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## EXAMINATION OF THE LEGAL BASIS FOR CONDITIONAL TRANSFERS TO STATES AND ISSUES RELATING TO PERFORMANCE-BASED INCENTIVES FOR STATES

*Report to the Fifteenth Finance Commission*

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## CHAPTER I: INTRODUCTION

### A. RESEARCH QUESTIONS AND CONTEXT SETTING

This report enquires into the legal basis for conditional fiscal transfers from the Union to state governments in India, and develops a framework for the design of such transfers based on best practices from around the world. Intergovernmental transfers are an outcome of the division of duties between the Union and subnational governments, where the Union of India is reposed with sovereign powers to raise revenues, and subnational governments are reposed with responsibilities of catering to the local needs of their constituent communities. These transfers are used to distribute taxes and funds from the Union to the subnational governments, to ensure that revenues match their expenditure needs, and in order to enable them to provide basic services to citizens. As such, they are used to meet the following national, regional, and local objectives:

- (i) To address ‘vertical imbalance’, and to correct for the asymmetry of revenues and expenditure between the Union and the state governments.
- (ii) To mitigate ‘horizontal imbalances’ and to correct for the asymmetry amongst governments operating at the same level, *i.e.*, to correct for the asymmetry in revenue distribution amongst various state governments.
- (iii) To correct for inter-jurisdictional spillovers and to account for externalities in local areas, such as health epidemics or environmental disasters that affect more than one state.

Additionally, they may also be used to ensure macroeconomic stability, maintain prudent fiscal management, and to create a common economic union.<sup>1</sup>

In this context of intergovernmental transfers, three primary research questions arise:

- (a) What is the legal basis for conditional transfers to states by the Finance Commission under the Constitutional scheme?
- (b) What is the most appropriate framework for designing conditional transfers, particularly those incorporating incentives to improve the performance of states in delivering services?
- (c) What is the legal basis for conditional transfers through the Centrally Sponsored Schemes (CSS) in light of the learnings of the Sarkaria Commission,

<sup>1</sup> Anwar Shah, Policy Research Working Paper; No. 4039, World Bank “A Practitioner’s Guide to Intergovernmental Fiscal Transfers” (2006) at p. 1.

and Punchhi Commission?

In order to provide some context, it is necessary to understand what is meant by conditional transfers. Conditional transfers are the transfer of funds, from a federal government to a subnational government, based on certain conditions that have to be met by the subnational government. These conditions are used to influence the policy preferences of subnational governments, either by defining where and how the subnational government may use the grant money, or by using conditions to nudge subnational governments to behave in a certain manner. Conditional transfers can take several forms, depending on the kind of policy meant to be achieved, and include, amongst others, “specific purpose transfers”, and “performance-linked transfers”. These terms are explained presently.

From our analysis of the Constitution of India and selected countries from around the world, we have formulated certain design principles, which we believe apply to all kinds of intergovernmental transfers, irrespective of whether they are made under the ambit of Article 275 of the Constitution of India (Constitution), which governs all grants-in-aid; or other kinds of conditional transfers like those made through CSS, which have usually been transferred under Article 282. This report recommends that such schemes should also be governed on the same key principles as the category of grants under Article 275. In an attempt to understand and analyse the overarching role of conditional transfers in achieving policy objectives, this report seeks to undertake an examination of the key design principles that can be employed to achieve more accountable, equitable, and efficient conditional transfers in India.

## B. ORGANISATIONAL SCHEME OF REPORT

This report is divided into three parts. The first part, in **Chapter II**, explains the Constitutional scheme of conditional transfers in India, by examining the distribution of revenue between the Union and the states. In this part, the report grounds its analysis in three provisions of the Constitution, the first of which is Article 270, which governs the distribution of taxes levied and collected by the Union, to be distributed between the Union and states. It is found that these transfers are: (i) determined through a formula proposed by the Finance Commission; (ii) unconditional; and (iii) not designed to affect any expenditure or other preference at the subnational level. The second pertinent provision is Article 275 of the Constitution, which governs all grants-in-aid. These transfers are made on the recommendations of the Finance Commission, and can be conditional or unconditional, since there is no specific constitutional specification one way or the other. Lastly, Article 282 of the Constitution which deals with discretionary grants, gives power to both the Union and the state governments to make grants for any purpose irrespective of whether the subject matter of the purpose falls in the Seventh Schedule, i.e. the purpose is one with respect to which the Parliament or

the Legislature of the state(s) can make laws, provided that the purpose in question amounts to a “public purpose”. These grants can also be conditional or unconditional in nature, and fall outside the purview of the recommendations of the Finance Commission.

We find that conditional transfers under the Constitution are legal, and conditions may be imposed on grants-in-aid recommended by the Finance Commission under Article 275 of the Constitution. Further, the power under Article 275 is not restrictive in nature, and hence grants-in-aid can be given for general or special purposes, as well as for capital or revenue grants, and there is nothing to prevent conditions from being imposed on any such grants. Conditions may also be mandated for transfers under Article 282.

The second part of the report, in Chapter III, undertakes an examination of selected countries across the world, in an attempt to draw upon best practices in the design of efficient intragovernmental transfer systems that can ensure both high performance in service delivery, as well as responsible and accountable local governance. This Chapter delves into the study of the design of conditional transfer schemes in various countries, which provide funding to diverse sectors, including education, health, transportation, public safety, sanitation, environment and welfare programmes. The principles we evolve answer six key questions regarding the effective design of conditional transfers, such as (a) who should design the transfer; (b) what conditions should the transfers be based on; (c) how should performance be assessed and measured; (d) who should be able to monitor performance and compliance by recipient governments; (e) what should be done when recipient governments fail to comply with the grant conditions; and (f) how should conflict be managed in the context of conditional grants. On this basis, we recommend the following:

1. Encourage greater collaboration between the Union and subnational governments in the design of conditional transfers to better tailor transfers to local conditions and to enhance local autonomy;
2. Design incentives that are performance-linked, rather than input-linked for subnational governments;
3. Set up systems to accurately and credibly measure and assess the performance of grant recipient governments;
4. Establish institutional arrangements for monitoring and evaluation of subnational governments;
5. Develop processes to address non-compliance with grant conditions; and

6. Create institutional mechanisms and processes to manage conflicts, that incorporate due process.

The third part of the report in **Chapter IV** examines prior experience with intergovernmental conditional transfers in India, including a summary of the recommendations of previous Finance Commissions relating to conditional transfers, particularly those channelled through Centrally Sponsored Schemes (CSS). It also analyses some CSS programmes, and weighs them against the key principles of design established by the second part of the report.

The report is supplemented by two annexures.

**Annexure I** charts the history of conditional transfers in India by providing a brief overview of conditional grants and transfers made by previous Finance Commissions, as well as specific recommendations made by previous Finance Commissions on the design of conditional transfers.

**Annexure II** contains a brief overview of the recommendations made by the Sarkaria Commission, and the Punchhi Commission on the use of conditional transfers through CSS in India.

## PART I

## CHAPTER II: CONSTITUTIONAL SCHEME OF CONDITIONAL TRANSFERS IN INDIA

## A. FISCAL FEDERALISM IN THE INDIAN CONSTITUTION

The federal structure of the Constitution is rooted in the division of executive and legislative powers between the Union and the states. The relations between the Union and the states is reflected in a number of provisions,<sup>2</sup> enshrined in Part XI of the Constitution, which clearly spell out legislative and administrative relations, as well as the distribution of responsibilities. Accordingly, Article 246 of the Constitution lays down a framework for distribution of legislative powers between the Union and states, specifying the subject matter of laws that can be made by the Parliament, and by the state Legislatures. This is supplemented by Part XII of the Constitution, which specifies the distinct taxation powers of the Union and state governments. However, the Union Government has some overarching powers over state governments, including the power to amend the Constitution in certain circumstances. Broadly, like many other federal States across the world, the Union Government of India has been vested with the responsibilities of maintaining macroeconomic stability, international trade and relations, matters which concern more than one state, and the wide-spread provision of public services. State governments on the other hand, have been vested with the functions of public order, health, agriculture, land rights, fisheries and minor minerals, with additional responsibilities derived from the Concurrent list on the subjects of education, insurance, transportation and social security.<sup>3</sup>

This distribution of legislative powers, as described in the paragraph above, is enumerated in Schedule VII of the Constitution, which provides for three lists: List I or the Union List, which contains entries over which the Union Parliament has sole competence; List II or the State List, which provides for entries over which the state Legislatures have sole competence; and List III or the Concurrent List, for entries over which both the Union Parliament and the state Legislatures have competence to make laws. A bare perusal of the enumerated subjects indicates that while the power to levy and collect revenue on most subjects has been vested with the Union, which has been further clarified by other provisions in the Constitution, most entries relating to developmental expenditure have been allocated to the state governments. This creates a dichotomy between the sources

<sup>2</sup> Articles 245-263 of the Constitution.

