Second, Third and Annual Plans, the correlation between the per capita income and the ratio of repayments to aggregate debt servicing payments was negative, signifying longer maturity for States with high incomes. From the Fourth Plan onwards, this trend, however, has been reversed. During the Second, Third and Annual Plan periods ~~when Plan assistance~~, the ratio was the lowest for high income States as may be seen from Table VIII-11. During the Fifth and the Sixth Plans, it was the lowest for middle income States, largely on account of the debt relief. This ratio was the lowest for the Group C States, among the non special category States only during the Fourth Plan.

Ratio of Repayment instalments to Aggregate debt Servicing Payments, 1956-81

In Percentage

States	Plan Periods						
	II	III	AP	IV	V	VI	All
Punjab	40.1	57.5	64.3	63.6	78.8	67.3	68.6
Haryana	40.1	57.5	70.2	72.5	66.5	63.3	66.3
Maharashtra	59.3	55.0	61.3	70.4	64.5	41.6	61.9
Gujarat	60.1	52.4	62.3	68.0	69.2	43.7	63.6
West Bengal	1.7	55.0	61.3	67.1	61.1	62.4	62.1
GROUP	48.1	55.4	63.2	68.6	66.6	56.4	63.7
Tamil Nadu	77.9	72.0	73.0	76.2	60.1	60.3	69.0
Kerala	78.4	[illegible]	64.0	70.3	62.2	43.6	65.1
Orissa	54.8	56.5	62.6	65.0	46.9	43.0	55.1
Assam	56.1	77.4	73.7	72.7	44.1	41.7	61.2
Karnataka	66.0	68.6	71.9	76.7	62.3	65.7	69.3
Andhra Pradesh	78.3	79.5	67.9	72.6	55.7	52.7	65.8
GROUP B	72.5	73.0	68.9	72.7	56.1	53.5	65.0
Uttar Pradesh	62.2	63.7	65.8	69.4	63.7	50.5	62.8
Rajasthan	62.7	68.0	70.2	71.6	46.2	71.2	64.5
Madhya Pradesh	82.2	65.8	66.3	70.5	59.4	50.3	64.3
Bihar	54.4	63.8	57.1	56.3	65.8	50.0	59.9
GROUP C	67.1	65.1	65.1	67.6	60.4	55.9	62.8
Himachal Pradesh	40.1	57.5	--	48.1	48.6	34.3	47.3
Jammu & Kashmir	98.1	73.8	65.5	59.8	43.9	41.0	54.0
Tripura	--	--	--	57.3	40.8	54.0	54.5
Manipur	--	--	--	58.9	54.9	73.4	61.2
Nagaland	56.1	77.4	--	36.2	70.3	81.6	65.0
Meghalaya	56.1	77.3	73.7	69.3	33.3	76.9	64.1
Sikkim	--	--	--	--	47.5	59.6	59.0
GROUP D	81.0	71.0	65.2	57.9	47.4	48.5	54.3
GRAND TOTAL	64.8	66.1	66.2	69.3	60.5	55.5	63.4

Sources: Reserve Bank of India, "Finances of State Governments," op.cit.

The Pearson Commission's observations on the responsibility of both the debtor and the creditor in the mounting debt service problems of the States was noted earlier. The debtor country or the debtor State finds it difficult to service the debts if the debt amounts have been spent in financially unproductive ventures, which need not necessarily be unproductive, if one takes the long term development perspective and the social and aconomic benefits accruing from it. These benefits are very rarely reflected in the commercial cost-benefit ratios or are reflected only in the long run. Many of the investments in human capital or social overheads are productive only after comparatively longer gestation periods unlike the directly and immediately productive investments. But the directly productive investments which are commercially remunerative are indirectly dependent on the existence of a critical minimum level of social overhead capital. The hard core developing countries or their counterparts among the Indian States perforce will have to invest larger proportion of the loans received in economically productive but commercially non remunerative ventures with longer gestation periods. So a larger proportion of the fiscal transfers to the poorer States will have to be in non repayable forms. Even when loans are extended, the maturity and interest terms should be more concessional for those loans advanced to the poorer States. Unfortunately, for the poorer States in India, this well established principle has not been taken note of so far.

The Centre's lending norms and practices do not conform to that of a modern banker either. If the borrower of a bank lands himself in a liquidity crisis or gets into repayment difficulties, it can sometimes be traced to the mistake of the banker in prescribing shorter repayment schedules and grace periods which do not correspond with the funds flow of the venture. The interest rates and maturity periods of Central loans to States have not been fixed either on the basis of the end use of funds or on the basis of their financial productivity. It is with the help of patterns of assistance that the loan and the grant components of Central assistance to be released against each head of development in the State Plan are determined. These patterns do not take into account the financial remunerativeness of schemes". As the Seventh Finance Commission estimated, the percentage of Central loans utilised for 'non productive purposes - which are unlikely to generate returns sufficient to cover interest charges much less of repayment instalments - ranged from 40 to 100 per cent in the case of some of the special category States. Even in the case of other semi productive and productive loans, the repayment fixed is unrealistic and arbitrary.[14] For instance, the block loans given in the Fourth Plan are repayable within 15 years, with a grace period of one year.[15] What is worse, the terms of repayments are uniform for all States irrespective of their different stages of development or the nature of investments proposed by each State. These

terms imply that these loans will generate resources equal to one fifteenth of the loan amount plus interest within one year in all States. This may be possible only if the State governments were to utilise the loans for trading, that too in fast moving commodities. Loans for relief of distress caused by natural calamities are repayable in ten years. Even if it is assumed that all these loans are utilised for creation of physical assets, it would still be unrealistic to assume that they would generate enough revenues to meet both interest and repayment schedules in ten years. As pointed out by the study group of the Administrative Reforms Commission, "the standard period of 15 years and the upper limit of 25 years prescribed for the period of repayment are based on the periods of maturity of medium and long term market loans and are not related to the capacity of the schemes financed to yield returns."[16]

The loans are granted not only for building up of physical assets, but also for meeting the revenue component of the State Plan Outlays which very often are not worked out with any degree of accuracy. "Another drawback in the present scheme of financing is that there is no attempt to determine separately the gap between the revenue component of its Plan Outlay and to cover the gap by revenue grant assistance. The result is that a State is sometimes forced to finance its revenue Plan expenditure from capital funds. This is not sound financial practice".[17]

Till the beginning of the Fourth Plan, loans were being granted for State Plans on the basis of the 'schematic patterns of assistance'. If these patterns do not take into account the financial remunerativeness of the schemes, the mistake obviously cannot be attributed to the States. A large number of Central and Centrally sponsored schemes with varying loan grant contents are implemented more at the behest of the Union Ministries than at the request of the State Governments. As the Administrative Reforms Commission Study Group asked, "what will happen to the national Plan if the States decline to implement these schemes on the grounds of unfavourable patterns of assistance."[18]

A striking feature of this process of Plan formulation in the States pointed out by the Administrative Reforms Commission is that till the end of the Plan formulation stage, the Centre and the States are thought of as partners in a common endeavour. The ostensible aim is to assist each State according to its developmental needs, such needs having been determined in the national Plans. A State, when assured of a certain quantum of Central assistance for its plan, is committed to its execution. There can be no question of a State backing out on the plea that the Central loan assistance earmarked for it will prove unduly burdensome. A logical corollary of this partnership would be to ensure an equitable sharing of the repayment obligations which the capital resources distributed bring in their wake. But the present scheme of financing is not designed to ensure this. "Consequently when the Plans

are implemented and plan assistance is released, a relationship of partners is transformed into a creditor-debtor relationship. Herein lies the anomaly which has placed an unduly heavy burden of outstanding loans on the States.[19]

One peculiarity of the creditor debtor relationship between the Centre and the States is that the Centre, unlike the ordinary creditors, partakes in the profits generated besides getting back the principal and interest. For, the economic development financed by the loans also adds to the buoyancy of Centre's revenues. As the Administrative Reforms Commission Study Group notes, "as a sharer in the fruits of such projects in the States, the Centre cannot, in fairness to States, absolve itself of all responsibility for shouldering a reasonable portion of the repayment obligations".[20] As it is today, the Centre is in an enviable position of a banker who is also entitled to dividends.

For the purposes for which it gives grants, if undertaken directly by it, the Centre only gives loans if it is undertaken by the States. For example, Centre's civic expenditure is financed by capital grants whereas similar expenditure in the States are financed by loans[21] A substantial part of Central government's expenditure on industry is financed by equity contributions. Some of the Centre's pet schemes for slum clearance and rural housing are financed by grants. But if the same schemes are undertaken by the States in a flood or cyclone devastated area, the mode of financing is loans, repayable in ten years.

The Need for Debt Relief

Fears are often expressed that any substantial debt relief of the existing loans and the softening of the terms of future loans might adversely affect the Centre's finances. To the extent, debt relief leaves the States with non Plan revenue and capital surpluses, the requirement for Centre's loans for State Plans and grants under Article 275 will correspondingly be reduced. The States' own resources can then substitute the Centre's Plan assistance. In other words, it is not only that the Centre's receipts from the States which will come down as a result of debt relief but also that its need for further disbursements in the States would be affected. The change does not matter for the States also as they are more concerned with net flows (than with gross flows) in relation to their Plan and non Plan requirements. The savings in the ever increasing army of book keeping personnel employed unproductively to keep accounts of the tapering flow of net loans would not also be an insignificant advantage.

An aparently sound objection raised by the Sixth Finance Commission was that the debt servicing payments add to the Centre's pool of resources which are amenable for redeployment in favour of the poorer States.[22] But the basic assumption here is that the repayments due are more from the richer States. This is not always true as may be seen from the very weak though positive correlation between outstanding debt and per capita State income. Even in

simple per capita terms, the outstanding debt position of States shows a mixed pattern. The per capita outstanding debt to the Centre at the end of March 1974 and March 1979 given in Table VIII-12 shows that it was the highest for special Category States than for all other categories. So a complete writing off will help these poorest States the most. It is admitted that such a step would have benefited the middle income and the high income States more than the low income States, during the Fifth Plan as well as the Sixth Plan. But some of the poorer States like Rajasthan with its highest per capita debt outstanding would have benefited the most out of such a step. Bihar and Uttar Pradesh would have benefited more than Gujarat, Maharashtra and Tamil Nadu as the per capita outstanding debt was more for the former States. Besides, as noted earlier, though per capita debt outstanding is marginally smaller for the low income States, their debt burden in relation to their capacity to service these debts is higher. What is more, the inter-State differences in advantages arising out of such a step aree not as high as not being amenable to be corrected while allocating current resources by both the Finance Commission and the Planning Commission. "To the extent that the correction of past imbalances in resource transfers is called for, it can effectively be done through the allocation of currently transferable funds without them being supplemented by recoveries of past loans."[23] Besides as Gulati asks, "if the argument were to be pursued to its

