

**AUSTRALIA** (in £A millions)

Tax reimbursements, special financial assistance, special grants and payments under the financial agreement,	162.30	204.82
Commonwealth aid for roads, grants to universities, and grants for long-service leave in the coal-mining industry, encouragement of meat production, Western Australia water works, mental institutions and imported houses, price control reimbursement and tuberculosis benefits .	20.59	38.93***

\*Excludes grants from the federal highway trust fund, estimated at \$ 1,137 millions in fiscal year 1957.

\*\*Excludes \$ 77.2 millions on account of old-age pensions as they have since been federalised.

\*\*\*Excludes £A 14.77 millions paid to the States from the National Welfare Fund. £A 1.36 millions paid on account of agricultural and other services and £A 14.23 millions paid for assistance to primary producers.

Note.—Figures for Australia under column 2 are for 1953-53.

## VI. Principles of Grants-in-aid

59. Article 280(3) (b) of the Constitution casts on us the duty of recommending the principles which should govern the grants-in-aid of the revenues of the States.

60. It would be interesting to recall the scope of grants-in-aid in the scheme of devolution under the Government of India Act, 1935, which set the pattern for such devolution. Sir Otto Niemeyer, on whose award the scheme was based, treated grants-in-aid as a form of residuary assistance for certain Provinces after taking into account the sharing of taxes and the adjustment of debt. While estimating the overall fiscal need of a Province, he took note of the differences in administrative needs which, he thought, could not be obliterated by Central assistance on a basis common to all the Provinces. He recognised the responsibility of each Province to ensure budgetary equilibrium and was anxious to set those Provinces, which were suffering from chronic budgetary deficits, on an even financial keel, without endangering the solvency of the Central Government. He took an integrated view of the finances of the Centre and the Provinces and recognised that any scheme of devolution, which

the export duties, half the excise duty on beer, the proceeds of personal income tax, and mining royalties were devolved on the constituent regions and distributed as nearly as possible by origin. This scheme of distribution is now due for revision.

56. The Rhodesian constitution provides, among other things, for the devolution to the States of not less than thirty-six per cent of the federal taxes on income and export duties, and not less than two-thirds of the sales and turn-over taxes.

57. We may refer finally to the constitution of Pakistan, which came into force in March, 1956. While the pattern of federal financial relations embodied in this constitution is generally similar to that of the Indian Constitution, there are some differences. Sales taxes are centralised and railways provincialised; there is no provision for the distribution of estate duty on non-agricultural property, while there is a permissive provision enabling the Federal Government to distribute any export duty or any specified tax. The Pakistan constitution provides also for the appointment of a Finance Commission. Pending the recommendations of that Commission, the existing scheme of distribution of revenues as adopted at the time of the unification of West Pakistan has been maintained, subject to a minor adjustment on account of the collections attributable to federally-administered territories.

58. A noticeable trend in all federations has been the progressive increase in the size of federal payments to the states. For the three major federations which have been referred to in the earlier paragraphs of this Section, this growth is illustrated by the figures set out in the following table :

	Fiscal year 1951-52	Fiscal year 1956-57
<i>U. S. A.</i> (in \$ millions)		
Net federal expenditure in aid of States and local governments . . . . .	2,604	3,317*
<i>CANADA</i> (in \$ millions)		
Tax rental payments and statutory subsidies . . . . .	10.2	395.6
Grants for unemployment assistance, old-age assistance, pensions and allowances for blind and disabled persons, health grants, and university grants . . . . .	37.3**	92.5

sought to help the financially weaker Provinces, involved subsidisation at the expense of the financially stronger Provinces. He said that "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". The "correctives" he applied to the scheme of devolution of revenues were debt adjustment, unconditional grants-in-aid, either fixed or tapering, and in the case of the jute-growing Provinces a larger share of the net proceeds of the jute export duty.

61. After the Niemeyer award, the perspective changed as a result of independence and the new conception of close financial collaboration between the Union and the States on the basis of a national plan of economic development. It was no longer merely a question of higher or lower "standards of administration" in the restricted sense. The transition from a police state to a welfare state brought about fundamental changes in the scope of governmental functions and resulted in widening the content of fiscal need. Nevertheless, the basic overall approach of Niemeyer still remains valid; the States and the Union have to balance their budgets within their available resources and the needs of the States, which cannot be met by devolution of shares of taxes, have to be covered by grants-in-aid.

62. The principles formulated by the previous Finance Commission for regulating grants-in-aid of the revenues of the States are, if we may say so, unexceptionable. They suggested that the budgetary needs of the States should be the starting point for determining the assistance required by the States, but that the needs thus disclosed should be adjusted with regard to certain other considerations. First, the budgets of the States should be reduced to a comparable basis by making adjustments in respect of abnormal, unusual and non-recurring items of revenue and expenditure. Secondly, due allowance should be made for "clear cases" of failure of States to maximise tax effort. Thirdly, in order not to place a premium upon extravagance, the States' endeavour to secure reasonable economies in expenditure should be taken into consideration. Fourthly, where standards of social services in any State are significantly lower than in others, it should qualify for special assistance. Fifthly, special disabilities of States due to abnormal conditions beyond their control should be

provided for. Lastly, grants may be made to certain States for the furtherance of broad purposes of national importance, such as primary education, in respect of which they may be specially backward.