<sup>3</sup> Nirvikar Singh, "Fiscal Federalism" in the Oxford Handbook for the Constitution of India (Oxford 2016), Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), at p. 524.

of revenue and items of expenditure for the states, thereby necessitating a scheme for distribution of revenue. The Constitution recognizes that the assigned revenue powers are inadequate to meet expenditure responsibilities of the state governments and provides for the mechanism to transfer funds from the Union to state governments by way of tax devolution and grants in aid. To effect the transfers on an objective basis, the Constitution provides for the appointment of the Finance Commission every five years<sup>4</sup>. In this regard, it has been noted that the existence of fiscal imbalances, both vertical and horizontal, may not be a cause for concern, as long as there is an efficient and equitable mechanism of intergovernmental transfers to offset such these imbalances.<sup>5</sup> Therefore, Part XII of the Constitution, more precisely Articles 268 to 281, provides for a mechanism of distribution of revenue between the Union and state governments.

## B. ROLE OF THE FINANCE COMMISSION: LEGALITY OF CONDITIONAL TRANSFERS

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Article 280 of the Constitution mandates the establishment of the Finance Commission. The recommendations made by the Finance Commission aids in the reduction of vertical fiscal imbalances<sup>6</sup> between the Union and the states. Its recommendations are also intended to promote greater economic efficiency of national tax collection, and the subnational spending for public goods and services.<sup>7</sup> Therefore, the Finance Commission has been a key component in the effective distribution of revenue in the country. The Constitution does not prescribe the principles of distribution of revenue, but instead leaves it to the recommendations of the Finance Commission.<sup>8</sup> The Constitution also makes it obligatory to take these recommendations into consideration, which have conventionally been treated as binding in nature.<sup>9</sup>

The Constitution does however, prescribe the methods of distribution. The distribution of revenue is primarily through two methods: first is the devolution of taxes levied and collected by the Union, between the Union and the states, which has been dealt with under Article 270; second is through the grants-in-aid of revenues of such states that are charged on the Consolidated Fund of India (CFI) under Article 275. Additionally, Article 282 of the Constitution permits the Union

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<sup>4</sup> M. Govind Rao, IMF Publication, November 2000, “Fiscal Decentralization in Indian Federalism”, p 13 available at <https://www.imf.org/external/pubs/ft/seminar/2000/fiscal/rao.pdf>

<sup>5</sup> NIPFP, Indian Fiscal Federalism, p. 24, available at [https://www.nipfp.org.in/media/pdf/books/BK\\_28/Chapters/3.%20Indian%20Fiscal%20Federalism.pdf](https://www.nipfp.org.in/media/pdf/books/BK_28/Chapters/3.%20Indian%20Fiscal%20Federalism.pdf)

<sup>6</sup> Vertical Fiscal Imbalance refers to the asymmetry of revenues and expenditure between the Union and the state governments.

<sup>7</sup> Nirvikar Singh, ‘Fiscal Federalism’ in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), *The Oxford Handbook for the Constitution of India* (Oxford 2016) at p. 524.

<sup>8</sup> Granville Austin, *The Indian Constitution: Cornerstone of Nation* (Oxford 2015), at pp. 274-275.

<sup>9</sup> Granville Austin, *The Indian Constitution: Cornerstone of Nation* (Oxford 2015), at pp. 274-275.

and the state governments to make grants for any public purpose. The Seventy-third and Seventy-fourth amendments to the Constitution further introduced provisions that required the Finance Commission to consider measures for supplementing the resources of local bodies.

Thus, intergovernmental fiscal transfers in India are made from the Union to the states through the sharing of central tax revenue with the states under Article 270 of the Constitution, as well as through grants under Articles 275 and 282 of the Constitution. Through the years, transfers have been recommended by various agencies including the Finance Commission, Planning Commission, and the central ministries of the Government of India. In the next section, the report focuses in more detail on the Constitutional provisions governing the transfers recommended by the Finance Commission, which has the primary responsibility of determining states' shares in tax revenue sharing. Chapter IV of the report gives more detail on the types of conditions that have been imposed by previous Finance Commissions, and key design principles that should govern conditional transfer schemes.

So far as Article 270 is concerned, tax revenue sharing under this provision has been used for meeting both vertical and horizontal objectives of transfers. Horizontal transfers may be used for equalization, or for neutralising disabilities, or providing incentives for tax effort and fiscal discipline.<sup>10</sup>

In this regard, it is important to bear in mind the historical perspective of intergovernmental transfers in India. Initially, the Constitution provided for the sharing of only two Central taxes with states. As per the then Constitutional provisions, tax sharing recommended by the first ten Finance Commissions was restricted to the proceeds of income tax and Union excise duties. However, the 80th amendment to the Constitution in the year 2000 provided for sharing of the proceeds of all Union taxes and duties with the states, except for the Central sales tax, consignment taxes, surcharges on Central taxes and earmarked cesses. This was done to enable states to derive the advantage of sharing the buoyancy of all Central taxes, to ensure greater certainty in the resource flows to the states, and to facilitate increased flexibility in tax reforms.<sup>11</sup>

Apart from tax revenue sharing under Article 270, the main alternative channel available to the Finance Commission for fiscal transfer to states, exists as grants-

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<sup>10</sup> D.K. Srivastava and C. Bhujanga Rao, Review of Trends in Fiscal Transfers in India, Madras School of Economics, 2009, at p. 1, available at [https://fincomindia.nic.in/writereaddata/html\\_en\\_files/oldcommission\\_html/fincom13/Discussion/report02.pdf](https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom13/Discussion/report02.pdf) .

<sup>11</sup> Finance Commissions- A Historical Perspective, available at: <https://fincomindia.nic.in/ShowContent.aspx?uid1=2&uid2=1&uid3=0&uid4=0> .

in-aid of revenues under Article 275 of the Constitution. The determination of these grants follows from two exercises carried out by the Finance Commission: one, assessment of expenditures of each state on revenue account (non-plan or total), and two, assessment of the state's own revenues. Once tax devolution to each state has been determined, grants-in-aid are determined as a residual, which is the difference between the assessed expenditure and the sum of the projected own (state's) revenues and shares in central taxes. In other words, grants-in-aid under the Finance Commission are meant to fill up a "gap" which represents expenditure not covered either by the state's own revenues, or its share in central taxes. Further, it is significant to note that while Article 270 (for division of taxes) speaks of percentage share, Article 275 refers to specific "sums". The Constitution prescribes that these grants are to be "charged" on the Consolidated Fund of India (CFI) and must be recommended by a Finance Commission.<sup>12</sup> It has also been noted, that the transfers recommended by Finance Commissions through tax devolution under Article 270 and grants-in-aid under Article 275 are not charity to the states. They are meant to enable the states to provide comparable levels of services, at comparable tax rates, while ensuring a budget balance in the revenue account.<sup>13</sup>

Thus, the role of the Finance Commission is to recommend the principles, as well as the quantum of grants to those states which are in need of assistance, and for that purpose different sums may be fixed for different states. Therefore, one of the prerequisites for grants under Article 275 is the assessment of the needs of the states.<sup>14</sup> The First Finance Commission had laid down five broad principles for determining the eligibility of a state for grants.<sup>15</sup> By and large, these principles have guided the grants recommended by all the Finance Commissions, and subsequently, successive Finance Commissions have distilled these principles into four main considerations which must govern grants-in-aid. These principles state that grants-in-aid may be given to the states to meet their residuary budgetary needs after taking the devolution of taxes into account. Grants-in-aid have also been recommended to facilitate the upgradation of standards of administrative

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<sup>12</sup> D.K. Srivastava and C. Bhujanga Rao, *Review of Trends in Fiscal Transfers in India*, Madras School of Economics, 2009, p. 29.

<sup>13</sup> M. Govind Rao, "15th Finance Commission: To realise the goals under new India 2022, here is what Centre must remember", *Financial Express*, December 5, 2017, available at <https://www.financialexpress.com/economy/15th-finance-commission-to-realise-the-goals-under-new-india-2022-here-is-what-centre-must-remember/960819/>

<sup>14</sup> "Finance Commissions- A Historical Perspective", available at <https://fincomindia.nic.in/ShowContent.aspx?uid1=2&uid2=1&uid3=0&uid4=0>.