Rs. per Capita

States	Loans Outstanding at the end of		Non Plan Capital Gaps			Debt Relief		
	Mar.74	Mar. 79	V	VI	Total	V	VI	Total
Punjab	179.3	295.2	-13.7	82.9	69.2	11.2	36.3	47.5
Haryana	230.1	313.8	53.6	67.9	121.5	33.0	29.8	62.8
Maharashtra	136.1	199.8	- 9.1	26.0	16.9	13.2	25.6	38.8
Gujarat	131.1	199.3	8.4	41.8	50.2	13.6	31.8	45.4
West Bengal	183.5	314.8	34.6	41.7	76.3	32.3	35.2	67.5
GROUP A	160.2	251.6	11.4	41.9	53.3	20.3	31.0	51.3
Tamil Nadu	103.4	189.1	22.1	30.3	52.4	21.1	10.3	31.4
Kerala	171.9	256.2	58.8	61.9	120.7	51.4	45.3	96.7
Orissa	234.7	326.7	78.4	66.8	145.2	71.7	36.7	108.4
Assam	274.9	411.6	119.8	75.7	195.5	41.1	56.4	167.5
Karnataka	154.3	229.7	45.0	38.9	83.9	43.4	10.7	54.1
Andhra Pradesh	159.1	246.9	51.6	50.9	102.5	44.0	25.4	69.4
GROUP B	166.0	255.5	53.5	49.7	103.2	48.6	26.1	74.7
Uttar Pradesh	103.7	222.3	19.5	53.5	73.0	17.1	33.2	50.3
Rajasthan	295.4	374.1	112.0	82.1	194.1	100.2	40.5	140.7
Madhya Pradesh	100.6	178.1	17.9	47.0	64.9	20.9	28.3	49.2
Bihar	132.9	219.7	26.4	46.8	73.2	23.7	26.2	49.9
GROUP C	134.1	231.4	32.2	54.2	86.4	29.7	31.3	61.0
Himachal Pradesh	404.6	442.2	116.2	82.8	199.0	99.9	71.7	171.6
Jammu & Kashmir	714.7	1329.9	308.2	306.4	614.6	289.0	225.7	514.7
Tripura	289.2	263.5	91.6	39.8	131.4	92.2	51.2	143.4
Manipur	382.1	531.2	142.7	102.6	245.3	141.9	82.6	224.5
Nagaland	484.5	910.9	111.2	206.9	318.1	113.2	240.5	353.7
Meghalaya	79.1	247.0	76.2	52.8	129.0	75.4	44.7	120.1
Sikkim	--	--	--	24.7	24.7	--	20.9	20.9
GROUP D	473.3	753.0	181.2	163.9	345.1	169.6	131.7	301.3
GRAND TOTAL	159.0	256.4	36.8	52.1	88.9	36.4	32.0	68.4

For Col. 1-2 Report on Currency & Finance, Vol. 1980-81 and Vol. II p.126.
3- Report of the Sixth Finance Commission, op.cit. 0.83.
6 Ibid. p. 25.
4 Report of the Seventh Finance Commission op.cit. 262.
7 Ibid. p. 116.

logical conclusion it should lead one to ask that all Central transfers should be made to the States in the form of loans because the criteria which are acceptable tomorrow may not be the same as the criteria of today."[24] The States falling into a debt trap and Centre falling into a creditor's trap are not necessary for achieving equity in fiscal transfers. The real tragedy in India today is that no attempt is being made to correct the inequities in the past allocation while making current allocation of resources.

A *via media* solution was suggested by the Study Team of the Administrative Reforms Commission. The Study Group suggested that all financially unremunerative schemes should be financed by grants - revenue and capital - All financially remunerative schemes should be financed by non repayable loans but carrying interest. But to be effective, the rates of interest and repayment schedules will have to be fixed on individual loans, taking into account the financial remunerativeness and the time span in which project will recoup the investment made. The creditor's control will be effective only if it is itemised. Such itemised control on sanctions and subsequent follow-up may lead to interference in the day to day administration of States, the results of which, judged by the itemised control under the 'schematic patterns of assistance' prior to the Fourth Plan are none too encouraging. Besides, the vast array of the existing book keeping personnel will have to be supplemented by control personnel, the nature of whose

control will be more than that of a banker.[25] It is doubtful whether such controls over the States by the Centre is desirable or necessary in addition to the existing controls by the audit and the legislatures.

Debt Relief by the Sixth and Seventh Finance Commissions

Even with their perception of opportunities available for redistribution of the loan funds coming back from the States, the Sixth and the Seventh Finance Commissions were compelled to go in for massive debt rescheduling. For, the existence of huge non Plan capital gaps with the States left them with only two alternatives,viz., to go in for unauthorised overdrafts or to utilise the additional resources mobilised by them for reducing non Plan capital gaps instead of utilising them for financing their Plans. It may be recalled that the Central Government, in order to maintain the States' agreed Fourth Plan outlays had to resort to concealed debt relief in the form of loans to clear as also to avoid overdrafts (loans for meeting gaps in resources, including special accommodation loans). Such adhoc non Plan loans given at the instance of the Union Government amounted to Rs.1,500 crores in the Fourth Plan. "All this assistance was, except in name debt rescheduling" as the Sixth Finance Commission correctly recognised.[26]

The Sixth Commission was asked by the Union Government for the first time to suggest changes in the existing terms of repayment having regard . to the size of the overall non Plan gaps of the States, their

relative position and the purposes for which the loans have been utilised and the requirements of the Centre."[27] But the Finance Commission did only a holding operation and did not examine the problem of States' debt burden from the long range point of view, possibly because of the time constraint. On the admission of the Sixth Finance Commission itself, "their proposals for debt relief are concerned primarily with mitigating the burden of repayment in the Fifth Plan period and that they do not make an enduring contribution to the long term issues of unsatisfactory creditor debtor relationship between Centre and States."[28] Perhaps, a better forum to find a long term solution to this problem would have been the Special Enquiry Committee recommended by the ARC Study Team.[29]

The Sixth Commission recommended debt relief aggregating Rs.1,970 crores for the entire Fifth Plan period mostly in the form rescheduling. In an indirect way, the Commission had also provided for the interest burden while calculating the non Plan revenue gap and trying to fill these gaps by means of Article 275 grants. That the Commission could only scratch the surface of this problem is evident from the fact even with Commission's debt rescheduling, three States faced the problem of nil or negative loan transfers. It is true that, in the absence of debt relief, seven more States would have faced the problem of negative transfers during the Fifth Plan.

Table VIII-12 gives the per capita debt relief recommended by the Sixth and the Seventh Finance Commissions to various States, as als the per capita non Plan capital gaps and outstanding debts (at the end of the Fourth and Fifth Plans). The Table shows that the debt relief recommended in per capita terms justifiably favoured the special category States the most and the high income States the least. But among the non special category States, the Commissions' recommendations benefited the middle income States more than the low income States. Within the groups, there were considerable inequitous inter-State variations too. During the Fifth Plan, the per capita debt relief to Haryana and West Bengal was more than that to Uttar Pradesh, Madhya Pradesh and Bihar. During the Sixth Plan, the per capita debt relief to Punjab and West Bengal was more than that to all low income States, barring Rajasthan.

The argument of the Sixth Finance Commission that debt servicing payments from the States to the Centre add to the resources of the Centre and thus provide an opportunity to utilise them for redeployment on a more equitable basis than in the past was referred to earlier. Despite this right perception, the Sixth as also the Seventh Finance Commissions merely applied their traditional gap filling approach to the non Plan capital gaps.

Like the non Plan revenue gaps, the non Plan capital gaps too are not true reflections of the economic backwardness of States or their resource raising capacity.

Besides, even when the gap filling approach suggested no debt relief to some of the developed States like Punjab, and Maharashtra which had surpluses in their non Plan capital acc unts, the Sixth Commission was still guided by the 'need to give every State some minimum relief'. For a large variety of loans, the Commission's approach partly influenced by its terms of reference was to give uniform debt relief, leading to augmentation of non Plan capital surpluses of the above two States. The Commission's discriminatory approach was confined to loans for irrigation and power projects, loans for natural calamities, special accommodation loans, miscellaneous development loans and block loans. In the case of loans for major irrigation and power projects, aggregate debt burden of the concerned State in relation to its general economic position was only one of the many considerations, the others being the stage of execution of the projects, the amounts outstanding and the terms already in force. With the limited importance given to discriminatory relief, the aggregate relief even in relation to the non Plan capital gap, was less favourable to the poorer States as may be seen from Table VIII-13. While the Commission covered more than the gaps of the high income States, its coverage was only 90.7 per cent of the group B States's gaps, 92.0 per cent of the group C States's gaps and 93.6 per cent of the group D States's gaps. Even excluding the surplus States, in group A, the debt relief covered 92.6 per cent of the non Plan gap of the other three high income States. In fact, the Commission more than covered the gap of Gujarat and left it with a large capital surplus.

Figures in Percentages

States	Plan Periods		
	V	VI	Total Gaps
Punjab	82.0	44.1	68.6
Haryana	61.6	43.5	51.7
Maharashtra	145.1	98.7	229.6
Gujarat	162.2	76.1	90.4
West Bengal	93.4	84.5	88.5
GROUP A	178.3	73.9	96.2
Tamil Nadu	95.7	34.2	59.9
Kerala	86.6	73.2	80.1
Orissa	91.5	54.7	74.7
Assam	92.7	74.4	85.7
Karnataka	96.2	27.8	64.5
Andhra Pradesh	85.2	50.0	67.7
GROUP B	90.7	52.50	72.4
Uttar Pradesh	87.5	62.0	68.9
Rajasthan	89.5	49.3	72.5
Madhya Pradesh	117.0	60.0	75.8
Bihar	89.7	56.0	63.2
GROUP C	92.0	57.8	70.6
Himachal Pradesh	86.0	85.5	86.2
Jammu Kashmir	93.8	73.8	83.7
Tripura	100.7	134.3	109.1
Manipur	99.5	81.5	91.5
Nagaland	101.7	118.8	111.2
Meghalaya	99.1	85.6	93.1
Sikkim	--	84.6	84.6
GROUP D	93.6	80.5	87.3
ALL STATES	98.7	61.4	76.9

Sources: For Col.1 Report of the (Sixth) Finance Commission. op.cit. p.83, 95.
For Col. 2 Report of the (Seventh) Finance Commission, op.cit. p.262, 116.

The Seventh Finance Commission too did not fare any better in bringing about more equity in debt relief. The Commission which filled 73.9 per cent of the gap of the Group A States filled only 57.8 per cent of the gap of the group C States. The coverage of group B States' gap was even lesser. While the coverage was as high as 98.7 per cent for Maharashtra, it was only 27.8 per cent for Karnataka. Thus the Finance Commissions failed even to do what they had been doing with the non Plan revenue gaps of States' budgets. What is worse, the size of the uncovered gaps was more for the low income States than for the high income States.

One of the major failures of the Finance Commission was its inability, either due to its terms of reference or due to its own other constraints to take equity considerations to their logical ends, by taking an integrated look at the non Plan revenue and capital gaps. As a result whatever revenue surpluses were left with the States after devolution of taxes shared were allowed by the Finance Commissions to be utilised by the States for financing larger plans. The same States, if they had gaps on non Plan capital account, were given debt relief to varying extent irrespective of the revenue surpluses they had. This had led to a situation where some States had an overall deficit in their non Plan account while some others had big surpluses which could be utilised to finance larger Plans. The right approach should have been to merge the revenue surpluses with the capital gaps and then to relate the debt relief to the overall surplus/deficit.

The result of this compartmentalised approach of the Finance Commission following the wrongly formulated terms of reference of the Union Government may be seen from Table VIII-14 which gives the surplus/deficit position in the aggregate non Plan budget. During the Fifth Plan, the high income States had an average surplus of Rs.102 per capita even before debt relief, while all other groups had deficits. While all States other than West Bengal in group A had surpluses before debt relief, only two States in group B (Tamil Nadu and Karnataka) and one State in group C (Madhya Pradesh) had any surpluses. The surpluses of these States outside group A were smaller than that of the high income States.

Even after the debt relief, all the deficit States continued to be deficit States. The only exceptions were Tripura and Nagaland which were left with very marginal surpluses. Thus while the debt relief continued to add to the surpluses of the already surplus States, it failed even to cover fully the overall gaps of the deficit States. In their case, the additional resources they mobilised, perforce had to be diverted for debt relief from Plan financing.

