POLICY IMPACT ON INSTITUTIONS OF FEDERAL FINANCIAL TRANSFERS IN AUSTRALIA AND INDIA

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In a federal democratic setup different formulae and policy framework are evolved for fiscal sharing between the Centre and States. Fiscal equilisation has been an important working principle for federal transfers. This article discusses in detail the institution arrangement for fiscal transfers in India and Australia and highlights similarities and dissimilarities in constitution and working of these institutions. It focusses on the steps that put thrust on macro-economic management and situation arising out of liberalisation policies.

THIS ARTICLE examines the background and the basis of the institutions of fiscal federalism in Australia and India. The changing emphasis of different factors in the evolution of the formulae for federal sharing are analysed to relate them to the impact of policy changes (*e.g.*, policy of Liberalisation in India), as well as the changing nature of federal relations (*e.g.*, New Federalism in Australia). Four such institutions that are examined, in a comparative framework are the Commonwealth Grants Commission (CGC) and the Australian Loan Council (ALC) in Australia, and the Finance Commission (FC) and the Planning Commission (PC) in India. The CGC and the FC, responsible for managing federal financial transfers, are comparable. The ALC and the PC were created in response to the requirements of their respective countries. Also, while the FC and the ALC owe their existence to constitutional provisions, the CGC was created by a legislative enactment, and the PC came into being by an executive order.

By the time the Constitution of India was finalised in 1951, the Australian CGC had already had about two decades of functioning experience. The Australian example was extensively quoted in the deliberations on the system of sharing federal finances in the Indian Constituent Assembly.

The ALC became a part of the Australian constitutional arrangement after it was approved by a Referendum in 1928. Since then the ALC has

become an important mechanism for the management of federal finances. In India, issues of loans and grants to the states are managed by constitutional provisions and by regular governmental channels. The new thrust of the macro-economic management and the Liberalisation policy requires some regulation of the states' debts and loans. The need for a coordinated system of unified management of federal debt and for proper utilisation of loan money was felt in India. Such coordination, it was argued, would also avoid competition among states. Suggestions were also made for setting up a Loan Council for India.

The PC in India came into existence in response to the needs of national planning. As the planning process became important, the PC became an important channel for the transfer of finances to the states, almost at par with the FC, thus creating a distinction between Plan funds and Non-plan funds.

I

AUSTRALIA

(i) *Commonwealth Grants Commission (CGC)*

The Australian Constitution empowered the Parliament to make grants to the states and also decide about the terms and conditions of such grants. Sections 87, 94 and 96 outlined the institutions and the methods for federal transfers. The Commonwealth grants to the states were originally sources of conflict in the federation, leading to *ad hoc* decisions under several pressures. A need for a permanent body was felt in the 1920s to undertake regular reviews of federal finances and work out rational formulae. The Royal Commission in 1929, recommended for the revival of the Inter-state Commission for taking over the responsibility of continuously watching the effect of federal laws and administrative machinery on various states and advise, either with or without a special inquiry, whenever applications for grants were made to the Commonwealth. A Parliamentary Joint Committee made recommendations for a permanent advisory body in 1931 on Public Accounts. As pressures from diverse sources for the setting up of a permanent body built up, political compulsions provided the occasion for the setting up of the CGC: 'It was political instability in Australia, associated with strong secession movements in three states which considered that they were disadvantaged by national policies at the same time as they were forced to accept great inequalities in taxation and service provisions, that led to the establishment of the Commonwealth Grants Commission (CGC) in 1933 and the development of a fiscal equalisation system' (Mathews

1994: 3). Growing sessionist movement in western Australia, and pressures from Tasmania and south Australia, hastened the process and the Commonwealth Grants Commission Act of 1933 brought into existence the permanent institution of the CGC.

Two-year period, during 1936-38, was of uncertainty for the CGC because of the proposal to revive the Inter-State Commission. Legislation to create this Commission was introduced in 1937, but was not passed. The term of the CGC was extended first until January 1938 and then till June 1938. As the pressures favouring the replacement of the CGC by the Inter-state Commission waned, the CGC established itself firmly.

Fiscal equalisation referred to the two concepts of vertical equalisation and horizontal equalisation. The first made efforts to provide resources to a level of government commensurate with the functions that were to be performed by it. For the performance of its functions the governmental level was to have resources over which it has full control and for which it should be fully responsible: 'each government financing its expenditure from funds it raises in its own name'.Horizontal equalisation was concerned with the capacity of a governmental level to provide services to its citizens that are not costlier (in terms of taxes paid) than those provided by other units at the same level. The importance of such equalisation for a federal system was argued from theoretical as well as political points of view.