<sup>15</sup> The first was that the Budget of a state was to be the starting point for examination of a need. The second was the efforts made by states to realize the potential and the third was that the grants should help in equalizing the standards of basic services across states. Fourthly, any special burden or obligations of national concern, though within the state's sphere, should also be taken into account. Fifthly, grants might be given to further any beneficent service of national interest to less advanced states.

and social services<sup>16</sup> and to ensure minimum expenditures on such services across the country.<sup>17</sup> They have also been recommended to meet the special needs, burdens and obligations of the states and also to address the specific sectors of national importance.<sup>18</sup> Finally, grants-in-aid have been recommended for augmenting expenditures, rather than for substituting what a state government is already spending.<sup>19</sup>

This section deals with the legality of conditional transfers, while the next section provides in greater detail, the methods of distribution of revenue.

### 1. Devolution of taxes under Article 270

Article 270(1) of the Constitution provides that all taxes levied and collected by the Union (including any surcharges on taxes levied under Article 270(1), other than the taxes that are already assignable to the states under the provisions of the Constitution, shall be distributed between the Union and the states. Post the introduction of the Goods and Services Tax (GST), Articles 270(1-A) and 270(1-B) were added by way of amendments, to include the amounts collected and apportioned to the Union under GST in the above pool. The requirement of distribution from this pool of revenue collected by the Union to the states is mandatory under the Constitution.

The procedure for distribution of this pool has been provided for in Article 270(2) of the Constitution. It provides that such percentage of the net proceeds collected in a particular year shall not form part of the CFI, but shall be assigned to the states within which that tax or duty is levied in that year; and shall be distributed among those states in such manner and from such time as may be prescribed. Thus, the tax collected by and apportioned to the Union by way of Articles 270(1), 270(1-A) and 270(1-B) of the Constitution form the divisible pool of revenue, which is to be mandatorily allocated between the Union and state governments.

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<sup>16</sup> Over the years, the types of specific purpose grants given to states have further expanded to include those which are intended to reduce disparities in the availability of various administrative and social service burdens across states, and to allow particular states to meet special financial burdens emerging as a result of their unique circumstances. See Chapter 3, Report of the Thirteenth Finance Commission, p. 35.

<sup>17</sup> From the Sixth Finance Commission onwards, specific purpose grants were targeted towards bridging the disparities in the provision of various social services across states, and bringing them up to the national level. Similarly, the report of the Eleventh Finance Commission identified several sectors which required specific assistance, such as those of district administration, police administration, health services, elementary education, public libraries etc., in those states which required upgradation of standards.

<sup>18</sup> Finance Commissions have granted specific purpose grants in order to ensure that certain progress was made in matters of national importance, which otherwise state governments would not have considered necessary. See Report of the Third Finance Commission.

<sup>19</sup> Report of the Fourteenth Finance Commission, para 11.4.

Article 270(3) of the Constitution provides clarity to the word “prescribed” as used in Article 270(2) (with respect to the percentage of net proceeds of taxes), to mean that which is prescribed by the order of the President, after considering the recommendations of the Finance Commission. Additionally, Article 280(3)(a) of the Constitution makes it a duty of the Finance Commission to make recommendations in respect of the net proceeds of the taxes that are to be distributed between the Union and state governments, and the allocation between the states *inter-se* of their respective shares.

Therefore, the wordings of Article 270 and Article 280(3)(a) make it clear that the primary responsibility of the Finance Commission is to determine the percentage of the divisible pool that is to be assigned to the states (vertical distribution) and the percentages that are to be allocated to states *inter-se* (horizontal distribution). Hence, the provision does not give any discretion in determining whether such transfers can be made or not, but only allows the Finance Commission to determine the percentages. In this regard, the Fourteenth Finance Commission was of the view that this devolution from the divisible pool should form the major chunk of the transfers to the states.<sup>20</sup> Therefore, these transfers are general and not specific in nature. The determination of the percentages is through a formula, which is proposed by the Finance Commission by taking several variables into account. For instance, the Fourteenth Finance Commission had recommended that 42% of the divisible pool will be distributed to the states as an unconditional transfer.<sup>21</sup>

The factors determining the formula fall under three criteria namely: (a) factors reflecting needs (such as population and income); (b) cost disability (area and infrastructure); and (c) fiscal efficiency indicators (tax effort and fiscal discipline). For the purpose of *inter-se* distribution amongst states, the Fourteenth Finance Commission proposed that the weightage be accorded by the following criteria: (i) population (17.5%); (ii) demographic change (10%); (iii) income distance (50%); (iv) area (15%); and (v) forest cover (7.5%).<sup>22</sup>

**Table 1** below, gives a brief overview of the parameters used by various Finance Commissions in the past.

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<sup>20</sup> Report of the Fourteenth Finance Commission, at p. 90.

<sup>21</sup> Report of the Fourteenth Finance Commission, at p. 97.

<sup>22</sup> Report of the Fourteenth Finance Commission, p. 97.

No	Parameter	Finance Commission Number						
		VIII	IX	X	XI	XII	XIII	XIV
1	Population 1971	25	25	20	10	25	25	17.5
2	Adjusted area			5	7.5	10	10	15
3	Income distance/fiscal cap distance	50	50	60	62.5	50	47.5	50
4	Fiscal discipline				7.5	7.5	17.5	
5	Tax effort			10	5	7.5		
6	Index of infrastructure		12.5	5	7.5			
7	Inverse income	25	12.5					
8	Demographic change 2011 population							10
9	Forest area							7.5
	Total	100	100	100	100	100	100	100

VIII and IX FC—Formula adopted for Income Tax Distribution shown, which applied only to 90% of the collection.

**Table 1: Formula for Devolution of Taxes used by Finance Commissions<sup>23</sup>**

It is clear that once the formula with different weights to parameters is applied, no conditions can be set on the right of the state to receive such funds. Thus transfers under Article 270 are unconditional.

## 2. Grants-in-aid of Revenue under Article 275 of the Constitution

Article 275(1) of the Constitution provides that such sums as Parliament may by law provide, shall be charged on the CFI each year, as ‘grants-in-aid’ of the revenue of such states. This is determined by the Parliament on various parameters, including considering states that are in need of assistance; with different sums being fixed for different states. Further, the proviso to Article 275(1) and Article 275(1-A) specifically deal with grants for promoting the welfare of Scheduled Tribes, and to autonomous states.

Article 275(2) provides that until such provision is made by the Parliament, the powers conferred on the Parliament will be exercised by the President, who will be obliged to consider the recommendations of the Finance Commission. Article 280(3)(b) of the Constitution provides that it shall be the duty of the Finance Commission to make recommendations on the principles which should govern the grants-in-aid of the revenue of the States out of the CFI.

Therefore, the Finance Commission has greater discretion in determining the circumstances in which such grants should be given, as compared to devolution of taxes, considering the Constitution entrusts the Finance Commission with the responsibility of developing the principles governing such grants. These grants in the past have not only been restricted to address revenue deficits, but have also been released to facilitate the upgradation of standards of administrative and

<sup>23</sup> V. Bhaskar, ‘Stance on Devolution and Grants’ (2015) Vol 1 No 21 Economic and Political Weekly at pp. 36-40.

social services, and to ensure minimum expenditures on such services across the country, to meet the special needs, burdens and obligations of the states, and also to address the specific sectors of national importance, and lastly for augmenting expenditures, rather than for substituting what a state government is already spending.<sup>24</sup> So far as revenue deficit grant is concerned, the Fourteenth Finance Commission recommended a total revenue deficit grant of Rs. 1,94,821 crore during the award period for eleven states.<sup>25</sup>

While grants that are aimed at addressing revenue deficits would by their very nature be unconditional, grants that are aimed at more specific purposes, under Article 275, have had conditions attached to them.<sup>26</sup> Such conditions include the receiving state having to “match” or contribute some proportion of the money received from the Union Government.<sup>27</sup> This was intended to prevent the misuse of the grant and to ensure performance. This would also provide the grant recipient state an incentive to utilise the funds towards a particular purpose.<sup>28</sup> Conditions can be attached to specific purpose grants for which there is a case of externalities, or on equalisation transfers, or for loans extended by the Union.<sup>29</sup> Conditions have also been linked to specific-purpose grants to incentivise better fiscal management and planning amongst states, and to enact critical reforms. For instance, the Eleventh Finance Commission recommended creating the “Incentive Fund”. This Fund constituted 15% of the states’ share in non-plan revenue expenditure. Grants from this fund were to be released on the basis of defined monitorable fiscal reforms.<sup>30</sup> Further, the Thirteenth Finance Commission recommended that state-specific grants should not be released until: (i) states are no longer in violation with the GST agreement they have signed with the Union (this applies to the state’s share of the GST incentive agreement as well); or (ii) the states have enacted the relevant legislative changes in the Fiscal Responsibility and Budget Management Act (FRBM) to reflect fiscal targets. The Finance Commission also specified that such grants could not be used for land acquisition.<sup>31</sup>

Attachment of conditions has thus been seen as depending on the economic purpose of the transfer. Since the First Finance Commission, conditional grants

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<sup>24</sup> Report of the Fourteenth Finance Commission, p. 140.