As a result of the Seventh Finance Commission leaving revenue surpluses with all the States, though to varying degrees, all but ten States had overall surpluses in non Plan account even before debt relief, inspite of the fact that all the States had a non Plan capital gap to

Non Plan Budgetary (Revenue & Capital) Surpluses (+) Deficits (-) of States 1974-1984

Rupees per Capita

States	Before Debt Relief Plans			After Debt Relief Plans		
	V	VI	Total	V	VI	Total
Punjab	266	403	669	277	439	716
Haryana	169	460	629	202	490	692
Maharashtra	158	453	611	171	479	650
Gujarat	117	290	407	131	322	453
West Bengal	- 35	94	59	-2	129	127
GROUP A	102	310	412	123	341	464
Tamil Nadu	23	105	128	44	116	160
Kerala	- 59	32	- 27	- 8	78	70
Orissa	- 78	- 55	- 133	- 7	- 18	- 25
Assam	- 120	- 21	- 141	- 9	35	26
Karnataka	34	233	267	78	243	321
Andhra Pradesh	- 52	126	74	- 8	151	143
GROUP B	- 29	92	63	19	118	137
Uttar Pradesh	- 20	132	112	- 2	165	163
Rajasthan	- 112	- 18	- 130	- 12	23	11
Madhya Pradesh	9	178	187	30	207	237
Bihar	- 26	119	93	- 3	145	142
GROUP C	- 27	118	91	3	150	153
Himachal Pradesh	- 116	- 65	- 181	- 16	7	- 9
Jammu & Kashmir	- 308	- 276	- 584	- 19	- 50	- 69
Tripura	- 92	- 22	- 114	1	29	30
Manipur	- 143	- 33	- 176	- 1	49	48
Nagaland	- 111	- 151	- 262	2	90	92
Meghalaya	- 76	- 16	- 92	- 1	29	28
Sikkim	--	- 4	- 4	--	17	17
GROUP D	- 181	- 133	- 314	- 12	- 1	- 13
ALL STATES	3	156	159	40	188	228

Source: 1. Report of the (Sixth) Finance Commission, op.cit. p. 83, 73, 95.
2. Report of the (Seventh) Finance Commission, op.cit. p. 116, 262, 146.

begin with. The States saddled with deficits even then were Orissa, Assam, Rajasthan and all the Special category States. Even after debt relief, Orissa and Jammu and Kashmir continued to have over-all non Plan gaps. The size of the overall surpluses also varied. The surpluses were the highest for high income States and the lowest for middle income States. Among individual States, Haryana followed by Maharashtra and Punjab had the largest surpluses, while Himachal Pradesh, Rajasthan, Tripura and Meghalaya had the least amount of surpluses. This inequitable position left behind by the Finance Commissions even after their debt relief operations is brought out by the high positive value for the rank correlation coefficients between per capita income and overall surpluses. During the Fifth Plan, the correlation was significant at one per cent level. During the Sixth Plan it was significant at five per cent level. This obviously is the best, though sad, commentry on the Finance Commission which had perceived a great opportunity for redistribution in the mounting debt service burden to States.

Rank Correlation Coefficients with Per Capita Income

	Plan Periods					
	II	III	AP	IV	V	VI
1. Per Capita Debt Servicing payments	+ 0.184	+ 0.179	+ 0.143	+ 0.125	+ 0.450	+ 0.217
2. Ratio of Debt Servicing to Gross Loans	+ 0.266	- 0.030	+ 0.218	+ 0.163	+ 0.018	+ 0.180
3. Ratio of Debt Servicing to Aggregate Expenditure	+ 0.025	- 0.334	- 0.325	- 0.408	- 0.321	- 0.454
4. Ratio of Debt Servicing to States' own total Resources	- 0.056	- 0.534	- 0.547	- 0.554	- 0.514	- 0.525
5. Rates of interest on Central Loans to States*	--	+ 0.340	- 0.513	- 0.571	- 0.285	+ 0.337
6. Ratio of Repayments to total debt Servicing payments	- 0.346	- 0.364	- 0.007	+ 0.036	+ 0.586	+ 0.275
7. Outstanding Loans from the Centre **	--	--	--	--	+ 0.111	+ 0.064
8. Overall Surpluses before Debt Relief	--	--	--	--	+ 0.704	+ 0.582
9. Overall Surpluses after Debt Relief	--	--	--	--	+ 0.711	+ 0.589

Notes: * Relates respectively to the years 1960-61, 64-65, 69-70, 73-74 and 1980-81.

** At the end of March 1974 and March 1979.

Notes and References

1. See footnotes to Table VIII.1.
2. See Col.1 and 2, Table VIII.12
3. Partners in Development (Report of the Commission on International Development -Chairman Lester B. Pearson), Pall Mall Press, London, 1969, p.156.
4. Ibid. p.156.
5. Ibid. p.164.
6. Ibid. p.385.
7. See Table VIII-8 and 9. The interest rates calculated in these tables are only approximations as they are worked out by using interest payments during an year and outstanding debt at the end of the year. When gross receipts of loans are increasing steadily, this method of computation has an element of understatement.
8. Reserve Bank of India, Report on Currency and Finance 1980-81, Bombay, 1981, Vol.II, p.87.
9. Computed from the data given in Report on Currency and Finance, 1980-81, Ibid. p.118.
10. "The predominant influence of principal repayments on changes in aggregate debt service is symptomatic of the length of debt owed by these countries . . . The rising share of repayments therefore suggests a shortening of the average effective period of repayments", See Dragoslav Avranovic and Ravi Gulhati, Debt Servicing Problems of Low Income Countries, John Hopkins Press, Baltimore, 1960 p.20.
11. Report of the (Sixth) Finance Commission, op.cit. p.93.
12. Partners in Development, op.cit. p.385.
13. Ibid. p.156.
14. For a definition of these terms as also for data, see Report of the (Seventh) Finance Commission, op.cit. p.113.

15. Repor [illegible] Sixth) Finance Com[illegible]ission, op.cit. p.94

16. [illegible] Reforms Commis[illegible]ion, Report of the Study on Centre-State Relationships, Government of India [illegible] 968, Vol. I p.51.

17. [illegible] .52

1[illegible] Ibi[illegible] p.50.

19. Ibid p.50.

20. Ibid. [illegible].2[illegible].

21. Ibid. p.51.

22. Report of the (Sixth) Finance Commission, op.cit. p.85

23. Gulati I.S., "Centre-State Financial Relations: Review of an Old Model" in ed. Krishnaswamy K.S., Society and Change, Oxford University Press, Bombay, 1977, p.231.

24. Ibid.

25. [illegible] suggestion to constitute a National Development Bank to route the Central loans to States was made by the Study Team on Financial Administration, appointed by the Administrative Reforms Commission. See Administrative Reforms Commission, Report of the Study Team on Financial Administration, Government of India, New Delhi, 1967 Vol. I. p.89-95. This suggestion was not acceptable to the Administrative Reforms Commission's Study Team on Centre-State Relationships, see Administrative Reforms Commission, Report of the Study Team on Centre-State Relationships, op.cit. p.64.

26. Report of the (Sixth) Finance Commission, op.cit. p.96

27. Ibid. p.84.

28. Ibid. p.85.

29. Administrative Reforms Commission, Report of the Study Team on Centre-State Relationships, op.cit. p.70.

CHAPTER IX

FLOW OF INSTITUTIONAL FINANCE

The Role of Institutional Finance

It was noted in Chapter II how the budgetary expenditure of States vary directly according to the per capita State incomes.[1] The reason for this was also considered viz., the failure of the budgetary transfer mechanism to correct the disequalising trends in the States' internal resources. As with public expenditure, expenditure in the household and corporate sectors, both for investment and consumption, also varies directly with State incomes. This is because of the fact that the savings and capital f formation in the corporate and household sectors are higher in the high income States. The profits ploughed back to business - both incorporated and non incorporated - which are the important elements of aggregate savings are likely to be higher in the more developed States. Personal savings also may vary directly according to State income. Therefore, higher levels of investment expenditure in the corporate and household sectors can be sustained in States with higher levels of per capita income even if the flows of private capital from the backward States to the developed States are not taken into account.

But fortunately in India, an institutional infrastructure has been built up under the Union Government's ownership and control which can, if so desired, act as a corrective to these disequalising trends. Firstly, the role of the capital market as providers of funds is small in India. Of the project costs of new companies which issued share capital in 1980, only 33.5 per cent was financed by issue of shares.[2] A large share of even this capital is contributed by the all-India financial institutions. Of the private capital issues subscribed in 1980, 23.1 per cent was by governments and financial institutions. Besides, no capital issue can succeed in India without underwriting by these institutions. The percentage share of amounts underwritten in the capital offered to public in 1980 was as high as 77.8 per cent.[3] Further, direct financing by these institutions accounts for a large share of the sources of funds of the Indian corporate sector. Of the project costs of new companies issuing capital, 57.8 per cent were met by these institutions. And these institutions now have a virtual monopoly over the financial savings of the community.

The disbursal of funds by these institutions has not been studied extensively from the Centre-State financial relations angle, though the importance of institutional financial flows in accentuating regional disparities was felt even earlier.[4] Firstly, most of these institutions have been established by, or transferred to the public sector under the Central Government for the explicit purpose of

implementing national objectives. Secondly, these institutions draw basically from the same pool of the community's resources as budgetary finance. Thirdly, most of these institutions rely heavily on the Union budget and the Reserve Bank of India for their funds. Fourthly, the volume of their disbursements in different States is quite high in comparison with the Union Government's disbursal of budgetary funds to State governments as may be seen from Table IX-2. Fifthly, the volume of finance from these institutions going to the States is very high in comparison with the States' own disbursements from their capital budgets, as may be seen from Table IX-1. The disbursements of these institutions in some of the sectors included in the State list in the Constitution are more than that of the State Governments out of their own budgets.

Table IX-1 brings out sharply the relative role of the financial institutions vis-a-vis the States' capital budgets in correcting regional disparities. It may be noted that these capital budgets themselves are largely financed by Union Government. The disbursal of funds by major development banks in 1978-79 in different States amounted to Rs.815 crores. During the same year, the combined capital outlay of these States on industry was only Rs.95 crores.[5] The States' combined capital outlay on industry and infrastructure together (power and transport) amounted to Rs.514 crores which was Rs.300 crores less than the annual disbursements by the development banks. The

Capital Disbursements of State Governments and State-wise Disbursements of Term Financing Institutions, ARDC and Commercial Banks during 1978-79

Rs. per Capita

States	Budgetary Outlay						Disburse ments by Develop-ment Banks	Disburse-ments by ARDC and term lend-ing to agriculture by Com.Banks
	Transport	Power	Total Physical infrastructure (1 + 2)	Industry	Industry & infrastruc-ture (3 + 4)	Agricul-tural and allied services		
Punjab	9.3	--	9.3	6.1	15.4	20.5	15.3	41.3
Haryana	8.3	--	8.3	2.0	10.3	1.8	26.7	50.5
Maharashtra	7.8	3.3	11.1	1.9	13.0	6.2	25.1	8.9
Gujarat	6.7	--	6.7	1.6	8.3	1.4	64.3	11.4
West Bengal	2.6	--	2.6	0.8	3.4	3.2	14.3	5.0
GROUP A	6.2	1.2	7.4	1.9	9.3	1.3	28.2	14.1
Tamil Nadu	2.9	--	2.9	1.7	4.6	0.8	16.3	3.9
Kerala	4.9	--	4.9	4.3	9.2	2.4	12.5	8.3
Orissa	6.5	--	6.5	0.9	7.4	7.8	5.5	7.2
Assam	10.9	--	10.9	1.4	12.3	6.9	2.9	2.0
Karnataka	2.1	0.02	2.1	2.4	4.5	5.9	21.8	13.6
Andhra Pradesh	4.4	9.7	14.1	3.7	17.8	4.2	15.6	14.7
GROUP B	4.5	2.5	7.0	2.5	9.5	4.1	14.1	9.1
Uttar Pradesh	5.5	--	5.5	1.2	6.7	3.7	8.8	11.8
Rajasthan	7.1	--	7.1	1.9	9.0	3.2	11.3	16.0
Madhya Pradesh	5.3	0.01	5.3	0.8	6.1	10.2	5.3	8.7
Bihar	5.3	Neg.	5.3	0.9	6.2	4.9	3.3	7.3
GROUP C	5.6	Neg.	5.6	1.1	6.7	5.3	6.9	10.5
Himachal Pradesh	58.4	--	58.4	2.9	61.3	10.0	14.7	3.6
Jammu Kashmir	27.9	10.1	38.0	7.6	45.6	13.1	13.2	1.4
Tripura	36.8	20.4	57.2	3.3	60.5	5.4	7.6	1.0
Manipur	77.8	39.0	116.9	7.1	124.0	36.8	0.3	4.6
Nagaland	135.3	50.0	185.3	11.8	197.1	1.7	0.4	0.2
Meghalaya	48.6	--	48.6	13.4	62.0	0.6	17.2	0.1
GROUP D	48.3	11.9	60.2	6.3	66.5	11.7	13.4	2.1
ALL STATES	6.4	1.4	7.8	1.9	9.7	4.0	15.0	10.8

Notes: 1. Investment Banks covered are (1) IDBI (2) ICICI (3) IFCI (4) IRCI (5) LIC (6) UTI and GIC.