(a) Vertical Imbalance: In the initial years, Sections 94 and 87 of the Constitution were in use for transferring surplus Commonwealth revenue to the states. The Surplus Revenue Act of 1908 provided for diverting surplus money to a trust fund to meet the expenses on account of old age pension. Subsequent to the negotiations between the Commonwealth and the states at the Melbourne Conference in August 1909, it was agreed to make grants to the states at the rate of $2.50 per capita in place of the Section 87 transfers and that western Australia would receive additional payments of larger per capita contribution to customs revenue, to be funded by a reduction in grants to other states. In 1912, Tasmania also became eligible to receive the additional grants. 'Fiscal dependence on the Commonwealth, combined with political debate on the economic side effects of Federation (notably the impact of uniform external tariff), saw social grants to the states become an increasingly important feature of Commonwealth-State funding from 1910 to the 1920s'. By the 1930s it was an established practice for the states with less population to receive special grants. Instead of leaving the quantum of these payments to continuous haggling, it was agreed to constitute a permanent body of the CGC to regularly monitor the payments on the basis of agreed principles and make annual recommendations in its reports.

The States Grants (Income Tax Reimbursement) Act of 1942 gave the CGC the additional responsibility of the implementation of a uniform income tax policy, under which states not levying income tax could be given annual grants. The Commonwealth monopoly over income tax was restored in 1946 and the states were to receive tax reimbursement grants, thus allowing the CGC's role to recede to the background. Reimbursement was made on the basis of adjusted population in 1957-58—an arrangement that was opposed by some states and that required judicial intervention. The system that came to be known as financial assistance (rather than reimbursement grants), was decided 'by augmenting the total tax reimbursement and supplementary grants which would have been payable in 1959-60 under the old scheme.

The Points of Understanding announced by the Premiers' Conference in April 1976 agreed on a system of personal income tax sharing whereby 'the states would receive a fixed percentage of Commonwealth personal income tax receipts, distributed among them on the basis of the per capita relativities implied in the distribution of 1975-76 financial assistance grants...'. . The CGC was to be involved in the consideration of special grants to the less populous states and in recommending 'equalisation payments to make up for the difference between the revenue per capita they receive from it and the per capita amount that would have been received by the standard states if the latter had levied surcharges at the same rate'.

The equalisation efforts were extended to local bodies in 1973. The direct assessment method adopted by the CGC calculated the grant to a local body 'as the sum of the revenue differential calculated by applying a standard rate of taxation to the difference between its taxable capacity and a standard taxable capacity; and the expenditure differential that is necessary to enable it to provide a "standard" range and level of services and amenities'

Suggestions were made to review the taxing powers of the Commonwealth. A working group recommended guarantee to the states six points of income tax scale that would correspond to a decline in Financial Assistance Grants (FAGs). As a part of the NCP, the 'Commonwealth renewed its commitment to maintain the real per capita guarantee of FAGs on a rolling three year basis'. Fiscal reforms of 1999, brought forth by the Inter-Governmental Agreement on the Reform of Commonwealth-state Financial Relations, abolished FAGs and Revenue Replacement Payments (RRP) to the states, and revenue raised by the Goods and Service Tax (GST) is now distributed among states: the CGC decides the share of the states.

(b) Horizontal Imbalance: Horizontal fiscal equalisation has been the main focus of the CGC, which started by introducing the criterion of financial

need, giving the claimant states grants to allow them to function at a level that is comparable to other states. The CGC was careful to point out that the grants were meant to help contain budget deficits. The claimant states were also expected to raise revenue at a level that was above the average and a penalty was worked out for mistakes. The penalty provision was removed after 1945.

A review of horizontal equalisation efforts during the first four decades of the working of the CGC concluded that 'while the principle of compensating states for low taxable capacity and high cost of providing services is firmly established...the distribution of financial assistance grants, specific purpose payments and loan funds does not appear to conform to...the requirement that resources for development should be distributed in accordance with relative economic advantage' (Mathews and Jay 1972: 295).

(ii) *Australian Loan Council (ALC)*

Heralded as 'a most significant move in the direction of co-operative federalism' (Mathews and Jay 1972: 109) and 'a unique institution among federations' (Jay 1977: 101), the ALC was formally set up in 1928.