<sup>25</sup> Report of the Fourteenth Finance Commission, p. 150.

<sup>26</sup> Report of the Fourteenth Finance Commission, p. 150.

<sup>27</sup> Report of the First Finance Commission, available at: <https://fincomindia.nic.in/ShowContent.aspx?uid1=3&uid2=0&uid3=0&uid4=0>.

<sup>28</sup> Chapter VII, Report of the First Finance Commission, pp. 95-96 available at: <https://fincomindia.nic.in/ShowContent.aspx?uid1=3&uid2=0&uid3=0&uid4=0>.

<sup>29</sup> Bagchi and Chakraborty, NIPFP, Towards a Rational System of Centre State Revenue Transfers in India: An Exploration (2013), at p. 26.

<sup>30</sup> Report of the Eleventh Finance Commission on the Additional Term of Reference, 4-8.

<sup>31</sup> Report of the 13th Finance Commission, pp. 73, 140, 252.

have been considered permissible under Article 275 of the Constitution, and these grants have recently grown in importance in Indian fiscal federalism<sup>32</sup>. The Fourteenth Finance Commission however avoided making sector-specific grants under Article 275, and instead suggested a new mechanism (under the Inter-State Council) for the same.

The scheme of the Constitution, the open-ended nature of Article 275 (not specifying types of grants-in-aid to states) and consistent practice of Finance Commissions in this regard means that it is now well-settled that conditional transfers may be made under Article 275.

A detailed overview of the conditional grants made by previous Finance Commissions under Article 275 has been provided in **Annexure I** to this report.

### 3. Grants under Article 282 of the Constitution

Article 282 of the Constitution is an omnibus provision that allows the Union and states to make grants for any public purpose, notwithstanding that the purpose is not one with respect to which the Parliament and state Legislatures may make laws. As opposed to the other provisions of the Constitution, the language of Article 282 gives a lot of flexibility in making transfers to the states. Prior to the abolition of the Planning Commission (PC), transfers for plan expenditure used to be made under Article 282, and even transfers by Central Ministries for various schemes of the Union Government were justified under Article 282.<sup>33</sup> Thus, Article 282 has been used to justify both Central ministry transfers, as well as PC transfers.<sup>34</sup>

Whether this is truly within the intended Constitutional mandate has been a matter of debate, with constitutional law experts such as Nani Palkhivala stating that Article 282 is only a residuary Article to enable the Union or a State to make a grant for any public purpose. He states that Article 282 is like the inherent power of the court under section 151 of the Code of Civil Procedure to meet the ends of justice. Therefore, to regard Article 282 as the substantive Article under which the Union can confer grants on the states as a matter of bounty, while the strained resources of the states are crying for their legitimate right to grants-in-aid under Article 275, is to distort the clear scheme of the Constitution.<sup>35</sup> In fact, the

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<sup>32</sup> Sujit Choudhry and Benjamin Perrin, “The Legal Architecture of Intergovernmental Transfers”, p. 279

<sup>33</sup> Nirvikar Singh, Fiscal Federalism in The Oxford Handbook for the Constitution of India (M. Khosla *et al* eds., 2016), at pp. 536-537.

<sup>34</sup> Nirvikar Singh, Fiscal Federalism in The Oxford Handbook for the Constitution of India (M. Khosla *et al* eds., 2016). p. 536

<sup>35</sup> Opinion of N.A Palkhivala on the scope of Article 275, 280 and 282 of the Constitution of India, on the request of the Ninth Finance Commission.

Supreme Court of India in *Bhim Singh v. Union of India*<sup>36</sup> observed that while both Articles 275 and 282 were sources of spending funds/monies under the Constitution, Article 282 was normally meant for special, temporary and ad-hoc schemes. In practice, however Article 282 has been used to justify all manners of discretionary grants with the attachment of conditions. *Bhim Singh* interpreted Article 282 expansively, and held that no fetter can be placed on the scope and width of the provision. The Supreme Court also noted that the wording of Article 282 allowed both the Union and the states to make grants for any purpose that could be identified as “public purpose” within the meaning of the Constitution<sup>37</sup>. It is clear from a reading of the text of Article 282 and its interpretation that conditional transfers may be made as there is no fetter on the exercise of power under this article.

One such example of a transfer which is made by the Union to the states is that of Centrally Sponsored Schemes or CSS. In this regard, Nani Palkhivala has opined that as the scope of Article 275 extends to conditional grants as well as grants which are earmarked for specific purposes such as CSS, such transfers made by the Union for the purpose of CSS should be carried out under Article 275 and not under Article 282 as has been done in the past by the PC.<sup>38</sup> However, CSS continued to be provided under Article 282.

It is pertinent to note that CSS are development programmes implemented by state governments, where the cost of the programme is shared between the Union government and state governments. Such schemes are dependent on the state fulfilling certain conditions. The purpose of such schemes is to influence expenditure in areas which otherwise form part of the Constitutional responsibility of states.<sup>39</sup> Ordinarily, the Union government can implement schemes only on subjects which are named in the Union List; and the states must take up programmes and projects involving matters in the State List. However, in certain situations, the Union may identify particular matters of national interest contained within the State List, and can encourage states to implement such programmes by making specific-purpose matching grants towards these CSS. Till 2013-14, funds for the CSS were routed through two channels: the Consolidated Fund of the States; and directly to state implementing agencies. After the recommendations of the Fourteenth Finance Commission were accepted, the architecture of intergovernmental transfers changed, and from 2014-15 onwards, direct transfers

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<sup>36</sup> *Bhim Singh v. Union of India*, (2010) 5 SCC 538.

<sup>37</sup> *Bhim Singh v. Union of India*, (2010) 5 SCC 538, paragraph 76.

<sup>38</sup> Opinion of N.A Palkhivala on the scope of Articles 275, 280 and 282, Question 3, pp. 9-10, on the request of the Ninth Finance Commission.

<sup>39</sup> Flow of Funds and Monitoring Arrangements under selected Centrally Sponsored and Earmarked State Plan Schemes (sponsored by Planning Commission), p. 4, available at: [http://planningcommission.gov.in/reports/sereport/ser/stdy\\_flwfnds.pdf](http://planningcommission.gov.in/reports/sereport/ser/stdy_flwfnds.pdf) .

to state implementing agencies were done away with, and all transfers to states for CSS were routed through the Consolidated Fund of the State.<sup>40</sup>

The number of CSS in India has fluctuated over the years. For instance, there were ninety-two at the end of the Third Five Year Plan, which increased to two hundred and sixty-two in 1984. Over the years, several attempts have been made to reduce and consolidate existing CSS.<sup>41</sup> At present, the number of CSS stands at twenty-eight following the recommendations regarding the rationalisation of CSS published by Niti Aayog in 2015.<sup>42</sup> These twenty-eight schemes have been further classified into “core of the core”, “core” and “optional schemes”. While core schemes involve compulsory participation by the states, states can decide whether to participate in optional schemes.<sup>43</sup> This classification is also made on the basis of the financial contribution of the states towards the costs of the schemes. For example, core of the core schemes, which comprise umbrella schemes of the highest national priority, have a minimal state contribution, and the rest is taken care of by the Union Government. These schemes include the Mahatma Gandhi National Rural Employment Guarantee Programme (MGNREP), the National Social Assistance Programme, the Umbrella Scheme for Development of Scheduled Castes, the Umbrella Scheme for Development of Scheduled Tribes, the Umbrella Scheme for Development of Minorities, and the Umbrella Programme for Development of Other Vulnerable Groups. On the other hand, schemes under the core group are funded in the ratio of 60:40 for general states, and 90:10 for North-Eastern states. Some of these schemes include the Pradhan Mantri Gram Sadak Yojna (PMGSY), the Pradhan Mantri Awas Yojna and the National Health Mission. Finally, the share of Union to state funding in optional schemes is 50:50 for general states, and 80:20 for North-Eastern states.<sup>44</sup>

<sup>40</sup> Report of the Fourteenth Finance Commission.

<sup>41</sup> These included incorporating the recommendations of the sub-committee constituted by the National Development Council in 1967, capping the value of all CSS at one-sixth the value of Central Plan assistance to the States, the Expert Committee chaired by Shri K. Ramamurthy in 1985, the Committee chaired by P.V. Narasimha Rao in 1985, the Varma Committee report in 2005 and the B.K. Chaturvedi Report in 2011. See B.K. Chaturvedi Report of the Committee on Restructuring of CSS (2011), pp. 5-17, available at: [http://planningcommission.nic.in/reports/genrep/css/rep\\_css1710.pdf](http://planningcommission.nic.in/reports/genrep/css/rep_css1710.pdf).