Sources: 1. Finances of State Governments during 1979-80, RBI Bulletin - Sept. - Oct. 1979, p. 676-721.

2. IDBI, Operational Statistics 1978-79, p.160

3. ARDC, Annual Report 1980-81.

4. RBI, "Report on Currency & Finance, 1979-80, Vol.II, p.61, for Commercial Banking Data.

disbursal of term credit to agriculture by the Agricultural Refinance and Development Corporation (ARDC) and the Commercial banks in 1978-79 amounted to Rs.586 crores against Rs.217 crores provided by the States' capital budgets for agriculture and allied services.[6]

It can be seen from Table IX-2 that the institutional finance formed 43.0 per cent of the total financial flows to States comprising of budgetary transfers and funds flowing from the major financial institutions. It can even be argued that from the point of view of their impact, institutional funds are more important than is indicated by this ratio. While a high proportion of budgetary funds goes to cover the States' current consumption expenditure, almost all institutional funds are directly linked to investment and production.

This Chapter seeks to review the inter-State flows of institutional finance to show how progressive/regressive they have tended to be. This analysis however suffers from a number of limitations.

Limitations of the Analysis

Firstly, unlike in earlier Chapters, the period covered is only 7 years (1973-80). We were forced to select March/June 1973 as the starting period, due to the non availability of banking data on end use basis prior to December 1972. For the first time, the Reserve Bank of India started collecting credit data on end use basis

through the Basic Statistical Returns only for Dec. 1972. The data available for earlier years are compiled according to districts of sanction. In some States, the difference between credit on the basis of sanction and utilisation has been substantial due to outflow or inflow of funds. For instance, in Haryana utilisation of Credit was 189 per cent of the credit as per sanction whereas in West Bengal it was only 87 per cent. As the latest date for which State-wise data on commercial banks' investments are available is 31st March 1980 we were forced to limit the the study to the year 1979-80.

Second limitation arises out of the incomplete coverage of the institutions. Some exclusions have been made deliberately to avoid double counting, while others were made for want of sufficient information. For instance, the ways and means advances and overdrafts allowed by the Reserve Bank of India to the States have been excluded because they eventually get reflected in the Central budgetary flows. Similarly refinance granted by the Reserve Bank of India to commercial banks has also been excluded to avoid double counting. Advances by the Reserve Bank to the co-operative sector have not been included, as these loans which are of a short term nature get repaid within the period under the present review itself. The funds that are disposed of by organisations under different Union Ministries like the University Grants Commission, Central Social Welfare Board, Housing and Urban Development Corporation,

National Co-operative Development Corporation and various commodity boards, have been excluded for want of detailed information.[7]

The third limitation of the study arises * from aggregating net with gross flows. With respect to 74 per cent of the total institutional finance flowing from commercial banks, the position given is net of repayments and disinvestments. For the remaining 26 per cent, the position indicated is gross of repayments and disinvestments. Net figures for the term lending institutions are not available as the State-wise data on repayments are not compiled by them. On the other hand, gross figures of commercial bank credit and investments are just not collected. The fourth limitation arising from the problem of aggregating repayable with non repayable flows cannot be considered a major one, because there is already such a practice of aggregating in budgetary data. Secondly, it is the current availability of funds which is more important and only the total quantum of funds, whether it is in non repayable or repayable form, which will give the appropriate figure. Of course, loans do generate debt servicing problems in the long run.

State-wise flow of Institutional Finance

It can be seen from Table IX-2 that the ratio of institutional finance to total financial flows is the lowest (10.3 per cent) for special category States. As between the rest of the States, the corresponding ratio is the

Per Capita Centre-State Financial Flows 1973-80 - Budgetary and Institutional

Rs. Per Capita

State	Budgetary (Net)	Commercial Banks			Development Banks	ARDC	Total Institutional (4+5+6)	Institutional & Budgetary	Share of Institutions' finance in total
		Credit	Investments	Total (2+3)					
Punjab	491	734	42	776	78	87	941	1432	65.7
Haryana	447	446	74	520	113	123	756	1203	62.9
Maharashtra	412	618	49	667	151	30	848	1260	67.3
Gujarat	471	323	69	392	219	27	638	1109	57.5
West Bengal	498	321	49	370	70	9	449	947	47.4
GROUP A	459	472	54	526	129	35	690	1149	60.0
Tamil Nadu	402	327	38	365	97	19	481	883	54.5
Kerala	504	316	69	385	67	14	466	970	48.0
Orissa	659	85	35	120	31	18	169	828	20.4
Assam	749	92	40	132	35	6	173	922	18.8
Karnataka	388	315	34	349	122	35	506	894	56.6
Andhra Pradesh	492	213	30	243	59	45	347	839	41.4
GROUP B	497	244	38	282	74	26	382	879	43.5
Uttar Pradesh	500	121	28	149	37	28	214	714	30.0
Rajasthan	559	168	51	219	60	26	305	864	35.3
Madhya Pradesh	424	111	27	138	26	32	196	620	31.6
Bihar	445	83	26	109	23	20	152	597	25.5
GROUP C	477	115	30	145	34	26	205	682	30.1
Himachal Pradesh	1741	144	61	205	58	8	271	2012	13.5
Jammu & Kashmir	2087	163	74	237	77	1	315	2402	13.1
Tripura	1904	100	49	149	17	2	168	2072	8.1
Manipur	2886	50	91	141	5	8	154	3040	5.1
Nagaland	7052	84	280	364	35	4	403	7455	5.4
Meghalaya	2488	55	127	182	86	--	268	2756	9.7
GROUP D	2315	125	80	205	56	4	265	2580	10.3
ALL STATES	521	252	40	292	73	28	393	914	43.0

Notes and References:

For Col.1. Budgetary transfers = states' share in Central taxes + grants + fresh loans. Minus debt servicing payments.

For Col.2. Figures given for commercial bank credit represent difference between the outstanding credit at the end of June 1973 and that at the end of June 1980. Credit figures are according to the district of utilisation (ie. according to where the unit utilising the credit is located).

Sources: 1. Reserve Bank of India, "Basic Statistical Returns", June 1973 and June 1980.

For Col.3. Figures for commercial bank investments represent difference between the outstanding investments of commercial banks in the securities of state governments and other state associated bodies as at the end of March 1980 and March 1973.

Sources: 1. Reserve Bank of India, Statistical Tables relating to Banks in India (1973) and

2. Trends in Investments of Scheduled Commercial Banks," 1979-80, Reserve Bank of India Bulletin, Jan. 1982.

For Col.5. IDBI, Operational Statistics, various issues.

For Col.6. Annual Report of the Agricultural Refinance and Development Corporation.

States	Net Budgetary	Commercial Banks			Development Banks	Agricultural Refinance and Development Corporation (ARDC)	Total Institutional	Institutional and Budgetary
		Credit	Investments	Total				
					Index Numbers			
Punjab	94	291	105	266	107	311	239	157
Haryana	86	177	185	178	155	439	192	132
Maharashtra	79	245	123	228	207	107	216	138
Gujarat	90	128	173	134	300	96	162	121
West Bengal	96	127	123	127	96	32	114	104
GROUP A	88	187	135	180	177	125	178	126
Tamil Nadu	77	130	95	125	133	68	122	97
Kerala	97	125	173	132	92	50	119	106
Orissa	126	34	88	41	42	64	43	91
Assam	144	37	100	45	48	21	44	101
Karnataka	74	125	85	120	167	125	129	98
Andhra Pradesh	94	85	75	83	81	161	88	92
GROUP B	95	97	95	97	101	93	97	96
Uttar Pradesh	96	48	70	51	51	100	54	78
Rajasthan	107	67	128	75	82	93	78	95
Madhya Pradesh	81	44	68	47	36	114	50	68
Bihar	85	33	65	37	32	71	39	65
GROUP C	92	46	75	50	47	93	52	75
Himachal Pradesh	334	57	153	70	79	29	69	220
Jammu & Kashmir	401	65	185	81	105	4	80	263
Tripura	365	40	123	51	23	7	43	227
Manipur	554	20	228	48	7	29	39	333
Nagaland	1353	33	700	125	48	14	103	816
Meghalaya	478	22	318	62	118	--	68	302
GROUP D	444	50	200	70	77	14	67	282
GRAND TOTAL	100	100	100	100	100	100	100	100

Source: As in Table IX.2

highest for group A high income States (60 per cent), next higher (43.5 per cent) for group B, middle income States and the lowest (30 per cent) for Group C low income States. (see also Table IX-3). Thus, broadly speaking, the lower the per capita income ranking of a State, less important is the role of institutional finance in the total flow of finance taking place to such a State. This is confirmed by the positive correlation between per capita income and the share of institutional finance in aggregate financial flows given in Table IX.6. Of course, there are deviations from this trend within each group and the most significant of these deviations occur in group B. While for Tamil Nadu, Kerala and Karnataka, the ratio of institutional to total finance is significantly above the group ratio for Orissa and Assam it is significantly below the group ratio. That the deviations are most significant for group B is reflected also in the range of the ratios, For Group A, the range is narrower. For group C and D the range is still narrower.

The aggregate financial flows - budgetary and institutional- have been highly regressive as may be seen from the high value of the coefficient of rank correlation between per capita income and per capita financial flows. The group D States had received the largest amounts in per capita terms. But among the non special category States, it was the high income States which received the largest quantum of funds. The low income States received the least amount. The first five States which ranked high in the per capita income ladder were the ones which ranked

high in the matter of total finance. The ranks of Uttar Pradesh, Madhya Pradesh and Bihar were more or less the same in both receipt of funds and per capita income. Of the eight States which failed to get national average amounts four each belonged to the middle income and the low income groups. None belonged to either the high income group or to the special category. In other words, it is these two categories of States which benefited the most from financial flows taken in their totality. States like Kerala and Assam, ~~Karnataka and Rajasthan~~ belonging to ~~other~~ group B also received more than average sums.

As compared to the pronounced regressiveness of institutional finance, the budgetary financial flows showed no pronounced bias either regressive or progressive This is seen from the weak rank correlation.

The per capita amount of institutional finance received by the low income States was the lowest. The special category States fared only slightly better. It was the highest for group A States. The per capita institutional finance received by group A States was 181 per cent that of group B States and 337 per cent that of group C States. The per capita institutional credit of Punjab which received the maximum was 619 per cent that of Bihar. Only nine out of the 21 States (excluding Sikkim) received more than the average sums of institutional finance. Of these five belonged to high income group, three to middle income group, one to special category and none

to low income group. Conversely, of the States which failed to get the average sum of institutional finance, five belonged to special category, four to group C, three to group B and none to group A.