Each year the ALC received estimates of loans needed by the Commonwealth and the states for the new works and housing. Loan expenditure proposals did not include the repayments available to meet the loans. The loan programmes included revenue deficits, though temporary loans that the governments could raise did not form a part of the loan programmes. The ALC determined the borrowings in a year, keeping in view reasonable terms and conditions. It also determined the interest rates and issue prices. After determining the loan programme, the ALC allocated the amount to the applying parties. It was necessary for this decision to be unanimous, failing which 'the Commonwealth would be entitled to up to one-fifth of the amount to be borrowed, if it so desired...and that amount not taken by the Commonwealth was to be divided between the states in proportion to the net loan expenditure, during the previous five years'. The Commonwealth was made responsible for arranging 'all borrowings approved by the Loan Council and for all conversions, renewals, redemption and consolidation of the public debts of the Commonwealth and the states'. In order to deal with seasonal shortages of cash, states could raise temporary loans, which were outside the control of the ALC, though the interest rates decided by the Council applied to these loans as well.

The role of the ALC was examined by the Advisory Council for Intergovernment Relations (ACIR) in 1982 which pleaded for greater scope for states' management of their public sector activities and for more flexibility and recommended the setting up of a new institution called the Federal Financial Council.

By the 1990s the Commonwealth made only general-purpose capital assistance to capital grants. The states became responsible for financing and managing their debts, though the Commonwealth's responsibility for the debts issued by it on behalf of the states continued. It was agreed at the ALC meeting of 1990 that 'the states would progressively redeem the debt which the Commonwealth had issued on their behalf, by making annual payments to the National Debt Sinking Fund so as to fully take over the debt by 2005-06'. In 1992 states were allowed to borrow from the domestic market in their own names.

(iii) *Trends in Federal Transfers and the NCP Reforms*

Financial transfers to the states over time have generally been in the form of *(a)* FAGs (Untied Grants); *(b)* Specific Purpose Payments (SPPs-Tied Grants); *(c)* Special Revenue Assistance (SRA); *(d)* NCPPs, *(e)* Contributions; and *(f)* GST. This trend was a subject of frequent complaints by the states that such payments reduced budgetary flexibility of the states and put controls on expenditure that were not always manageable. The administrative reporting of this grant was often cumbersome. The more important complaint was that funding of programmes initiated by the Commonwealth could, in some instances, be reduced or withdrawn, leaving the states with a significant expenditure commitment to meet resultant community expectations. There were demands from the states to initiate reforms in inter-governmental financial relations.

The Special Premiers' Conference (SPC) of October 1990 sought to operationalise New Federalism in terms of achieving greater balance of resources and responsibilities. states made efforts in the 1990s to achieve 'fiscal security and policy autonomy through reform of vertical imbalance and reduction of overlap and duplication'. Suggestions were made to review the SPPs and also the Commonwealth's taxing powers.

In 1998 the Commonwealth proposed alteration or abolition of some Commonwealth and state taxes and corresponding changes in the Commonwealth grants to the states. Under this arrangement 'the Commonwealth would cease to make FAGs and Revenue Replacement Payments (RRP) to the states, and ... the states receive the entire revenue raised by the Goods and Services Tax, on condition that they abolish a number of indirect taxes and take over full responsibility for the funding of Local Government'.

The Inter-Government Agreement on the Reform of Commonwealth-State Financial Relations of 1999 was hailed as ' an important milestone in Commonwealth-State financial relations'. The Agreement provided for GST by Commonwealth and abolition of wholesale tax and RRP, abolition of states' taxes and Financial Institutions Duty and Stamp duty quoted

marketable Securities, resulting in the loss of RRPs to the states and loss of their own sources of revenue.

II

INDIA

Transfer of federal finances from the Centre to the states is through three channels - the FC, the PC and the ministries of the Central Government. The FC is responsible for tax revenue shares and conditional and unconditional grants. The PC looks after national planning and deals with Plan expenditures. The third channel of discretionary grants includes financial assistance provided directly through the ministries of the Central Government.

TABLE 1: TRANSFERS TO THE STATES UNDER THE INSTRUMENTALITIES OF FC, PC AND DISCRETIONARY GRANTS, 1951-1999 (% OF TOTAL TRANSFERS)

Periods	*FC*	*PC*	*Discretionary Transfers*
1951-56	31.24	24.46	44.30
1956-61	32.00	36.89	31.11
1961-66	28.39	44.91	26.70
1969-74	33.33	30.05	36.62
1974-79	43.01	30.55	26.44
1980-85	41.00	29.34	29.65
1985-90	43.77	28.94	27.29
1992-97	47.09	29.35	23.56
1998-99	41.00	39.00	21.5

SOURCES: Sury (1998: 72); Thimmaiah (1999: 64-65)

As shown in Table 1, there have been occasions when discretionary transfers have been higher than statutory transfers through the FC, and transfers through the PC have been higher than those flowing through the FC. While transfers through the FC and the PC follow certain well-thought out and transparent formulae, though never without criticisms, discretionary transfers do not follow such clear cut, negotiated and well argued criteria. Also, under Article 293, the Central Government may grant loans to the states or give guarantees in respect of loans raised by them.