<sup>42</sup> Niti Aayog, Report of the Sub-Group of Chief Ministers on Rationalisation Of Centrally Sponsored Schemes (2015), available at: <http://niti.gov.in/writereaddata/files/Final%20Report%20of%20the%20Sub-Group%20submitter%20to%20PM.pdf>.

<sup>43</sup> Rationalisation of Centrally Sponsored Schemes- Based on the Recommendations and Suggested Course of Action By the Sub-Group of Chief Ministers (File No. O-11013/2/2015-CSS & CMC), August 17, 2016, available at: <http://niti.gov.in/writereaddata/files/OM%20for%20circulating%20decision%20of%20the%20Cabinet%20on%20rationalisation%20of%20CSS.PDF>.

<sup>44</sup> Economic Times, Niti Aayog Processing CM sub group’s report on CSS: Govt, December 11, 2015, available at: <https://economictimes.indiatimes.com/news/economy/policy/niti-aayog-processing-cm-sub-groups-report-on-css-govt/articleshow/50137800.cms>.

Historically, CSS programmes have not been a very popular form of intergovernmental transfers for a number of reasons. First, the Union is seen to impose its spending preferences on states, thereby curbing state autonomy and leading to unwanted investments. This is especially relevant in those schemes where states are required to match a high proportion of the CSS grant, as well as maintain it thereafter, increasing its fiscal burden.<sup>45</sup> Second, the transfers are discretionary and non-transparent in terms of how they have been formulated. In particular, concerns have been raised over how several CSS are often formulated without adequate consultation with the states, which require them to adopt expenditure patterns which do not reflect their own priorities.<sup>46</sup> Other issues relate to overlapping priorities and objectives across multiple schemes, poor monitoring, and a lack of accountability for the funds spent.

Therefore, attempts have been made over the years to limit the amount of money that is transferred to states through CSS,<sup>47</sup> and to reduce the number of schemes and consolidate them.<sup>48</sup> For instance, the Twelfth Finance Commission suggested that each state should have the flexibility to pick and choose which CSS were most appropriate to its needs, within the limits of its grants.<sup>49</sup>

However, despite the controversy surrounding the schemes, CSS play an important role in fiscal transfers, as they are designed to promote important national development goals, such as that of education, health, employment, literacy and poverty alleviation. For instance, the Fourteenth Finance Commission noted that certain sectors such as health and education are of critical importance, as they also have significant inter-state externalities. Therefore, designing grants to these sectors should be done with a great deal of care, and with the involvement of the Union and state governments, along with domain experts.<sup>50</sup>

While Chapter IV of this report evaluates some important CSS against key principles of design set out in Chapter III, it is interesting to note that the erstwhile Planning Commission had also made attempts to improve the underlying

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<sup>45</sup> Chapter 12, Report of the Thirteenth Finance Commission, pp. 203-251, available at: [https://fincomindia.nic.in/writereaddata/html\\_en\\_files/oldcommission\\_html/fincom13/tfc/Chapter12.pdf](https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom13/tfc/Chapter12.pdf).

<sup>46</sup> Chapter 12, Report of the Fourteenth Finance Commission, available at: [https://www.thehinducentre.com/multimedia/archive/02321/14th\\_Finance\\_Commi\\_2321247a.pdf](https://www.thehinducentre.com/multimedia/archive/02321/14th_Finance_Commi_2321247a.pdf)

<sup>47</sup> The National Development Council limited assistance via CSS to 1/6th of Central assistance for State Plans.

<sup>48</sup> For instance, the number of schemes have been reduced from 147 to around 66 and further to 28 schemes.

<sup>49</sup> Chapter 4, Report of the Twelfth Finance Commission, p. 83, available at: <https://fincomindia.nic.in/ShowContent.aspx?uid1=3&uid2=0&uid3=0&uid4=0>.

<sup>50</sup> Chapter 12, Report of the Fourteenth Finance Commission, p. 157, available at: [https://www.thehinducentre.com/multimedia/archive/02321/Fourteenth\\_Finance\\_Commi\\_2321247a.pdf](https://www.thehinducentre.com/multimedia/archive/02321/Fourteenth_Finance_Commi_2321247a.pdf).

design principles of CSS specifically, and specific purpose grants in general.<sup>51</sup> The key principles set out by them included:

- (i) **Limiting the scope of conditional grants-** It was recommended that conditional grants should not attempt to tackle a large number of areas. They should be limited to situations which require Central Government intervention in areas of importance which are otherwise unlikely to be taken up by state governments due to paucity of resources and other externalities which cannot be mitigated through normal transfers.
- (ii) **Allocation criteria should be formula-driven or on a competitive basis-** depending on the objectives sought to be achieved. The intention behind this suggestion was to ensure transparency in allocation, to the extent possible. To achieve this, the objectives of each scheme should be clearly defined.
- (iii) **Capacity of Union Government to Monitor Schemes-** The design of conditional grants should keep in mind the capacity of the Union Government to manage the schemes, and to monitor their implementation.
- (iv) **Sunset Clauses-** Due to the fact that many specific purpose grants are perennial in nature, and continue year after year, it was suggested that having a scheme terminate after the expiry of a particular period of time would incentivise time-bound performance.<sup>52</sup>

These design principles act as a starting point in order to ensure that the conditional transfers are transparent, and fair. However, as the broader aim is to design a framework for facilitating more effective conditional transfers, we review some 'core' Schemes and 'core of the core' Schemes in Chapter IV, in order to determine how they weigh against global best practices as identified in Chapter III of this report.

#### 4. Grants to Local Bodies

Through the Seventy-third and Seventy-fourth Amendments to the Indian Constitution, sub-clauses (bb) and (c) to clause (3) of Article 280 were introduced. These amendments required the Finance Commission to make recommendations on measures needed to supplement the resources of the Panchayats and the

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<sup>51</sup> Flow of Funds and Monitoring Arrangements under selected Centrally Sponsored and Earmarked State Plan Schemes (Sponsored by Planning Commission), p. 8, available at: [http://planningcommission.gov.in/reports/sereport/ser/stdy\\_flwfnds.pdf](http://planningcommission.gov.in/reports/sereport/ser/stdy_flwfnds.pdf) .

<sup>52</sup> Flow of Funds and Monitoring Arrangements under selected Centrally Sponsored and Earmarked State Plan Schemes (Sponsored by Planning Commission), p. 8, available at: [http://planningcommission.gov.in/reports/sereport/ser/stdy\\_flwfnds.pdf](http://planningcommission.gov.in/reports/sereport/ser/stdy_flwfnds.pdf) .

Municipalities respectively, on the basis of the recommendations of the finance commissions of the states. The Constitution does not provide any clarity on what form such measures are required to take *i.e.* under what provisions such measures are to be granted.

While grants under this head were initially ad-hoc; the Thirteenth Finance Commission recommended that a percentage of the divisible pool be set-aside for local bodies and be given to them as a grant-in-aid under Article 275 of the Constitution.<sup>53</sup> However, the Fourteenth Finance Commission suggested a fixed grant under Article 275,<sup>54</sup> taking a view that the Constitution did not permit the Finance Commission to make grants through local bodies through devolution.<sup>55</sup> It recommended for the grants to local bodies to be made in the form of a fixed/basic grant (90% of the grant), and a performance-based grant (10% of the grant).<sup>56</sup> For performance grants- rural, the grant was made conditional on the gram panchayats submitting audited annual accounts that related to a year not earlier than two years preceding the year in which the gram panchayat sought to claim the performance grant, and also showed an increase in the (own) revenues of the local body over the preceding year, as reflected in the audited accounts. Further, state governments were made responsible for giving detailed procedures for disbursement of the performance grant to gram panchayats based on revenue improvement, keeping in view the two conditions outlined above. The quantum of incentive to be given was left to the discretion of the state governments.<sup>57</sup> The Fourteenth Finance Commission worked out the total size of the grant to be Rs. 2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats was Rs. 2,00,292.2 crore, and that to municipalities was Rs. 87,143.8 crore. In the case of gram panchayats, 90% of the grant was to be the basic grant, and 10% was to be the performance grant. In the case of municipalities, the division between basic and performance grant was recommended to be on a 80:20 basis.

### C. OVERVIEW - LEGALITY OF CONDITIONAL TRANSFERS IN INDIA

From the Constitutional analysis in the preceding section, the report concludes that the Constitution permits conditional transfers made under Article 275 and Article 282. No conditions can be imposed for devolution under Article 270.

Further, it is found that the power of the Finance Commission in recommending grants-in-aid under Article 275 is not restrictive in nature, and they can be given

<sup>53</sup> Report of the Thirteenth Finance Commission, 174.