Among the States, Nagaland received more than average sums of both institutional finance and budgetary funds. Orissa and Rajasthan though they received more than average budgetary funds, got very little institutional finance and consequently they fared badly in overall financial flows. The States like Assam and the special category States other than Nagaland made up their deficits in institutional finance by budgetary transfers. On the other hand, all States in group A and Kerala made up their deficit in budgetary funds by receipt of institutional finance. Tamil Nadu and Karnataka were the only States in whose case the surplus in institutional finance proved inadequate to cover the shortfalls in budgetary flows. Four States viz., Andhra Pradesh, Uttar Pradesh, Madhya Pradesh and Bihar received inadequate budgetary funds and grossly inadequate institutional finance.

The role of financial institutions vis-a-vis the State budget as providers of capital funds for industry and infrastructure as may be noted from Table IX-1 was small for the low income States despite the smaller amounts per capita spent by them from their own budgets. A perusal of Table IX-1 shows that the States which can spare little

budgetary funds for capital investment in industry and infrastructure facilities on account of their poor resource base are left to fend for themselves by the financial - institutions to a greater degree than the more developed States.

Inter-State distribution of all the different streams of institutional finance shows more or less similar trends as may be seen from the high coefficient of rank, concordance for all the streams of flows (0.621). Of the total institutional finance, the commercial banks accounted for 74 per cent, the term lending institutions catering to industry for 19 per cent and Agricultural Refinance and Development Corporation for 7 per cent. In the succeeding paragraphs, the performance of each stream of institutional flows in fulfilling the objectives of equalisation is being examined.

Commercial Bank Credit

The State-wise distribution of commercial bank finance shows pronounced regressive trends as may be seen from the high positive value of the coefficient of correlation (+0.907). One finds that the per capita bank finance of group C States was only 28 per cent that of the corresponding figures for group A States (Rs.145 as against Rs.526), and one half of the corresponding figure for group B States (Rs.145 as against Rs.282). Bihar's per capita receipt of bank funds was only 14 per cent that of Punjab. One has to appreciate that the disparities noticed in this table

are in the incremental credit and investment and not in their outstandings. What is more, the incremental figures relate to the post nationalisation period.

A major argument advanced in favour of nationalisation of all except the small commercial banks in the country in 1969 was that it facilitates redeployment of bank finance to suit a policy of balanced regional development.

One of the major complaints levelled against the prenationalised banks was that these "banks mobilised resources in the form of deposits in certain areas and utilised them elsewhere thus aggravating regional imbalances".[8] It was argued at the time of nationalisation, that "these trends can be corrected and the policy of balanced regional development which has frequently been emphasised can be implemented when banks are under public control."[9] Table IX-4 which gives the State-wise ratios of bank funds to bank deposits, clearly show that even after nationalisation, banking system is serving as an instrument of redistribution not in favour of the poorer States but in favour of the better off States.

Table IX-4 is significant from another angle. In Chapter III, we had noted an argument that even with _per se_ regressiveness in transfers, some inter-State redistribution can take place in as much as the developed States get back only less than what they contribute to the Central pool and the backward States get back more than what they contribute. We had also noted the insurmountable data

Figures in Percentages

States	L.I.C. (1978-79) Investment Premium Ratio	Per Capita Investment	Commercial Banks (1973-80) Credit-Deposit Ratio	Investment Deposit Ratio	Credit+Investment Deposit Ratio	Proportion of banks' investments in total state loans outstanding as on March 1979
Punjab	42.1	11.1	75.5	4.3	79.8	60.5
Haryana	--	14.5	100.5	16.7	117.2	60.6
Maharashtra	20.6	5.9	74.3	5.9	80.3	51.8
Gujarat	40.9	9.5	51.5	11.0	62.5	54.3
West Bengal	22.5	3.3	55.4	8.4	63.8	46.3
GROUP A	--	6.8	67.1	7.6	74.8	--
Tamil Nadu	41.4	5.8	78.7	9.1	87.9	60.0
Kerala	53.5	6.9	67.1	14.7	81.8	55.7
Orissa	114.5	4.0	65.0	27.0	92.0	49.2
Assam	84.7	4.0	51.2	22.4	73.7	48.0
Karnataka	24.0	3.9	74.0	7.9	82.1	60.4
Andhra Pradesh	51.2	5.7	68.4	9.7	77.9	54.9
GROUP B	--	5.2	71.4	11.1	82.6	--
Uttar Pradesh	56.8	4.4	46.8	10.7	57.8	53.2
Rajasthan	72.3	6.8	76.0	23.1	99.1	57.5
Madhya Pradesh	56.2	3.3	56.9	13.6	70.5	49.4
Bihar	83.7	3.6	48.9	15.4	64.0	48.6
GROUP C	--	4.2	52.6	13.7	66.1	--
Himachal Pradesh	42.1	4.2	36.3	15.3	51.7	79.6
Jammu & Kashmir	--	10.0	28.9	13.1	42.0	81.2
Tripura	--	4.9	69.7	34.2	103.8	73.9
Manipur)	+ 84.7	5.1	29.5	53.7	82.8	74.1
Nagaland)		38.2	28.0	93.9	121.9	64.8
Meghalaya		27.2	16.4	37.9	54.3	92.7
GROUP D		9.7	31.7	20.3	51.9	--
GRAND TOTAL	41.2	5.4	64.3	10.2	74.7	54.8

Notes: 1. Premium figures for Punjab, Haryana, Himachal Pradesh, Jammu & Kashmir, Chandigarh and Delhi are not available separately. Premium figures for Assam and other North Eastern States and Union territories are not available separately.

2. Data relating to Union Territories are included in the data relating to the adjoining states.

Sources: For Col.1 and 2, Life Insurance Corporation of India, Annual Reports, 1977-78 and 1978-79.

For Col.3 and 4 and 5 as in Table IX.2

For Col.6 Trends in Investments of Scheduled Commercial Banks, R.B.I. Bulletin March 1981.

problems which make it almost impossible at present to test this argument empirically. But the State-wise position of credit deposit ratios indicates that this argument does not hold good at least as far as bank funds are concerned. On the other hand, the banking system continues to siphon off more funds from the backward States for lending and investment in developed States.[10] This is not surprising as the private capital funds tend to flow from the backward to the developed regions attracted by larger opportunities for profits.

The position of Life Insurance Corporation is much better in this respect as may be seen from the investment premium income ratio. Due to the non availability of detailed data this ratio however could be computed for only one year. The rank correlation between per capita income and investment premium ratio was negative and significant. The reason for the progressive investment premium income ratio is the diversification of LIC portfolio to social overhead capital. In per capita terms, however even the LIC investments favoured the developed States.

Going back to Table IX-2 and IX-3 it can be seen that the distribution of investments, regressive though it is, is less skewed than that of credit. This is seen from the value of the coefficients of correlation between banks' investments and per capita income which was lower than bank credit Besides group D States had the highest per capita

investments. While bank credit per capita extended to group A States was four times more than that to group C States, the investments per capita made in group A States were only twice as large as those in group C States.

One would have expected still better from bank investments because these are not constrained by the credit absorption capacity, the lack of which is often trotted out to be the principal reason for the smaller institutional flows to backward States.[12] For, if only these institutions had invested more in the backward States, the credit absorption capacity of these States would have gone up. The banks should have consciously striven through the distribution of their investments to ensure that, the ratio of credit <u>plus</u> investments to bank deposits in the low-income States reached at least the all-States' average. The blame for this failure must be shared by the Reserve Bank of India and the Planning Commission too, for they have a definite say in the investment decisions of commercial banks.

The low per capita investments is not due to the non availability of State Government securities. The proportion of banks' investments in total State's loans outstanding, given in column 6 of Table IX.4 shows that the banks had subscribed to a larger proportion of securities of some of the developed States than that of some of the poorer States. This is also seen from the positive and significant correlation between this proportion and per capita income. The banks which owned 60.6 per cent of the securities of Punjab owned only 48.6 per cent that of Bihar.

If the banks had done at least to equalise the credit+investment deposit ratios, the low income group C States would have had at their disposal additional bank funds to the tune of Rs.387 crores over a period of seven years covered by our exercise. Uttar Pradesh would have received an addition amount of Rs.393 crores and Bihar Rs.99 crores. This amount is of course, small when one calculates what these same States would have got, additionally, if bank funds were distributed equally in per capita terms among all the States. According to the calculation, the additional entitlement of group C States would have worked out to Rs.3,118 crores. Uttar Pradesh would have received Rs.1,263 crores more, Bihar Rs.1,031 crores, Madhya Pradesh Rs.641 crores and Orissa Rs.377 crores.

Reasons for the regressive flows of bank funds are not far to seek. Nationalisation had set two objectives before the banking system, viz., sectoral and regional diversification of credit. While following the first objective which was relatively easier, the banks tended to overlook the second objective which unlike the first was never quantified.[13]

The differences in the additional entitlements if bank funds were distributed on equal per capita basis and on equal credit + investment deposit ratio basis show how the argument for equalisation of credit deposit ratios raised some times by the backward States themselves, is

inadequate to safeguard their interests. The deposits in a State are largely a function of State incomes. Accordingly, equalisation of credit deposit ratios or for that matter credit + investment deposit ratios will merely stem the present outflow of bank funds from the poorer to the richer States. This itself, however will not lead to redistribution of bank funds. Equalisation of these ratios will merely imply that the richer States will be entitled to the use of the bank deposits, the size of which will be higher. Acceptance of this principle will tantamount to the acceptance of the principle of contribution largely rejected by the Finance Commissions. That a higher ratio for poorer States can camouflage a lower per capita investments is brought by the pattern of Life Insurance Corporation investments.

Development Banks

The institutions included in this group are: (i) Industrial Development Bank of India,[14] (ii) Industrial Finance Corporation of India, (iii) Industrial Credit and Investment Corporation of India, (iv) Industrial Reconstruction Corporation of India, (v) Unit Trust of India, (vi) Life Insurance Corporation and (vii) General Insurance Corporation.

Distribution of finance to industry by these term lending institutions was almost as strongly regressive as bank credit. The rank correlation coefficient with

per capita income was as high as 0.832. Group C States secured only little more than one fourth of the per capita finance which group States got during the period under review. Inter-State deviations were also quite wide with Bihar getting less than one tenth and Manipur one twentieth of what Gujarat got. Maharashtra got six times more than what Madhya Pradesh got. Thus a stream of finance that was supposed to play a major role in correcting regional imbalances in investment actually followed an opposite course.[15] Besides, the regressiveness in the flow of investment credit is bound to be reflected in the regressiveness of bank credit for working capital finance, eventually.

In view of the leverage that the term lending institutions have come to exercise in recent years with respect to industrial investments, they could have certainly played a more important role in securing balance in regional development if their policy for directing investment finance to backward areas had been scrupulously implemented. In fact, the highly inequitous financial flows took place during a period when these institutions were operating a conscessionary financing scheme to correct regional disparities.[16]

Agricultural Finance

This stream, consisting of only the Agricultural Refinance and Development Corporation (now renamed as National Bank for Agricultural Refinance and Development) is found to have been quire regressive, though to a lesser extent than

the other streams. The rank correlation coefficient between per capita state income and ARDC credit is lower. Group States secured about 35 per cent more per capita finance from even this source than group C States. Group D States were significantly worse off than even group C States. They received only one nineth that of group A States. Meghalaya is yet to find a place in the Corporation's map of India.

It is somewhat intriguing that agricultural finance too followed the pattern of the flow of industrial finance, of more to the developed States.[17] The usual explanation for the skewness of distribution of bank credit is that the old dominance of industrial credit together with the lopsided industrial development existing already in the country prevents any sudden change in their regional pattern. For the skewness of credit from a new institution like ARDC, that too concerned with agricultural credit, explanations will have to be sought elsewhere.