(i) *Finance Commission*

The system of federal finance that became operative after 1950 evolved over a period of time. The Expert Committee set up by the Constituent Assembly under the chairmanship of N.R. Sarkar recommended the setting

up of a FC to deal with matters of allocation of resources between the Centre and the states, grants-in-aid to the states, as well as other matters referred to it by the President of India.

Issues that are dealt with by the FC under Article 280 are, *(a)* those that fall under its purview, and *(b)* those that may be referred to it by the President of India. Taxes shared by the Union and the states and principles of grants-in-aid of revenue, are in the first category. Other taxes, where sharing by the states depends on the Union's discretion and principles determining needs of the states for grants-in-aid are in the second category. In addition, the President of India can refer any other matter for the consideration of the FC.

Terms of reference prescribed by the Union Government for the eleven FCs set up during 1952-2000 show interesting shifts, culminating with the new emphasis in the light of the changed federal balance and the policy of Liberalisation in the 1990s. Starting with the issue of grants-in-aid to the states that the first FC was asked to look into, detailed guidelines were issued to the second FC, which became more elaborate for the fourth FC. The fifth FC was asked also to suggest the principles that were to govern the grants-in-aid to the states. The terms of reference of the sixth FC were made more comprehensive, marking a departure from the earlier 'gap filling approach', covering the states' budgetary deficits on revenue account which calculated the gap between the expenditure of the state and its existing resources from tax and non-tax sources of revenue. Another significant change came when the ninth FC was asked to examine also the Plan accounts, while the earlier FCs covered only the Non-Plan accounts. The ninth FC was supposed to keep in view a 'normative approach' in assessing the revenue accounts of the states and the Centre. This approach took into account fiscal parameters from the point of view of the expected level of revenue effort by the state and the expenditure that was justifiable and reasonable. Terms of reference of the tenth FC, constituted on the eve of the introduction of the Liberalisation policy included considerations of the ways and means of generating surplus and reducing fiscal deficit. By the time the eleventh FC was appointed in 1998, some developments had taken place in the area of federal relations and the policy framework of Liberalisation was in position. Controlling budgetary deficits at the Centre as well as at the state levels had received renewed emphasis. Mounting budgetary deficits, especially at the state levels, were posing serious problems. With the setting-in of competitive federalism, performance of states became important. Many of the SFCs had submitted their reports, which had to be taken into account.

The FC recommended grants-in-aid to the states on the basis of

submissions by the states and forecasts of their revenue, estimates of the budgetary needs of the states and expenditures over the ensuing five years in the light of their probable growth. The estimates were made comparable by the FC by making adjustments 'to work out the gross deficits on the non-plan current accounts of the state Government budgets excluding the share from the divisible pool of Central tax'. If states showed a gap even after getting their share of divisible pool of taxes, they were considered to be in need of grants-in-aid. Vertical sharing of income tax and Union excise duties between the Centre and states constituted a major exercise of the FC.

A major change was introduced by the 89th Amendment to the Constitution of May 2000 creating a single divisible pool of Central taxes, in place of dividing only the income tax and excise duties among the states under Articles 270 and 272. According to the Amendment, the states were entitled to a 29 per cent share from this pool, which was to be reviewed every five years by the FC. This recommendation, made by the tenth FC, became a part of the Central Budget of 1996 and was approved by the Inter-state Council (ISC) in 1997. The eleventh FC earmarked 29.5 per cent as states' share from the Central pool.

After determining the share of taxes to the states, the next exercise was to distribute them across the states to ensure horizontal balance. The FC, however, also kept in view certain other considerations. Collection efforts and the population of the states were the criteria for *inter se* distribution of income tax.

The criteria used by the FCs became more elaborate, comprehensive and also controversial over the years. For the first six FCs, population was the most emphatic indicator of the need of a state. The next 25 years witnessed experiments with a number of criteria for distribution of tax revenues among the states. With the changes in federal relations in 1977, when the seventh FC started its work, a set of three new criteria were introduced - per capita income of states, percentage of the poor, and a revenue equalisation formula. Along with population, all the four criteria were assigned equal weightage. The next four FCs (the eighth to the eleventh) progressively increased the weightage to income distance (from 50% to 62.5%) and gave less weightage to population (from 25% to 10%). A number of new criteria were introduced by the tenth and the eleventh FCs, some of which were in accordance with the policy of Liberalisation, *e.g.* tax efforts by the states, infrastructure facilities and fiscal discipline.