<sup>54</sup> Report of the Fourteenth Finance Commission, 112.

<sup>55</sup> Report of the Fourteenth Finance Commission, 111.

<sup>56</sup> In case of municipalities, the division was decided to be 80:20.

<sup>57</sup> Report of the Fourteenth Finance Commission, 113-114.

for both general, and special purposes, as well as for capital or revenue grants. As such, conditions may or may not be imposed on any of such grants, and may include earmarking such grants for particular sectors, or requiring performance of certain actions as a precondition to receipt. Lastly, there are no limitations given in the Constitution on the extent to which grants-in-aid may be made conditional, *i.e.* that the Constitution does not prescribe the proportion of the grant that may be made conditional.

Annexure I to this report sets out the previous instances where past Finance Commissions have recommended certain conditions for the release of funds as grants-in-aid. These conditions have been existed in various forms, from placing restrictions on funding in certain instances, to requiring the fulfilment of conditions prior to release of funds as a method to promote or restrict certain behaviours. Thus, Finance Commissions in the past have used conditional transfers to influence the policy preferences of subnational governments, either by defining where and how the subnational government may use the grant money, or using conditions to nudge subnational governments towards behaving in a certain manner.

As can be seen from Annexure I, typically, Finance Commissions have given specific grants in the form of sector-specific, state-specific, state disaster relief fund or grants to local bodies. Each Finance Commission has differed in its approach while restricting the scope of expenditure for each of the categories of these grants. In some cases, the area or the scope identified is very broad, and in other cases the scope of expenditure has been much more narrowly defined. Thus, in the Indian context, we largely understand these conditions to form under the following two areas:

- (i) earmarking spending on certain sectors/areas, in the form of specific grant;
- (ii) setting requirements to be fulfilled before the release of grants as a means to promote, or disincentivise certain behaviours.

In the larger context, when used efficiently and judiciously, conditional grants have been known to fulfill many policy objectives, and have been deemed useful in several cases. Chapter III of the report specifies in detail, the objectives sought to be achieved by intergovernmental conditional transfers, and how other countries have designed them efficiently.

## PART II

CHAPTER III - DESIGNING CONDITIONAL INTERGOVERNMENTAL TRANSFERS:  
GLOBAL EVIDENCE ON BEST PRACTICES

## A. INTRODUCTION - CONDITIONAL INTERGOVERNMENTAL TRANSFERS

Intergovernmental transfers made by federal governments to subnational governments are the cornerstone of subnational government financing in most countries. In many developing countries in particular, intergovernmental transfers have come to form a dominant revenue source for subnational governments, and play a major role in increasing the efficiency and equity of local service provision in sectors such as education, health, transportation, public safety, sanitation, environment, and welfare programmes.<sup>58</sup> Global experience has emphasised that for local public services to be efficiently provided, local governments must formulate a clear mandate, have adequate resources, and also be afforded sufficient flexibility to make decisions, while being held adequately accountable for the results they deliver.<sup>59</sup> The effective design of a system of intergovernmental transfers plays a critical role in ensuring that these objectives are met consistently.

Intergovernmental transfers can be broadly classified into two categories: general-purpose or unconditional transfers, and specific-purpose or conditional transfers.

Unconditional transfers are used primarily to achieve two objectives: (i) to offset vertical fiscal imbalances between the Union and subnational governments; and (ii) to establish horizontal equity across different subnational governments.

Conditional transfers, on the other hand, provide incentives for subnational governments to take specific actions. Conditional transfers may specify the type of expenditures that the subnational government may finance, or may require the subnational government to achieve certain performance outcomes or comply with nationally determined standards of providing service. Conditional transfers perform various functions. For instance, they may be given to subnational governments to enable them to carry out specific agency functions for the Union government,<sup>60</sup> or they may be used to subsidise the cost of undertaking activities that are a low priority for the subnational government, but are a high priority for

<sup>58</sup> Murali MG, Grin Publishing (2016), “Public Economics and Intergovernmental Grants”.

<sup>59</sup> Bird and Smart, World Development Vol. 30, No. 6, 2002.

Intergovernmental Fiscal Transfers: International Lessons for Developing Countries, pp. 899-912.

<sup>60</sup> Rao, Govinda & Singh, Nirvikar (2012), Intergovernmental Transfers: Rationale, Design and Indian Experience.

the Union government.<sup>61</sup> They may also be used to account for spillovers or externalities across jurisdictions (for example, in responding to a health epidemic spanning several states).

Recent research suggests that the design of a system of intergovernmental transfers should be guided by the principle that the purpose of transfers is not just to finance particular governmental entities and projects, but to also ensure the effective provision of services to the population.<sup>62</sup> By providing financial incentives to subnational governments to take certain actions, in particular, making transfers conditional on the achievement of specific performance outcomes by subnational governments, and asking them to comply with specific practices (that is, creating a scheme of performance-based conditional transfers) can ensure a higher quality of service provision.<sup>63</sup> Well-designed conditional transfers can also improve the fiscal health of subnational governments by ensuring that the grants they receive are used effectively for specific purposes, and not made fungible. While conditional transfers do impose federal policy preferences on local governments, they can also, if designed well, preserve subnational autonomy<sup>64</sup> by involving local government in the design of the transfers, and thereby ensuring local commitment, accountability, and responsibility for the funded activities.<sup>65</sup>

This report undertakes a review of intergovernmental fiscal transfer systems from around the world, and puts forward a set of six principles governing the design of conditional transfers that can ensure both high performance in service delivery, as well as responsible and accountable local governance. The countries reviewed include, amongst others, Australia, Germany, Spain, France, Uganda, Italy, Japan, Malaysia, Indonesia, South Africa, United Kingdom, Russia, Mexico, Finland, Nigeria, Canada, Uganda, and United States of America (USA).

As we understand from a study of these countries, the design of conditional transfer systems is specific to the policy objectives sought to be achieved by the federal and recipient governments, and should reflect existing institutional structures that already mediate spending and performance in these specific areas. There is no single conditional transfer system that can encompass incentives for fiscal reform, for example, on the one hand, and improved performance by primary healthcare providers on the other. The design features envisage a host of mechanisms, including negotiating grant conditions, through agreements and legislations with the subnational governments; setting of output-based

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<sup>61</sup> Boadway and Shah (2007), World Bank, Intergovernmental Fiscal Transfers, p. 4.

<sup>62</sup> Richard M. Bird, Transfers and Incentives in Intergovernmental Fiscal Relations, p. 14, available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.563.6318&rep=rep1&type=pdf>.

<sup>63</sup> Bird & Smart, World Development Vol. 30, No. 6 (2002), pp. 899-912 and p 905.

<sup>64</sup> Anwar Shah, World Bank Policy Research Working Paper 4039, A Practitioner's Guide to Intergovernmental Fiscal Transfers (October 2006).

<sup>65</sup> Anwar Shah, Policy Research Working Paper No. 4039. World Bank, A Practitioner's Guide to Intergovernmental Fiscal Transfers (October 2006) at p. 1.

performance metrics to monitor, assess performance and verify compliance of subnational governments with grant conditions; and processes to manage conflict between the federal and subnational governments that incorporate due process of law.

In the context of India as well, the conditional transfer scheme to incentivise better sanitation outcomes, for example, must be distinct from one to incentivise better public finance management by local bodies. We emphasise in particular, the importance of an institutional structure that lives through the lifecycle of the grant in order to provide a basis for negotiation, monitoring, assessment and compliance. While the Finance Commission can play an instrumental role in envisioning and designing effective transfer systems that allow the Union and state governments to meet their shared objectives, the Finance Commission cannot be the appropriate forum to manage the conditional transfers on an ongoing basis, since it is neither a permanent body, nor a domain specialist. To ensure standardised, reliable, and credible mechanisms of transfers, we believe that an intergovernmental forum, or other such appropriate body be institutionalised to adequately represent the interests of both the Union and state governments. Accordingly, such a body can be used not just for measuring and reporting performance to the Union government on a regular basis, but also serve as a means to manage conflicts, and undertake any other function to ensure compliance, and foster co-operation between the two levels of governments. This should be supplemented by existing domain specialist institutions to monitor particular grants and conditions imposed therein.

The principles we evolve from our study, answer a few key questions regarding the design of conditional transfers - who should design the transfer; what conditions should the transfers be based on; how should performance be assessed and measured; who should be able to monitor performance and compliance of conditions by recipient governments; what should be done when recipient governments fail to comply with the grant conditions; and how should conflict be managed in the context of conditional grants.