The salient features of the total picture that emerges from the foregoing analysis of the individual streams of institutional financial flows to the States are: (a) inter-State distribution of each stream of institutional finance has a pronouncedly regressive bias. Consequently the distribution of total financial flows (including budgetary flows) operated clearly to the benefit of States with higher levels of States income. The only exceptions are the group D

States as also Assam in whose case the regressiveness of institutional flows has been counteracted by the progressiveness of budgetary flows. This is as it should be.

The performance of the financial institutions is rather disturbing as they have been created to correct the distortions in fund flows through the capital market. The allocation pattern of capital market[18] guided as it is by profitability indicators, was thought to be not conducive to the implementation of desired planning policies.

In an economy where capital resources particularly foreign exchange resources are limited (these institutions are important conduits of foreign exchange). and where few institutions under government ownership have a near monopoly in their supply, their policies can have a definite say in the pattern of corporate and household sectors' investments. The carrot of liberal and concessionary availability of term finance in backward States and the stick of restricted and costly finance in the developed States can act as a stimulant to counter the location inertia of industries. But, for this purpose, clearer and time bound operational policy guidelines giving location-wise priorities have to be issued by the Government to the financial institutions. Preferably these guidelines will have to be expressed in quantitative terms as is being done elsewhere.[19] Secondly a separate institutional structure is necessary as in Italy to administer these regional policy aids.[20]

In the absence of such clear guidelines from the Government, the policies followed by the financial institutions had been largely adhoc and arbitrary. The implementation of these policies too had been half hearted. By and large the market forces guided the financial flows from these institutions and not the other way about. Despite professions to the contrary, the criteria adopted in allocation of funds were largely commercial. Adoption of socio-economic criteria by and large were only cosmetic. No wonder, their allocation pattern was not more progressive than that of the capital market.

At present, there is a chicken or egg controversy between the industrial licensing authorities and the financial institutions. The latter complains that they have little say in the location decisions of the firms as they are determined by the entrepreneurs and approved by the licensing authorities. The licensing authorities argue that they do not get sufficient number of applications from backward areas.[21] As seen before, when investment funds, especially in foreign exchange are scarce, any carrot and stick policy linking the supply of funds to the location priorities can work well notwithstanding the disclaimers of the financial institutions. Modern theories of location like the 'satisficing' theory tend to support this view.[22] In any case, the complaints of the financial institutions that they do not have a say in the location decisions can be satisfied to some extent by giving them participation

in the licensing committee as also in the Secretariat of Industrial Approval.[23]

Financing infrastructure Development

Another defense argument of these institutions is that they do not have much demand for funds from the backward States due to the poor credit absorption capacity in these States. The absorption capacity is said to be low in these States because of the low levels of development of infrastructure implying the failure of the State Governments. It is true that the Governments of the backward States, due to their limited resources position to which the failure of the fiscal transfer mechanism had also contributed, are not able to allot as much volume of funds for development as the developed States can afford. But then, the role of the financial institutions themselves was none too positive. In Chapter II, the inequalities in the budgetary support policies of these institutions were noted.[24] Table IX-5 shows how much these institutions had been financing the infrastructure development in different States. Even in the matter of developing infrastructure, these institutions had been pumping more money to States which on their own were spending more. In fact, they were only responding to the pressures for infrastructure, which were more vocal in the developed States. In short, infrastructure financed by these institutions only tended to follow growth and not lead them.

Institutional Finance to State Agencies for Infrastructure Development

States	Electricity	Transport	Total
Punjab	72.0	24.5	96.5
Haryana	100.7	16.0	116.7
Maharashtra	37.3	68.5	105.8
Gujarat	62.4	18.6	81.0
West Bengal	43.4	17.0	60.4
GROUP A	51.4	35.8	87.2
Tamil Nadu	40.5	8.7	49.2
Kerala	54.1	18.1	72.2
Orissa	45.1	8.3	53.4
Assam	38.5	9.0	47.5
Karnataka	22.0	18.5	40.5
Andhra Pradesh	26.2	6.4	32.6
GROUP B	35.8	10.9	46.7
Uttar Pradesh	21.6	8.2	29.8
Rajasthan	44.2	11.5	55.7
Madhya Pradesh	30.2	11.2	41.4
Bihar	22.5	7.8	30.3
GROUP C	26.3	9.1	35.4
Himachal Pradesh	51.7	15.3	67.0
Jammu & Kashmir	44.6	34.0	78.6
Tripura	513.8	18.1	531.9
Manipur	--	12.0	12.0
Nagaland	--	15.7	15.7
Meghalaya	162.4	12.9	175.2
GROUP D	110.2	22.2	132.4
ALL STATES	38.0	17.1	55.1

Notes: The institutions covered are only the L.I.C. and the Commercial Banks. In case of commercial banks, the loans and investments outstanding at the end of June 1980 and March 1980 respectively are taken. For L.I.C., loans advanced upto and investments outstanding at the end of March 1981 are included.

Sources:

1. Annual Report of L.I.C. 1980-81.

2. Investments of Scheduled Commercial Banks-RBI Bulletin, Jan. 1982.

3. Reserve Bank of India, Basic Statistical Returns, June 1980.

Thus the States are getting caught in the vicious circle of backwardness. The States which have limited internal resources due to the low levels of income spend less on infrastructure. The financial institutions provide them with little budgetary sup ort. Nor do they directly finance infrastructure development as much as they do in the developed States, all the time complaining of the poor credit absorption capacity in the backward States treating them as an **alibi** for lower quantum of direct financing in these States. The relatively more autonomous fiscal transfer mechanism too did nothing better. The low levels of institutional credit perpetuate the low income levels in these States, thus completing the vicious circle.

To the extent, however, that the institutional finance fails to deliver the goods (no reason why they cannot be made to deliver), the onus on Central budgetary transfers for reallocation of resources between States becomes, much greater. Only by increasing the budgetary flows to these backward States that they can hope to raise their credit absorption capacity. The prevailing position is that even Central budgetary transfers are not progressive, The very pronounced regressiveness of institutional finance as also the wide disparities in States' internal resources will call for the introduction of a very high degree of progressiveness in the inter-State distribution of Central budgetary transfers than is the position today.

According to our computations, group C States should have received in gross terms Rs.5,366 crores, more than what they actually received (Rs.8,560 crores) during the seven year period studied by us, if Central budgetary transfers as also institutional finance had been distributed among all States equally, to ensure for each the same amount in per capita terms. Group B would have been entitled to Rs.756 crore more. Group A would have been entitled to Rs.3,800 crores less. While Uttar Pradesh would have been entitled to Rs.2,110 crores more, there should have been a reduction by Rs.854 crores from what Punjab had actually received. While Bihar should have received Rs.1,871 crores more, Maharashtra should have received Rs.1,739 crores less. Lest these computations appear too staggering to be realistic, let it be added that all what they seek to do is to distribute Central budgetary transfers as well as institutional finance among the States on the same per capita basis. The introduction of any progressive bias in favour of low income States would call for much larger correction in the present pattern.

In conclusion, it can be said that in the correction of the present inequitous pattern of inter-State distribution, the greater the freedom with which the institutional finance is allowed to follow the market forces, the larger will have to be the corrective role to be played by the relatively more autonomous Central budgetary transfers. The tragedy in India today is that the budgetary transfers even by themselves do not have any progressive bias.

<u>Rank Correlation with Per Capita Income</u>

Sl.No.	Category of Transfers	Coefficients
1	Budgetary Transfers (Per Capita) 1973-1980	- 0.275
2	Bank Credit " "	+ 0.907
3	Credit Deposit Ratio (%) "	+ 0.5
4	Bank Investments " "	+ 0.630
5	Investment Deposit Ratio (%) "	- 0.593
6	Bank Credit + Investments(Per Capita)"	+ 0.907
7	Credit + Investment Deposit Ratio (%)"	+ 0.189
8	Share of Banks' Investments in outstanding state governments securities at the end of March 1980 (%) 1973-1980	+ 0.529
9	Credit from Development Banks (Per Capita) 1973-1980	+ 0.832
10	Credit from ARDC " "	+ 0.332
11	L.I.C. Finance (1978-79) "	+ 0.629
12	L.I.C. Finance, Investment: Premium Ratio (%) "	- 0.814
13	Institutional Finance (Per Capita) "	+ 0.904
14	Total Financial outflows - Budgetary and Institutional (Per Capita) 1973-1980	+ 0.914
15	Share of Institutional Finance in Total Flows (%)	+ 0.854
16	Instituional Finance for Infrastructure Development (Per Capita)	+ 0.829

Notes an References

.1 Chapter I

2. Reserve B India, "Financing of the Project Cost of Companies issuing capital", Report on Currency and Finance, 1980-81, Bombay, 1981, Vol.II, p.93.

3. Reserve of India, "Pattern of bsorption of Private Capital Issues", p.93.

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5. 1) Industrial Development Bank of India, Operational Statistics - 1978-79, Bombay, 1980, p.160. The institutions included are (1) IDBI, (2) ICICI (3) IFCI (4) IRCI, (5) UTI, (6) G.I.C.. (7) L.I.C.

2) Finances of State Governments, Reserve Bank of India Bulletin, Bombay, September-October 1979.

6. Agricultural Refinance Development Corporation, 18th Annual Report, 1980-81, Bombay pp17-18. (2) Reserve Bank of India, Report on Currency and Finance, 1979-80 and 1980-81. op.cit.

7. It may be noted that The Study Group of the Administrative Reforms Commission on Centre-State Relationships had viewed with concern the growth in the activities of these organizations. According to them "The role of autonomous Central Organisations in State subjects created or largely financed by a Ministry must not be allowed to exceed that of the ministry. The possibility of the use of such organisations for a massive encroachment on State subjects cannot be discounted. The National Co-operative Development Corporation and the Central Social Welfare Board provide ready examples. Unless restraints are placed on these, similar to those recommended for the ministries, the latter may tend to circumvent these by creating autonomous organisations and channelising funds through them". See Administrative Reforms Commission, Report of the Study Team on Centre-State Relationship, Government of India, New Delhi, 1968 Vol. I., p.163. See Also Vol.III for case studies of seven such Central agencies already in existence.

8. Prime Minister's Statement in Parliament on July 19, 1969. Even otherwise, it would ~~not~~ be reasonable to expect that in a planned economy with balanced regional development as a major objective, bank finance should be employed as an important instrument to correct regional imbalances. Though our study is confined to distribution of funds among States, it is worth noting that, even within a state be it low or high income State, the manner of inter-district distribution of is extremely important. As things stand, there has also been a tendency for funds to flow from backward to developed districts. See, George K.K., "Deployment of Bank Funds", Economic Times, September 5, 1975.

9. Ibid.

10. Due to Italy's technological dualism (the wide divergence in economic development of the North and South) savings in the Mezzogiorno tend to be attracted to the developed North for investment purposes" See Martillaro, A Joseph, Economic Development in Southern Italy, Catholic University of America Press, Washington, 1965, p.4. According to John Friedman, " . . it seems to be that if we exclude the corporate sector in rural areas such as estate farming in Malayasia, wealth for the most part does not go from rural areas to rural areas but from rural areas to the city. I am speaking of private investment here. The banking sector essentiall serves as a funnel to channel the flow of capital resources to cities where they are invested . ." In fact, according to Friedman, "The whole question of transfer of resources from rural to urbar areas underlies the theory of polarised development". Friedman John, in Growth Pole Strategy and Regional Development Planning, United Nations Centre for Regional Development, Nagoya, 1975. pp.404-405. These apprehensions on rural urban flow of funds have come true in India. See George K.K.,"Rural-Urban Flow of Bank Funds," Indian Manager, Cochin, July-September, 1979.

11. L.I.C. gives premium data only according to Divisions and not according to the States. Jurisdiction of some Divisions extends to more than one State. (See Footnote to Table IX-4). Besides, Division's jurisdiction undergoes changes frequently which makes computations for more years difficult. Again, for the above reasons our computations will have to be taken as approximations.