The 73rd and 74th Constitutional Amendments of 1992 added to the role of the FC to recommend 'the measures needed to augment the Consolidated Fund of a state to supplement the resources of the Panchayats

[the local government units below the state in the state on the basis of the recommendations made by the Finance Commission of the state'.

(ii) *Planning Commission*

The PC draws its rationale from the three provisions of the Constitution - the Directive Principles of state Policy, Economic and Social Planning in the Concurrent List, and Article 282. The PC assesses the existing resources of the states, as well as of the country as a whole, and formulates plans for development in the required fields for. Plan allocations are made accordingly. Schemes that are launched by the Centre are to be implemented by the states with Central assistance. These Centrally Sponsored Schemes (CSS) are funded by the Centre, either fully or on a matching basis, and implemented by the states. Rural development, family welfare and planning, primary education and child development are the major areas in which these programmes are funded on a 75:25 basis between the Centre and the states, and others are in the form of grants to the states. Central assistance to state plans is distributed through three channels. The PC constitutes the first of the plans transfers on an agreed formula. Central assistance for externally aided projects is the second, and the third is the specifically earmarked sectoral or area based schemes. 'In 1999-2000 the formula-based channel accounted for about half of Central assistance, the externally-aided channel for about 15 per cent earmarked programmes for the balance 35 per cent'.

The formula-based transfer of Plan funds has evolved over the years. The first three Five Year Plans followed the system of schematic assistance: 'Under this scheme, if expenditure incurred by the state under the head fell short of the plan provisions, Central assistance was proportionally reduced for that head of development. Conversely, if the expenditure under a head of development exceeded the plan provisions, the ceiling of plan assistance was maintained and the excess was treated as development loan'. The states often expressed dissatisfaction with the absence of any principles in this arrangement. On the eve of the fourth Five Year Plan as the Gadgil Formula upon in the National Development Council (NDC). The scheme of distribution according to this formula as modified on several occasions in later years, has been in use for the allocation of Plan funds to the states. The modification by the NDC in 1979 recommended that 'Central assistance should be divided into two parts - that available without any transfer of CSSs to be distributed on the basis of the Gadgil Formula and the amount likely to be available as a result of modification in the CSSs.

(iii) *System of Loans to States*

The Centre substantially controls states' borrowings. In fact such

restrictions are found in most of the developing countries. In a study of 53 developing countries, an IMF study found that 47 had such restrictions: lower level governments in 16 countries could not borrow and overseas borrowing was not allowed in 19 countries. In other countries, rule-based controls, administrative controls and controls in implementation of debt were exercised by the Centre.

Loans to states flow through four channels *(a)* the PC (Plan Loans), *(b)* the departments of the Central Government (Non-Plan Loans), *(c)* the financial institutions, and *(d)* the market. The FC also looks into the debt position of the states and suggests means to help the situation and often recommends formulae for writing-off and rescheduling of payment of state debts. The eighth FC made such recommendations. The tenth FC tied up the writing-off to better financial management. Central loans in 1997-8 represented the major portion of the loans to the states and total liabilities of the states were much larger on account of the Central loan and advances, as against market loans.

Plan loans that represented the major portion of loans to the states, were routed through the PC and were meant to meet the gap in their resources for plan expenditure. The Gadgil Formula provides for 30:70 share of grants and loans to states except the special category states for which the share is 90:10. The Non-Plan loans are for CSSs and/or exigencies and are at the discretion of the Central Government. Terms and conditions of these loans are decided by the Department of Economic Affairs of the Government of India, which fixed the interest rate at 12 per cent per annum in 1994, and to be paid in 20 years.

Loans and advances were available to the states from Small Savings Schemes, Employees Provident Fund deposits, financial institutions and market borrowings. While loans from small savings were estimated and affected by the Ministry of Finance of the Government of India, in the case of loans for natural calamities and some short-term loans, the Finance Ministry consulted other ministries as well. Share of deposits in Small Savings Schemes was an important source of borrowings in the category of Non-Plan Loans. Since 1998-99, the Centre has been passing on 80 per cent of the net accretion to the states where these deposits are made. An interest of 14 per cent on these loans was charged from the states. The share from Employees Provident Fund has shown a sharp increase in the 1990s. The Centre does not have much control on these borrowings.