Based on global best practices, we emphasise the following critical aspects: (i) the importance of collaboration between federal and subnational governments; (ii) critical design features of transfers that can improve performance; (iii) the development and reporting of credible metrics of measurement of performance; (iv) the establishment of robust and independent institutions to monitor the performance of subnational governments against these metrics; (v) the creation of institutional mechanisms of inducing compliance with the conditions; and (vi) creating a framework to manage intergovernmental conflict over fiscal issues.

**Section B** of this Chapter provides an overview of the principles governing the

design of conditional transfers.

**Section C** of this Chapter gives a brief overview of the recommendations made in the report.

## B. PRINCIPLES OF DESIGN - EFFECTIVE DESIGN OF INTERGOVERNMENTAL TRANSFERS

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### 1. Who Designs the Transfers - Greater collaboration between central and subnational governments in the design of conditional transfers can ensure greater transparency in the objectives of the transfers, and greater compatibility between central and subnational policy preferences.

A key issue in the design of an effective intergovernmental fiscal transfer program is to identify the objective sought to be achieved through the transfer. In most countries, subnational governments are looking to achieve multiple objectives. Unconditional grants give subnational governments a high degree of autonomy in achieving these objectives, while conditional grants are designed to provide sharper incentives to undertake specific expenditures, or specific behaviour.<sup>66</sup> By imposing the policy preferences of the Union government on subnational governments, conditional transfers could potentially impinge on local autonomy, as well as lead to allocative inefficiencies inherent in top-down planning. In this context, the joint development by both the Union and the subnational governments of the objectives of intergovernmental transfers, the conditions to be fulfilled, and outcomes to be achieved by subnational governments, helps to promote a collaborative vision of fiscal federalism, and achieve a more accountable system of governance.

This kind of collaboration between federal and subnational governments can be achieved through legislative processes or through bilateral agreements, and, in several cases, through a combination of both. These kinds of collaborations are discussed in more detail below.

#### (a) Enabling legislations at subnational levels

In the design of conditional grant systems, one way for countries to promote greater local autonomy, while ensuring that federal objectives are fulfilled, is to have a principal legislation at the federal level, containing the policy objectives sought to be achieved by the federal government, and have it supported by enabling legislations in each state or subnational level. In such a system, while the federal government's policy objectives are laid out in the principal legislation, each subnational jurisdiction adopts its own legislation, tailored to its individual requirements, and may also include setting specific milestones for projects to be achieved by the subnational governments, outputs to be achieved, due dates, reporting dates, timelines for review, and expected payments.

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<sup>66</sup> Schroeder and Smoker, Asian Development Bank, "Intergovernmental Transfers in Developing Countries: Concepts, International Practices and Policy Issues" (2002).

Through such a process, subnational governments gain the autonomy to articulate their requirements in their own legislations, while allowing for the federal government to negotiate grant conditions to be fulfilled for the transfer. The grant conditions can be negotiated between the federal and subnational governments, and the individual subnational jurisdiction legislations can be discussed and debated in more detail in, for example, state Legislatures. In addition to allowing for regional flexibilities and requirements to be built into the process, this collaborative exercise of crafting state-specific legislations also facilitates the joint development of standards and outcomes by the federal government and the individual subnational government(s).

An example of this kind of collaboration between the federal and the subnational government(s) is the intergovernmental grant called the ‘National Health Reform’ in Australia<sup>67</sup>, where the states, territories, and the Commonwealth (the federal government) are jointly responsible for funding and delivering a nationally unified, and locally controlled public health system.<sup>68</sup> The Council of Australian Governments (COAG),<sup>69</sup> which is the peak intergovernmental forum in Australia<sup>70</sup> tasked with matters of national significance or matters that need co-ordinated action by all Australian governments, plays a key role in the management of funding. It identifies the goals or targets to be achieved by states, such as improving patient access to services, improving the transparency of public hospital funding through a National Health Funding Pool,<sup>71</sup> and setting national performance standards and better outcomes for hospital patients. The National Health Reform Agreement, under the National Health Reform Act, 2011 (which is the principal federal level legislation), sets out the shared intention of the Commonwealth, and state and territory governments to work in partnership to improve health outcomes for all Australians and ensure the sustainability of the Australian health system<sup>72</sup>. It details certain specific responsibilities for states to

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<sup>67</sup> Professor Kathy Eagar, University of Wollongong, ABF Information Series 1, available at <https://ahsri.uow.edu.au/content/groups/public/@web/@chsd/documents/doc/uow082633.pdf> .

<sup>68</sup> Another international example comes from the UK, where, in its Public Health Ring-Fenced Grant (2018-19), the conditions for the grant include fulfilling functions under the National Health Service Act, 2006. These conditions are also embedded in the enabling legislation (Public Health Ring-Fenced Grant 2018/19, Local Authority Circular LAC(DH)(2017) 2 LA, United Kingdom).

<sup>69</sup> Website of the Council of Australian Governments, available at <https://www.coag.gov.au/about-coag>.

<sup>70</sup> It has the Prime Minister as the chairperson, and is represented by all state and territory ‘First Ministers’ and the President of the Australian Local Government Association.

<sup>71</sup> The National Health Funding Pool is the collective term for the state pool accounts of all States and Territories.

<sup>72</sup> Information on the National Health Reform Agreement is available at <https://www.publichospitalfunding.gov.au/national-health-reform/agreement> .

follow; for example, establishing local hospital networks and providing health and emergency services through the public hospital system, among others. The Australian States incorporate a set of these common provisions into their respective state legislations, which they are then bound by. However, the state legislations also include state-specific conditions as well, which are distinct from one another.

For example, the state of Australian Capital Territory enacted the Health (National Health Funding Pool and Administration) Act, 2013 and the state of Victoria enacted the Health (Commonwealth State Funding Arrangements) Act, 2012. The legislation for the Australian Capital Territory<sup>73</sup> provides a set of minimal conditions that specifies the activities which can be funded from the grant money,<sup>74</sup> as well as a set of conditions that these payments must fulfil.<sup>75</sup>

However, in the state of Victoria,<sup>76</sup> the conditions embedded in the legislation incorporate various bilateral agreements that exist between the state and the Commonwealth. For instance, ‘health service’ providers are required to ensure that their operations comply with the obligations of the Victorian government under various Commonwealth-state agreements. These include the overarching Commonwealth legislation, the National Health Reform Agreement, as well as the following:

- (i) *National Partnership Agreements* - these agreements support the delivery of specific projects, facilitate reforms or reward those jurisdictions that deliver on nationally significant reforms. Each national partnership agreement has specified reporting to the Commonwealth that Victoria is required to undertake.
- (ii) *National Healthcare Agreement* - this agreement lays out a performance framework including thirty-three performance indicators and seven performance benchmarks, against which the performance of individual jurisdictions is measured annually.

Each of the state-level legislations and agreements entered into by the particular

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<sup>73</sup> Section 22 of the Health (National Health Funding Pool and Administration) Act, 2013, available at: <http://www.legislation.act.gov.au/a/2013-2/current/pdf/2013-2.pdf>.

<sup>74</sup> It states that the *payments from the state managed fund are to be made only* to: (a) local hospital networks and other health services; (b) universities and other providers of teaching, training and research related to the provision of health services; and (c) a Territory banking account (other than the state pool account or the state managed fund).

<sup>75</sup> Further, payment of funds from the state managed fund is to be consistent with— (a) the purpose for which the funding was paid into the fund; and (b) the National Health Reform Agreement; and (c) any relevant service agreement between the director-general and a local hospital network.

<sup>76</sup> Victoria Health Policy and Funding Guidelines, 2013-14, Part 2: Health Operation.

state with the Commonwealth takes into account the specific requirements of the state, the national policy that the Commonwealth wants to pursue in the particular state, and the specific projects that the Commonwealth is funding in that state, when determining state-specific conditions to be fulfilled for the transfer.

### **(b) Bilateral Agreements**

In addition to supporting legislations, many countries further seek to preserve local autonomy while ensuring that federal goals are achieved through bilateral agreements or contracts between the federal government and subnational governments, defining the joint actions and responsibilities of both sets of government.

For example in Germany, through the legislation called “Act on the Granting of Consolidation Assistance (Consolidation Assistance Act), 2009”, subnational governments are required to sign bilateral administrative agreements with the federal government. While the federal government sets out its policy agenda in a national legislation, various state legislations and administrative agreements are used to tailor this national policy to local contexts by taking their specific requirements into account, like project milestones, outputs, reporting dates, and expected payments. Since subnational governments are part of the design process, the grant conditions are better customised to their needs and limitations.