12. In September 1976, the author had made out a case for Channelling more bank investments to less developed States. See, George K.K., "Investment Portfolio of Commercial Banks: Regional Pattern", Business Standard, Calcutta, September 24, 1976.

13. Priority Sector Credit had largely gone to urban areas and developed districts, particularly in developed States, See George K.K.(1)"Regional Distribution of Credit to Small Scale Industries" Financial Express, Bombay, June 24, 1975.

    (2) "Farm Financing: Regional Pattern," Financial Express, 18 Oct. 1975..

    (3) "Regional Disparities and Expansion of Bank Branches, Eastern Economist, New Delhi, 10 Dec. 1975.

14. Refinance to Commercial Banks by IDBI could not be excluded from our computation in the absence of State-wise Data on such refinancing. So there is a certain element of double counting in their figures with those of bank credit.

15. The Industrial Development Bank of India which is now "the principal financial institution to act and coordinate in conformity with national priorities, the working of institutions engaged in financing, promoting or developing industry" explicitly considers it important to follow an appropriate location policy while assisting projects" so as to help determine the geographical dispersal of industries and facilitate reduction in regional imbalances by creation of incomes and employment in the relatively backward regions of the country". See Industrial Development Bank of India, Development Banking in India, Bombay, 1976.

16. The Scheme had only served to widen inter-State disparities. This finding as also its reason has been brought out by Parameswaran Nair, N., and George, K.K., "Strategies for Development of Backward Areas - Do they widen inter-State disparities? ", in ed. IDBI, Industrial Development of Backward Areas, Bombay, 1981.

17. This was the regional pattern of commercial banks' lending to agriculture also. See George K.K., "Farm Financing: Regional Pattern", op.cit.

18. For the allocation pattern of Capital Market, see Kolanjiyil, G.K., "Institutional Investment in Industry: a Regional Study", Southern Economist, Bangalore, 1 Mar. 1976.

19. In the undivided Pakistan, fifty per cent of the credit budget was allotted for the erstwhile East Pakistan See Pakistan, Ministry of Finance, East Pakistan's Share in Central Revenue and Expenditure, Government of Pakistan, 1970.

20. See Martillaro Joseph, op.cit.

21. See Ministry of Industrial Development, Report of the Industrial Licensing Policy, Inquiry Committee (Main Report) Chairman- Dutt, S.,Government of India, New Delhi, 1969, p.110.

22. For a brief introduction to this theory see, Stillwell, J.B. Frank, Regional Economic Policy, Macmillan, London, 1972, p.28.

23. Such a suggestion was made by the author in 1973, see George K.K.,"Credit Planning and Industrial Licensing," State Bank of India Monthly Review, Bombay, Oct. 1973.

24. See Table II-8, Chapter II.

CHAPTER X

CONCLUSION

The problem of regional disparities in India is sometimes referred to in the international parlance, as a 'North-South' problem.[1] This expression in a geographical sense, is incorrect as all the poorest States are in the North. The Southern States, though not the richest, are relatively better off. The alternate expression, viz., 'Centre-periphery problem' is also incorrect as unlike in its original connotation,[2] all the States located in the centre are poor ones and those in the periphery, with the exception of the special category States, are the richer ones. Paradoxically, the States which are in the centre of political power are the ones in the periphery of economic development. It is the States with highest political representation in the Union legislature and Government which are lagging behind economically.

Whatever be the expression, more than half of India's population (55.6 per cent) now live in States with per capita income below the national average.[3] To the richer States who too have their problems of poverty and pockets of backwardness, it is largely a problem of redistribution of their high incomes within the States. But unlike the richer States which have more resources of their own to

tackle their problems of poverty, the poorer States require massive resource inflows from outside mainly through the Union budget and the all-India Financial Institutions.

But the conclusion that emerges from this study is that all the agencies entrusted with this task of resource allocation - the Finance Commission, Planning Commission, Union ministries and the financial institutions - have without exception failed to bring succour to the poorer States. All the major instruments of regional policy have failed to arrest the widening trend in regional disparities in India.[4] In fact, some of the agencies weilding these instruments had actually contributed to the accentuation of the divergence trends as they only acted as conduits for the outflow of savings from the poorer to the richer regions. They seem to have been vying with each other to prove the Biblical saying, "To the rich shall be given; from the poor shall be taken away". Instead of guiding the market forces, they were being guided by these forces. Instead of inducing development, they were only responding to pressures emanating from the already developed States. Even the very limited goal of equalising the per capita financial flows could not, therefore, be achieved by them.

It was noted earlier that one of the standard defence arguments of all these agencies particularly the financial institutions is that the absorption capacity of external funds is less in the poorer States than in the

richer ones. The social and administrative environment is also identified as an inhibiting factor. It is admitted that growth cannot be brought about solely by larger infusion of external funds.[5] But one cannot fail to notice the high positive correlation between the ranks in the growth rate in per capita income of States and their ranks in aggregate financial flows. The coefficient was +0.563 for the seven year period, 1969-76.[6] The correlation is still stronger between growth rates and the total of institutional financial flows and budgetary expenditure of States (+0.761). The correlation between ranks in budgetary expenditure and the ranks in growth rates in State income, itself was quite high (+0.739).

Besides, it has to be noted that due to resource constraints which were not removed by the Central Government agencies, the per capita expenditure of the poorer States on social and administrative services was much lower than in the richer ones as was noted in Chapter IV. Thus they could not, on their own do much to improve their administrative machinery or social environment. To recall, the per capita expenditure of Bihar on social services was only 37.1 per cent that of Punjab, though Bihar was spending 42.5 per cent of its revenue expenditure on these services against 40.6 per cent by Punjab. Bihar's per capita expenditure on administrative services was only half that of Punjab, though Punjab was spending only 13.6 per cent of its revenue expenditure on these services against Bihar's 19.5 per cent.

The multiplicity of agencies had only served to delay a solution to this problem of ineqitous financial flows by disjointing the picture of the aggregate financial flows to different States. This possibly may be one of the reasons why the magnitude of the problem of inequitous financial flows has not been brought home sharply till now resulting in delays to its solution. The multiplicity of agencies by itself would not have created much problem if only the national planners had co-ordinated effectively their activities. In reality, there was very little co-ordination and each agency was going about in its own way following its own lights. And the Plan authorities failed to beam the guiding lights from their commanding heights. There was no common set of regional objectives, expressed in precise terms, given to these agencies by the planners. As a result, the position as it emerged was that one agency was not knowing (or was not concerned with) what the other was doing. Nor did the national planners know. What appears to have been in operation was a composite policy that enables the national Plan to be interpreted as the individual policy maker sees fit.

A solution to the regional problem would require delineation of the areas where regional policy instruments are to be used. But as on today, there is not even an agreement among the different agencies on the units for administering regional policy aids. The financial

institutions generally take districts as the units of backwardness following the Wanchoo Working Group's recommendations.[7] And in their selection of districts, it is the industrial backwardness which is the major criterion used. Official agencies connected with agricultural development or poverty amelioration programmes also take districts as their units of backwardness. The criteria selected is the one suited for their immediate purpose without regard to the overall developmental status either of the area or of the State concerned. This identification of district as the unit for administering regional policy had led to a situation wherein the bulk of the concessional finance and fiscal incentives meant for the backward areas too were cornered by the developed States.[8] Of the concessionary finance extended by the term lending institutions to backward areas, 38.8 per cent went to high income States. The middle income States cornered another 38.1 per cent, against their share in population which was 31.8 per cent. The low income States which accounted for 39.2 per cent of the country's population received only 19 per cent of the concessionary finance. In per capita terms, while the group A States received concessional credit of Rs.61 and group B Rs.51, the group C States received only Rs.21. While Gujarat received Rs.131 per capita, Bihar received just Rs.10.[9]

A solution to the problem of regional disparities would first require an identification of the backward areas. This presupposes identification of the criteria of back-

wardness. So far, very limited research has been undertaken in India on regional inequality in general or on the criteria for comparing the economic development of States. The need for using, for inter-State comparison, several indicators instead of one single indicator, viz., per capita income had often been felt.[10] But the question relating to the selection of the variables as also their satisfactory aggregation into a composite index has not even been addressed, leave alone answered. This is partly a reflection of the secondary importance given to the regional problem, by Indian planners. The lack of consensus on the selection of development indicators and their relative weights, is a reflection not only of the absence of consensus on the measurement but also on the concepts and content of development."[11]

For inter-State comparisons, per capita income, despite its known conceptual limitations are being used by official agencies including the Planning Commission and the Finance Commissions. But even this data had been computed by the Central Statistical Organisation only from the end of the Second Five Year Plan, 1960-61 onwards. A time series study of the performance of different States even during subsequent years is not perfect as the data for 1965-66 and 1966-67 are not available. Besides, the regional income data are published after such a long time lag that it is not of relevance to policy makers. The latest available data relate to the year 1975-76. Further, the

quality of per capita State income data leaves much to be desired, (though there has been some improvement in recent years). For instance, the problem of differential prices and its effect on the inter-State comparability of State incomes has not yet received the attention it deserves. Though the Committee on Regional Accounts had recommended that the Central Statistical Organisation "should initiate a study on the purchasing power parity of Rupee in different States for a more meaningful comparison of Domestic Products between States", no such study appears to have been conducted till now.[12]

Another failure of the Planning Commission in solving the regional problem is its failure to state the regional objectives of Indian Plans in any precise, leave alone quantitative terms. The Plan documents or the technical Notes do not indicate within what Plan period and by how much regional income differentials are to be reduced, unlike in some other countries.[13] The conflicts between the objectives of inter-regional equity and aggregate efficiency and between national priorities and regional priorities have never been resolved by explicitly stating the 'trade off' between them. A keen observer of Indian planning process like Hanson observed". on so delicate a question (balancing between maximum economic returns and balanced regional development) the Planning Commission has expressed itself with less than its usual clarity and has refrained

from enunciating unambiguous principles. It is in this field indeed that the Commission's 'on the one hand but on the other' approach has received most anguished expression".[14]

Though there has been no explicit trade offs between regional equity and national efficiency, every national policy has a regional dimension and therefore it has an implicit trade off. But these had been mostly favouring national efficiency at the expense of regional equity. It is true as Alonso notes, that there is a perennial conflict of interests between those agencies charged with territorial planning and those charged with sectoral planning even in socialist countries. As he notes, "It so happens that a great deal of time, these sectoral agencies believe, as do their capitalist counterparts, that the best location is in the most advanced regions. It may be noted that on the whole, it appears that the sectoral agencies tend to win most of these arguments, possibly because they deal with concrete operational decisions while the territorial agencies tend to deal in general policy with respect to the location of productive activity."[15] This is precisely what happens in India.

The reason why territorial agencies are compelled to confine themselves to generalities is the absence of an explicit space dimension to the national plan. As noted by us earlier, there has never been an attempt to work out a model for allocating public expenditure among different

States with a view to equalise the State incomes within a stipulated time horizon. Such a model incorporating *inter alia* the variable regional multiplier, the calculation of which in turn requires an understanding of the inter-regional and inter-sectoral relationships has not been attempted in India. No serious attempt has been made till now even to provide a data base for this purpose in the form of a system of regional accounts. Any system of regional accounts has to resolve several conceptual and methodological problems of a kind different from those at the national level. "Thus, the State has an open boundary with the neighbouring areas, regions and transactions of the regions with these areas need to be recorded and treated in the same manner as the transactions of the country with the rest of the world if a complete regional accounts is to be prepared. However, hardly any data exist on inter-State transactions of goods and services as well as other financial flows which will enable such a measurement".[16]

The absence of spatial dimension to Plans left the field open to political pulls. For instances as Bhagavati and Desai notes: "The failure of the Indian Planners to work out the space dimension of their industrial targets on the basis of economic efficiency constrained by State targets of overall industrial investment designed to assure the States that they would get some minimum industrialisation, in effect left the field almost entirely to

political Pressures."[17] Apart from political pulls, the pulls of the market forces also determine the financial flows. If these pulls are to be countered, both the physical and financial Plans should have a regional dimension. An occasional 'touch here and fiddle' there will change the direction only marginally.