Loans were advanced to the states from financial institutions like the commercial banks and other institutions of development lending, like the Industrial Development Bank of India (IDBI), the National Bank for Agriculture and Rural Development (NABARD), Industrial Finance

Corporation of India (IFCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), Industrial Credit and Investment Corporation of India (ICICI), Housing and Urban Development Corporation (HUDCO) and National Cooperative Development Corporation (NCDC). While the commercial banks advanced short-term loans, those advanced by the other financial institutions, given for longer period, were at lower interest rates. Disbursement of loans from the institutions of developmental lending showed a bias against the less developed states, because besides the lower demand from such states, financial feasibility of the projects submitted by them was often unviable.

The impact of the policy of Liberalisation is visible in many ways. The RBI became more responsive to the market since 1990s with regard to debt management. Also, loans from financial institutions showed a clear preference for more developed states.

In 1999 the Central Government took the initiative to discuss the financial difficulties of the states in the NDC. It was agreed at a meeting of the Chief Ministers/Finance Ministers of seven states (Assam, Gujarat, Jammu and Kashmir, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal) and the Finance Minister of the Central Government that an assistance package by the Centre would include additional market borrowings and rescheduling of loan repayment. But this package was linked to the time bound fiscal reforms in the states. A Memorandum of Understanding (MoU), detailing the reform programme between the Centre and individual states, included items like downsizing the government, raising user charges, public sector disinvestment and restructuring, cash management, debt management and institutional reform including power sector reform.

(iv) *Trends in Federal Transfers and the Impact of Liberalisation Policy*

Transfer of resources from the Centre to the states through the three channels (the FC, the PC and the Central Government) show certain trends (Table 1). Statutory transfers through the FC show an increase since the sixth FC (1974-79) and have stabilised above 40 per cent. Plan transfers through the PC show a downward trend, though only slightly. Discretionary transfers through the Union Ministries, that accounted for 44.30 per cent of the first Plan transfers, came down to 23.56 per cent during 1992-93 and 9.19 per cent in 1998-99.

The degree of vertical imbalance in the Indian federation is on the higher side as compared to other federal countries, but this is perhaps understandable in terms of the constitutional provisions, the institutional arrangements and the emphasis on national planning. The debates have been more intense with reference to the inter se distribution of resources

among the states, *i.e.*, with regard to horizontal balance. Criticisms have been directed both at institutional arrangements and the criteria adopted by the institutions for the distribution of resources.

The FC and the PC work under different authorisations. While the FC has the status and functions authorised by the Constitution, the PC is a non-constitutional body. The PC is more prone to political bargaining and to central control. Giving nearly equal weightage to the two institutions in terms of percentage of Central allotment is a point of discussion by commentators as well as by the states. Centrally-sponsored projects, which are entirely at the discretion of the Centre, are also a matter of complaint by the states. In 1998-9, Plan transfers and discretionary transfers accounted for 46.1 per cent of financial transfers. While complaints are perhaps valid from the standpoint of the theory of federalism and arrangements following from that, any drastic change in institutional arrangements is not on the cards. In fact, there are strong advocates of Central initiative, both among the commentators and among the states. Support for Central initiative comes from those who believe that certain regions and sections of population have remained underdeveloped and need special attention. Centrally sponsored programmes are advocated mainly for such regions and target groups. Market forces are perceived as being typically insensitive to these needs. Also, competition among states tends to favour states that are already developed.

The criteria adopted for federal transfers are also to be seen in the context of regional balance in the country. Both the transfers, through the FC and PC, are expected to play an equalising role, not only from the viewpoint of the federation, but also from the point of view of the special needs of the states. There are two categories of states that receive special attention in financial allocations - states that are backward and states that need attention because of their special requirements and/or their location. Ten states, in the latter category, are taken care of in the division of the share of the states in plan assistance, as well as in the share of grants and loans, routed through the PC. This category of states attracted fewer controversies. Needs of backward states, however, were debated more often. The states' needs were supposed to be taken care of by the population and income distance criteria of the FC and the PC. The eleventh FC gave 10 per cent weightage to population and 62.5 per cent to income distance. The Gadgil Formula used by the PC in 1991 gave 60 per cent weightage to population and 25 per cent to 'per capita income below the national average'. The validity and adequacy of these criteria in defining the needs of the states were points of debate, just as their effectiveness in helping backward states was a constant debating point.

A new controversy regarding the balance between equity and efficiency arose after the report of the 11th FC. Its terms of reference stated specifically that the FC 'shall review the state of the finances of the Union and the states and suggest ways and means by which the government, collectively and severally, may bring about a restructuring of public finances so as to restore budgetary balance and maintain macro-economic stability'. An additional term of reference required the FC to suggest what grants to the states can be linked to performance on stipulated parameters. Keeping in view the importance of such considerations emphasised by the Liberalisation framework, some commentators felt that the FC 'must make its recommendations subject to certain specific stipulations.... The golden rule must be not [to] release any funds unconditionally'.