63. We see no reason for departing from this basic approach to the problem of grants-in-aid, although our emphasis on the various principles laid down by our predecessors has been influenced by subsequent developments. We endorse the principle of fiscal need and interpret fiscal need comprehensively by taking into account the impact of the completion of the first five year plan and the needs of the second. We have, as in the past, taken an integrated view of the finances of the Union and the States and the financial capacity of the Union to assist the States, after meeting its own essential commitments. We have sought to formulate a scheme of grants-in-aid which should, under normal conditions, enable the States to balance their budgets after meeting their normal revenue expenditure as well as the revenue expenditure incidental to the execution of the second five year plan. We have, as far as possible, reduced the State budgets to a comparable basis. We have also made allowance for the various factors by which the computation of budgetary needs has to be adjusted and have treated grants-in-aid as residuary assistance to the States after taking into account devolution of revenue in other forms.

64. Our predecessors thought that, while considering the eligibility of a State for a grant-in-aid and the amount of such aid, due weight should be given to tax effort, so that the States, which raise adequate resources through taxation, are not penalised and no premium is put upon lack of self-help. The principle of tax effort is unexceptionable, but, as they themselves admitted, "it is only in clear cases of inadequate taxation" that it should affect the quantum of assistance which the States may be otherwise qualified to get. "Clear cases" of inadequate taxation are difficult to determine. Low *per capita* taxation in poor States may simply be evidence of low taxable capacity. An agricultural State with a low level of purchasing power has to maintain a comparatively high level of *per capita* expenditure to sustain a reasonable standard of public services. An industrial State can raise a much larger *per capita* revenue than an agricultural State, even though the kinds and rates of taxes are the same in both. It is, therefore, difficult to decide whether a State is taxing its people adequately in relation to their income and taxable capacity. Some kind of empirical judgment is inevitable. In our

assessment of tax effort we have assumed that if a State raised additional revenue which it has promised for the plan, it will have done its part.

65. Another consideration, which weighed with the previous Commission, is the function of grants-in-aid in reducing inequalities in the standards of basic social services in the States. We recognise that maintenance of certain important services at a minimum national level may justify giving special grants-in-aid. Since total resources are limited, this can be achieved only by stages. We have taken the view that it is the function of the Planning Commission and the National Development Council to ensure the equalisation, so far as practicable, of the standard of essential social services in the various States of the Union. To the extent that plan expenditure incurred on raising the level of social services has become committed expenditure, we have taken it into account. For our scheme of devolution, we have accepted the plan as ensuring an equitable development in the field of social services. There is, therefore, now no room for any grants in this field, such as the grant for expansion of primary education recommended by the last Commission.

66. The principles of grants-in-aid, which we recommend, are as follows:

- (i) The eligibility of a State to grants-in-aid and the amount of such aid should depend upon its fiscal need in a comprehensive sense. In a Union, in which the Centre and the States co-operate for planned development, grants-in-aid should subservise this end. Priorities and provisions in the plan itself should determine the fiscal needs for development for the period of the plan.
- (ii) The gap between the ordinary revenue of a State and its normal inescapable expenditure should, as far as possible, be met by sharing of taxes. Grants-in-aid should be largely a residuary form of assistance given in the form of general and unconditional grants.
- (iii) Grants for broad purposes may also be given. While they last, they should be grants-in-aid of revenues, but the States would be under an obligation to spend the whole amount in furtherance of the broad purposes indicated. Where those purposes are provided for in a comprehensive plan, there will be no scope for such grants.

## VII. Review of State Finances

67. We shall now review briefly the trends in the revenue and expenditure of the State Governments during the period following the report of the last Commission. We propose to confine this review to the four years ending 1955-56, although the recommendations of the last Commission covered the year 1956-57 as well. This is because the financial picture was altered in November 1956 by the reorganisation of States. The four-year period is also convenient as it covers the last four years of the first plan and the actuals of these years reflect the impact of the plan on the State revenues.

68. Before dealing with individual States it will be interesting to view the picture for all the States taken together. In the four years covered by our review, the States excluding Jammu and Kashmir, which was not included in the last Finance Commission's scheme, had a cumulative revenue deficit of Rs. 57 crores. In this period, the revenue expenditure on schemes included in the first five year plan amounted roughly to Rs. 333 crores. The States received from the Union, under article 282 of the Constitution, grants amounting to Rs. 133 crores while they raised additional revenue of Rs. 77 crores. For the remaining plan expenditure amounting to Rs. 123 crores, they were able to utilise Rs. 66 crores which they had as surplus from their ordinary revenues and devolution under the scheme of the first Finance Commission, leaving an uncovered deficit of Rs. 57 crores. The scheme of devolution recommended by the last Commission did not make any direct provision for implementation of the first five year plan; it, however, turned out to be quite liberal in relation to the normal expenditure of the States and for most of them left a substantial margin which helped them in implementing the plan. Because of this liberal devolution, the States did not find it necessary, during the period of the first five year plan, to hold up any scheme for lack of funds, although some of them ran into sizeable deficits. The States did not also find it necessary to draw to any substantial extent upon their accumulated reserves for augmenting their revenues. For all Part A and Part B States together, excluding Jammu and Kashmir, the total withdrawals from reserves during the last four years of the first five year plan amounted only to Rs. 22 crores. Bihar withdrew in this period Rs. 8.5 crores, Bombay Rs. 3.5 crores, Madhya Pradesh Rs. 7.02 crores and Uttar Pradesh Rs. 2.92 crores.

69. We may now turn to a consideration of the position of individual States. Bombay, Madhya Pradesh, Punjab, Rajasthan, Travancore-Cochin and Uttar Pradesh ended this four-year period with