This analysis thus points towards two major deficiencies in the Indian Planning process. First, is the very failure of the Indian Plan models to work out a regional dimension. While the Indian planning models "have become fairly sophisticated in relation to inter-temporal phasing and perspective planning", they have "no comparable extension of analysis questions of spatial planning.[18] How to tie up regional plans with national Plans and how to arrange sectoral Plans in various regions are problems which "require innovative mechanisms for both Plan formulation and plan implementation". It is true that "at the present stage, the technology for such harmonisation is in an infant stage and there is not much international experience".[19] It is also admitted that till recently, even on a theoretical plane, national economic development was viewed as space free. But the absence of space dimension may also be due to the absence of any national consensus on how to share the fruits of development among regions.

The second lacuna in the planning process is the absence of a credit budget integrated with the governments' budgets (of both the Centre and the States) forming part of the overall financial Plan for the economy which in turn should be an adjunct to the economy's physical Plan. The need for such a Plan was felt earlier also. "There is need for better and continuing co-ordination between the credit budget, the Government budget and the Plan. The importance of such co-ordination has now been recognised and appropriate arrangements to bring it about are under way."[20] This was stated by L.K. Jha, way back in 1967 and when he was Governor of the Reserve Bank of India. The present position is no way better than what it was in 1967.

Whatever may be the reasons, it is certain that inter-State disparities in income levels can be corrected only by reversing the present directions of the financial flows from the Union Government and the financial institutions. This would imply that allocation of both credit and budgetary funds to the developed States will have to be considerably reduced. Instead of funds flowing from the backward to the developed States as at present, more funds should flow from the developed to the backward States. The magnitude of the financial flows in the reverse directions, necessary to correct the long accumulated disparities in the reasonable future is likely to be very high and this is likely to cause strains on the structure of the federal polity. Fear of these strains may possibly be one of the

reasons the Indian regional problem and its dimensions are rarely stated explicitly and discussed openly. Speaking of how decisions reconciling regional equity and national efficiency are taken by Indian planners, Hanson observes "At present no one knows and even if the Commission has this all worked out, no one is likely to be told at least just yet. For, if the whole complex process were laid bare, existing complaints of inequity, serious enough already would be redoubled.[21]

As seen earlier in Chapter II, the internal resources of some of the high income States at present exceed even the total budgetary expenditure of some of the low income States. Even if no budgetary funds are received by them from the Union Government, they will still be able to maintain a relatively high level of budgetary expenditure. Therefore, only minimum budgetary funds should logically flow to them for some years. But the big question is whether this would be possible under the present constitutional and political set up. "To direct more than a proportionate share of Central funds to one region requires that expenditure be curtainled in others. Since much government expenditure is directly related to pressing social demands (for schools, roads, hospitals, etc.) the opportunity costs of this sbrt of reallocation are likely to become a strong political issue. This is espcically true because the pressure on existing social capital is likely to be stronger in those areas which according to policies of this sort,

should have their share of government expenditure reduced."[22] Similarly, even if credit deposit ratios are equalised, some of the developed States will still have the use of larger volume of bank funds in per capita terms, as their deposit base is already very high. In their case, they should get for some years to come, only minimal share in the incremental bank credit. Will the present and potential users of bank funds with their financial and politial leverage allow such a decision to be taken? For, such a decision will compel them to move out of their comfortable 'satisficing' locations. It is clear that these economic interests will gain full political and administrative support from the governments of the developed States.

If attempts are seriously made to reverse the directions of the financial flows, it is likely to become a major political issue in the developed States who even now plead as a group before the finance commissions for much smaller causes like the adoption of the archaic principle of "contribution" in sharing the drying pool of income tax proceeds. Surveying the regional policy measures of the European Economic Community, the Economist wrote in 1975: "Germany's poorest areas are as wealthy as the richest of Ireland and Italy, but a German Politician who cuts out regional aids to Lower Saxony or Bavaria on these grounds would commit political suicide."[23] Substitute Germany with Punjab and Ireland with Bihar and we may get the situation

that is likely to emerge in India (notwithstanding the fact that Punjab and Bihar are States in the same Union, unlike Germany and Ireland) if the logical policy of reversing the funds flow were implemented. Gadgil was one of the earliest in India to note this dilemma. He observed as early as 1970, "In a federal polity, you will find it difficult to say you will not give any Central assistance. You have therefore a large question here of adjustment of relations and attitudes between members of a federal polity."[24] Thus the problem of Centre-State financial flows becomes part of a larger political problem.

In fact, the "adjustment of relations and attitudes between members of a federal polity" mentioned by Gadgil is going to emerge as a touchstone of Indian federal polity. Federal set up cannot survive if the developed constituents take the attitude of "Am I my brother's keeper?" Nor can it survive for long, if some of the poorer States feel that they are 'strangers at the feast' and they nurture the feeling that they are 'internal colonies'.[25] A federal set up cannot be sustained for long by sweeping the regional problem under the carpet as is being done today. In that process, the poorer States are made to finance the richer ones. The past policy of camouflaging the problem has failed as may be seen in the signs of conflicts between the haves and the have-not States. The conflicts of economic interests are increasingly getting crystalised and articulated on group basis before the Finance Commissions and

the Planning Commission. The meetings of the National Development Council are increasingly turning to North-South summits. What is more, expressions of these conflicts are no longer confined to these bodies. They are getting spilled over to the streets. The turmoil in North East, Assam, Jammu and Kashmir and of late in Punjab has its economic undertones.

The addition of Punjab to the above list goes only to confirm May's observation that the threat to federal polity comes not only from its poorer units but also from its richest.[26] Quebec is not the poorest region in Canada. Nor was Biafra the poorest region in Nigeria.

Here, then we have a still larger question with not only economic and political dimensions but also a social and cultural dimension, leading to the very nationality question itself. For, ultimately, it is the strength of their cultural ties which determines "the relations and attitudes between members of a federal polity" and makes the richer States to accept financial sacrifices for the sake of their poor relations, who in the past had contributed to their present affluence. After all, as Wills noted long ago, "The taking of tax money raised in this way for the purpose of State aid in other States is not unfair as it first seems. For one thing, the people in these cities who object to highways being built by the federal government in other States are just as likely to use the highways in those States as the people of these States;

and for another thing, the eople in all the States of the Union have helped to contribute to the making of the fortunes of the people in our large city centres."[27]

Notes and References

1. Godbole, M.D., *Industrial Dispersal Policies*, Himalaya Publishing House, Bombay, 1978, p.vii.

2. Raj Krishna, "The Centre and the Periphery", *Social Action*, New Delhi, Jan-March 1981, p.1.

3. The per capita income data relates to 1975-76 and population data to 1970-71.

   One major instrument, viz., Industrial Licensing Policy has not been discussed in this study as it is not directly used to effect financial flows, No doubt, the licensing policy affects the financial flows from the demand side. That even this policy has failed is brought out in George K.K., "Industrial Licensing: Regional Pattern", *Eastern Economist*, New Delhi, 20 Feb. 1976.

5. Further work remains to be done to find out why financial flows assumed the pattern noticed in this study. Such a study requires an understanding of the non financial factors also. See for instance, (1) Hanumantha Rao, C.H. 'Growth, Poverty and Tax Effort: An Inter-State Comparison with special reference to Bihar,' Institute of Economic Growth, New Delhi, 1979, (mimeo).(2) Shaibal Gupta, "Non Development of Bihar: A case of Retarded Subnationalism, " *Economic and Political Weekly*, Bombay, 12 Sept. 1981.

6. Data relating to financial flows have been taken from author's earlier paper jointly with Gulati, I.S., "Inter-State Redistribution through Institutional Finance", *Economic and Political Weekly,* Bombay, Aug. 1978. The data has some drawbacks mentioned in the paper itself. But it is of a minor nature and the findings are unlikely to be vitiated.

7. Planning Commission, *Fiscal and Financial Incentives for Starting Industries in Backward Areas*, Government of India, New Delhi, 1969.

8. This anomaly has been brought out in 1976 by the author in "Development of Backward Regions: New Strategy Distorted", *Economic Times*, Bombay, 1-2 Oct, 1976.

9. Compiled from data given in IDBI, *Operational Statistics* 1980-81, Bombay, 1982, p.102.

10. Central Statistical Organisation, (CSO) Report of the Committee on Regional Accounts, Government of India, New Delhi, 1976, p.7.

11. See Jan Drewnowski, Studies in the Measurement of Levels of Living and Welfare, U.N. Research Institute for Social Development, Geneva, 1974, p.15.

12. CSO, op.cit p.8.

13. For instance the Twenty Year Perspective Plan, (1965-85) o the erstwhile State of Pakistan aimed at parity inper capita income between the West and the then Eas Pakistan by 1985. See Pakistan Ministry of Finance, ast Pakistan's Share in Gentral Revenue and Expenditre, Government of Pakistan, 1970.

14. Hanson, A.H. The Process of Planning, Oxford University Press, ondon, 1966, p.315.

15. William Aloro, in preface to Nair, K.R.G., Regional Experience - a Developing Economy, Wiley Eastern, New Delhi, 82. p.viii.

16. CSO, op.cit p.5.

17. Bhagavathi gadish and Desai, Padma, India, Planning for Industrasation, Oxford University Press, London, 1977, p.268.

18. See Bhagavat, J.N., and Chakraborty, S., "Contributions to lian Economic Analysis - A Survey: Supplement the American Economic Review, Sept.1969.

"The Indian anning exercises are essentially aggregative and storal in character. These rely on a macro econc model which provides informations on the macro comic projections for Gross Domestic Product whics consistent with a desired average compound ratver the Plan period as a whole. Regional consid.ions and perspectives do not enter into the macro ecoic growth models; neither are the regional impations of the planning decisions worked out in the se of breaking up sectoral targets on a State basis Mathur, O.P., "The Problem of Regional Disparities: Analysis of Indian Policies and Programmes", Growth Pole Strategy and Regional Development Pol ed. Fu-Chen Lo and Kamal Salib, Pergamon Pr Oxford, p. 131.

19. Shahidah Sideq, Measures for Industrial Decentralisation in Malaysia, in Growth Pole Strategy and Regional Development Planning, op.cit.

20. Jha, L.K., "Need for Credit Budgeting", Reserve Bank of India Bulletin, Bombay, Oct- 1967.

21. Hanson, A.H., op.cit. p.321.

22. Stillwell, J.B. Frank, Regional Economic Policy, Macmillan, London, 1972, p.51.

23. 'A Survey of the Development Regions of the EEC", The Economist, London, Jan.25, 1975.

24. Gadgil, D.R., "Some Aspects of Centre State Financial Relations", in Kamat, A.R., ed. Selected Writings and Speeches of Prof. D.R. Gadgil on Planning and Development, 1967-71) Gokhale Institute of Politics and Economics, Poona, 1973, p.345.

25. Sachchidananda Sinha, Internal Colony: A Study in Regional Exploitation, Sindhu Publications, Bombay, 1973, The Colony alluded is Bihar. Some of the present Assam agitation leaders also use the same expression frequently. See Ghanshyam Pardesi, "Internal Colony in a National Exploitative System", Economic and Political Weekly, Bombay, June 7, 1980

26. See May R.J., Federalism and Fiscal Adjustments, Clarendon Press, London, 1969, p.51.

27. Wills, Constitutional Law, (1936) quoted by Kaushalendra Rao, R., in the Minute to the Report of the (First) Finance Commission, Government of India, New Delhi, 1952, p.114.