In the report of the 11th FC of July 2000, the poorer states (e.g., Uttar Pradesh, Bihar, Madhya Pradesh and West Bengal) got a larger percentage of funds, while the 'reforming and performing' states (e.g., Andhra Pradesh, Karnataka, Punjab, Haryana, Gujarat, Maharashtra and Tamil Nadu) received less than their share allowed by the tenth FC. Chief Ministers of the 'rich states' protested against the transfer of resources from the rich to the poor states, especially in the light of their own problems like budgetary deficits and increasing debt burden. Considerations of performance and fiscal discipline have acquired importance in the changed policy framework.

With the shift to the market-oriented model of development in 1990-91 there were certain changes in the pattern of federal transfers and in the working of the FC and the PC, and also in the system of giving loans to states. The first three years of economic reforms showed certain encouraging trends. Centre's fiscal deficit as a percentage of the GDP came down from 8.3 in 1990-91 to 5.6 in 1992-93. This reduction did not affect net transfers to the states. But at the state level, there was no corresponding 'pre-transfer reduction in fiscal deficits, which have remained around 7.6 per cent of the GDP in this period'. Some shifts were visible in transfer between 1990-91 and 1992-93. There was an increase in transfers in the form of tax shares and grants, while there was a noticeable decrease in savings (non-plan) loans. This helped to lower the states` post-transfer fiscal deficits marginally from 3.6 per cent of the GDP in 1990-91 to 3.2 per cent in 1992-93'. The next phase of stabilisation, however, was not so smooth because the level of Central deficit had reached a point where further decline was difficult. With pre-transfer deficit having a possibility of decline at the rate of 0.3 per cent of the GDP in 1993-4 (compared to 0.5 per cent in 1992-3), any post-transfer reduction was to be only on the basis of reduction in transfers. Deficits in the states were larger, debt burden heavy and fiscal management far from satisfactory.

The FC has become a mechanism for channeling aspects of policy reforms brought about by Liberalisation. The tenth FC was asked to look into 'balancing receipts and expenditures of revenue accounts of states'. The terms of reference of the eleventh FC included 'restructuring of public finances to restore budgetary balance and maintain macroeconomic stability' and drawing a monitorable fiscal reform programme aimed at reduction of revenue deficit in the states. This FC recommended that the grants to the states to cover the assessed deficit in their non-plan revenue account, may be linked to progress in implementing the programme' and also suggested ' what grants to the states can be linked to the performance on stipulated parameters'. The controversy about equity vs. efficiency raised by the 'reforming and performing states' (Andhra Pradesh, Karnataka, Punjab, Haryana, Gujarat, Maharashtra and Tamil Nadu) after the recommendations of the eleventh FC, pointed towards the importance of the new economic policy. The eleventh FC also included tax efforts by the states, infrastructure facilities and fiscal discipline in the states among the criteria for *inter se* sharing of taxes. Also, performance of states was built into the revised Gadgil Formula in 1991 for Plan transfers. The trend is also visible in the system of loans to the states. The share of loans and advances from the Centre, which was 70.6 per cent in 1975-76, came down to 58.2 per cent in 1999-2000 and market loans went up to 17.2 per cent in 1999-2000 from 15.4 per cent in 1975-96. Steps were also taken by the RBI to bring the system closer to the market.

Under the new policy framework, Central grants were sometimes used as levers of control to ensure financial discipline in the states. The Centre deducted Rs. 1360 crore from the Central Plan Assistance to the state of Bihar to clear the dues to the different central public undertakings that the Bihar state Electricity Board had to pay. Similar action was taken against Maharashtra to clear their dues to the Dabhol Power Corporation. The MOU signed by the Centre with the individual states for assistance package to overcome their financial problems, included conditions of time-bound fiscal reforms by them.

III

Institutions and Policies of Financial Sharing in Australia and India

There are interesting similarities and dissimilarities in the Constitution and working of the four institutions - the CGC and the ALC in Australia and the FC and the PC in India. While the CGC and the FC are comparable, the ALC and the PC were set up under specific circumstances and to handle specific functions. The trend towards shifting of importance from

the Centre (Commonwealth in Australia) to the states in certain respects in the post-Liberalisation (and tne NCP in Australia)period is also perceptible in the two countries, though with variations in the capabilities of the states in handling autonomy in managing their economy.

The CGC and the FC have similar functions of federal financial transfers, though the former was set up by an Act of Parliament, and the latter has a constitutional authorisation. The CGC 'recommends special purpose grants to the claimant states, but the general grants are determined largely on the basis of negotiations at the political level'. In terms of functions, the FC being a constitutional body has operated almost outside the political bargaining framework. At the same time, institutions in both the countries have well worked out objectives and technically defensible formulae to achieve vertical and horizontal fiscal balance to the extent that is possible within the overall constitutional and institutional frameworks. There are some similarities also in the criteria that the two Commissions. For example, the 'income distance method' used by the FC is similar to the 'standard state method' that the CGC adopted to take care of the states that needed special attention. Another similarity is the attempt by the ninth FC to estimate capacities and needs of the states for determining their entitlements for financial transfers. The Australian approach has been on the revenue-raising capacities of states and their expenditure needs. The CGC in Australia deals with the entire revenue budgets of the states, but the FC in India is responsible only for non-Plan allocations. The distinction between Plan and Non-Plan requirements and allocations has often been regarded artificial. As mentioned above, the terms of reference of the FCs have sometimes included the Plan requirements of the states. The recent effort under the 89th Amendment to create a single pool of taxes with an assured share for the states is similar, in certain respects, to the broad-based GST in Australia.

A more recent complaint in India, after the eleventh Finance Commission's report, has been from the rich states resenting the double transfer of resources to the Centre and then to the poor states. Similar arguments were put forth in Australia by larger states like New South Wales and Victoria when the Premiers' Conference approved the set of distribution criteria in 1982. After the introduction of the GST, New South Wales, Victoria and Western Australia expressed their concern that 'Queensland receives over $ two bn pa more than its economy contributes to Commonwealth taxes and other revenues'. CRCSF made a distinction between the 'donor states' (New South Wales, Victoria and Western Australia) and the remaining states, which are 'recipient states', from the point of view of receiving per capita share of the GST grant relativities.

The Indian scheme of distribution of federal finances by the FC shows a concern for inter-state development. The weightage for the distance criterion in the eleventh FC was increased to 62.5 per cent from 60 per cent in the tenth FC and that of the index of infrastructure development, to 7.5 per cent from five per cent. The Gadgil Formula for Plan transfers made provision for ten states that needed special attention because of their geographical location or some special problems that they faced. Commentators on the Australian system pointed out that 'between 1977-78 and 1991-92, Queensland, South Australia, and Tasmania had the lowest real GDP at factor cost per head for 14 out of 15 years'. The system of fiscal equalisation adopted by the CGC was questioned from the point of view of reducing inter-state disparities.

For loans and borrowings by states, setting up of the ALC in Australia in 1928 led to the evolution of a policy of coordinated system of borrowings. In India, regular government departments handled loans and borrowings by the states. As a result, *ad hoc* decisions were sometimes taken. Analysts and inquiry commissions often recommended setting up of an institution on the lines of the ALC for managing loans to states. In both the countries, the states were not very comfortable with the respective arrangements. Efforts were made to find ways and means to by-pass the system so that they had greater freedom in taking loans and in borrowings. In Australia, the ALC's importance started declining after the Campbell Committee Report, the Global Limit of 1984 and Financial Agreement of 1994, with the ALC having 'a limited collective monitoring role'. Trend towards the system moving closer to the market forces was visible in India as well, both in terms of proportion of loans to states from different sources and the working of institutions like the RBI. Receding importance of central planning and ascendance of market forces after the introduction of the Liberalisation policy reduced the importance of the PC.

In the post reform era of the 1990s in India there are indications of greater initiative being passed on to the states. The two markers in this direction are: *(a)* withdrawal of the Centre from many sectors of activities and leaving initiatives in these areas to the states, dependence on market forces and privatisation initiatives; and *(b)* the 1992 Constitutional Amendments providing constitutional status to local bodies, including the provision for SFCs. Even with regard to CSSs, the Finance Minister's Budget Speech of 1996-97 declared that '... most Centrally sponsored schemes should be transferred to the control of the states'. It has not been smooth for the states to operate within the Liberalisation framework. It is one thing to talk about fiscal autonomy for the states, but it is entirely another matter to manage that autonomy. This is amply illustrated by the states' efforts at

managing budgetary deficits and attracting private investments, both domestic and foreign, especially in the area of social infrastructure, like health, literacy and education, and poverty eradication. Most of these activities fall within the states' purview. Overseeing by the Centre and Central assistance will be needed, especially in the light of the not-so-robust economy of the states. This will certainly be so for about half of the 28 states of the Indian federation.

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