Similarly, in Spain, “Regional Incentives” are given by the federal government to various Spanish Autonomous Communities (ACs).<sup>77</sup> The federal government under the State Grants (Maintenance of Local Authorities) Act, 1981 is allowed to make grants to any AC for the maintenance of local authorities in that state. The federal government is also allowed to impose terms and conditions to be observed by the AC. This is followed by the enactment of Royal Decrees, for each of the ACs receiving the federal grant. Royal decrees or royal legislative decrees (Reales decretos-legislativos) are legislative acts through which the Spanish Parliament can authorise the government to adopt certain acts, such as giving of federal grants with certain conditions attached, on certain highly complex and technical matters<sup>78</sup>. These laws have the same force as laws approved by the national parliament, but apply only in the relevant region or AC. Once approved by the national parliament, each of these Royal Decrees have to be adopted by the

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<sup>77</sup> Articles 2, 138, and 158 of the Spanish Constitution.

<sup>78</sup> Each AC has different legislative powers, described in its ‘Statute of autonomy’. The ‘Statute of Autonomy’ refers to the rules governing each autonomous community, and are set out in the corresponding Statute. It is a collection of laws or legislation that governs the autonomous community, and functions as a constitution for an autonomous region inside the main State.

individual parliaments of the ACs.<sup>79</sup> Objectives and sectors on which the grant money will be utilised, monitoring mechanisms, and conditions to be fulfilled are set out in these Royal Decrees, and other regional policy guidelines.<sup>80</sup> This allows for the national policy mandate to be set out by the Spanish Government, then approved by the national Parliament, and lastly, to be adopted individually, by the respective parliaments of the ACs. Consequently, the Royal Decree containing the terms and conditions of the federal grant given by the federal government to the ACs is subject to the consideration of the parliament of each AC, making the Royal Decrees akin to bilateral financial arrangements between the federal government, and the government of each AC.

In France, Contrat de Plan Etat Région (CPER) are state region plan contracts, entered into between the federal Government and the regional authorities, for investing in certain sectors - multimodal transport; higher education, research and innovation; ecological and energy transition; digital innovation, future sectors, and territories. CPERs are used as a tool of public policy to attain horizontal equality across regions and each CPER defines high-level development priorities, a number of major projects and specific actions to be taken by both federal and subnational governments.<sup>81</sup> These contracts are established for a fixed period of time, and specify the agreed funds to be put forward by the State, the region and the European Regional Development Fund.<sup>82</sup> The contracts are signed between the regional prefect, representing the federal government, and the elected head of the regional council and define the joint actions of the federal government and the regional authority for a period of seven years. The federal government and the regional authorities together set the priorities and build a common strategy, allowing for a shared vision of development between the State and the regions to emerge.<sup>83</sup>

<sup>79</sup> Boletín Oficial del Estado, N-Lex, European Union, available at [http://eur-lex.europa.eu/nlex/info/info-es/index\\_en](http://eur-lex.europa.eu/nlex/info/info-es/index_en).

<sup>80</sup> For example, the Royal Decree of Galicia mentions all of these in its Royal Decree - available at <https://www.global-regulation.com/translation/spain/1444623/royal-decree-161-2008%252c-of-8-february%252c-which-delimits-the-area-of-economic-development-of-the-autonomous-community-of-galicia.html>.

<sup>81</sup> OECD Territorial Reviews OECD Territorial Reviews: France 2006, “Assessment and Recommendations”, p 20.

<sup>82</sup> European Commission, Policy Research Corporation, France-Country Overview and Assessment, available at [https://ec.europa.eu/maritimeaffairs/sites/maritimeaffairs/files/docs/body/france\\_climate\\_change\\_en.pdf](https://ec.europa.eu/maritimeaffairs/sites/maritimeaffairs/files/docs/body/france_climate_change_en.pdf).

<sup>83</sup> State-Region Plan Contract, CGET, Republique Francaise, available at <http://www.cget.gouv.fr/dossiers/contrats-de-plan-etat-region>.

### **Our Assessment**

The design of conditional transfers requires an effective way to ensure a more cooperative and collaborative vision of fiscal federalism between the Union, and the state governments. We believe that this can be achieved by means of a formal bilateral agreement executed between the Union government, and the relevant state government, to ensure that the local conditions and requirements of a particular state can be negotiated effectively, and find a suitable place in the agreement. This will ensure that the state governments have the autonomy to articulate their requirements in their respective agreements, and will also allow the Union government to negotiate and explicitly stipulate grant conditions and terms of the transfers to be fulfilled by the state governments. An intergovernmental forum as explained in subsequent sections of this Chapter, can be used as a platform to negotiate and execute these agreements.

## 2. What conditions should be set - Design conditional transfers so as to create incentives for establishing nationally mandated minimum standards and improving performance by subnational governments

Conditions are typically attached to grants in order to ensure one of two outcomes that are considered desirable to the grantor- either that funds are spent by subnational governments for a clearly specified purpose, or that subnational governments undertake certain actions or behaviours. Whether financial incentives can be successful in achieving these objectives depends substantially on the design of the transfer system.

Conditional transfers may either be input-based,<sup>84</sup> where they require subnational governments to make specific expenditures on specific purposes, or they may be output-based or performance-based - where they require subnational governments to achieve specific outcomes in terms of their performance. Traditional input-based conditional grants undermine local autonomy and budgetary flexibility while reinforcing a culture of opportunism and rent-seeking.<sup>85</sup> Experience suggests that there is no direct causal relationship between increased public spending and improvements in service delivery performance.<sup>86</sup> Rather, it is through appropriate performance-linked incentives that a results-based culture of accountability can be created.<sup>87</sup>

Conditional transfers may also be distinguished by whether they are matching transfers where the subnational government is required to match, to some extent, the funds transferred by the federal government to be spent on a specific purpose; or non-matching transfers - where there is no matching requirement imposed on the subnational government with respect to a particular transfer. Matching transfers have certain advantages and disadvantages. On the one hand, they can encourage subnational governments to increase spending on underfunded areas and reduce inefficiencies due to spillovers; on the other hand, they can impose high financial costs on some subnational governments, curb local autonomy, divert funds from other uses, and widen horizontal gaps across different subnational governments.

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<sup>84</sup> Input-based grants include all earmarked or sector-specific grants. For example, the UK Dedicated Schools Grant (DSG) (2017-18) which is paid in support of the local authority's schools budget, and is the main source of income for the schools budget. However, the grant cannot be used for any other purpose or sector.

<sup>85</sup> Boadway and Shah (2007), "Intergovernmental Fiscal Transfers", p. 13.

<sup>86</sup> Huther, Roberts, and Shah 1997, "A simple measure of good governance", in Shah, World Bank, "Introduction to the Public Sector Governance and Accountability Series", available at <http://documents.worldbank.org/curated/en/786601468139801976/pdf/343780PAPER0Pu101OFFICIAL0USE0ONLY1.pdf> .

<sup>87</sup> Anwar Shah, Policy Research Working Paper; No. 4039, World Bank, "A Practitioner's Guide to Intergovernmental Fiscal Transfers" (2006), and Anwar Shah, "Intergovernmental Fiscal Arrangements - Lessons from International Experience" (2003).

Governments across the world use a combination of different transfers, depending on the policy objective they are trying to achieve. Increasingly, however, federal governments are now seeking to achieve results-based accountability through performance-based transfers. The section below details how conditions can be designed to incentivise performance through the use of conditions.

### (a) Using conditional transfers to drive fiscal and administrative reforms

Several countries use conditional transfers to drive reforms that are considered a federal priority, at the level of the subnational government. For example, Russia and India have promoted fiscal reforms at the level of subnational governments through financial incentives linked to conditional transfers.

The Russian Regional Fiscal Reform Fund (RFRF)<sup>88</sup> awarded funds, on a competitive basis, to regions that had undertaken significant fiscal reforms. The grants were awarded in two installments, and were conditional upon the success of subnational governments in implementing a two-phase reform of regional public finance. The disbursement of the first installment was conditional on the implementation of at least eighty percent of the first phase of the public finance reform program, while the disbursement of the second installment was conditional upon the full implementation of the regional fiscal reform program, and compliance with the minimum standards of quality of budget management.

This is similar to the enactment and implementation of FRBM Act in India, to set targets for central and state governments to reduce fiscal deficits. The Twelfth Finance Commission made the enactment of fiscal responsibility and budget management legislations a condition for state governments to receive debt relief. The Commission recommended that the state legislations should, among other things, provide for the elimination of revenue deficit by a given deadline, reducing fiscal deficit to or below a target level.<sup>89</sup> The Thirteenth Finance Commission reiterated the importance of this measure and stated that the intention was not to restrict the discretionary latitude of states with respect to their fiscal domain, but to secure the commitment of all states to the national fiscal consolidation required for the achievement of macroeconomic stability.<sup>90</sup> The Fourteenth Finance Commission also recommended the establishment of an independent fiscal council to evaluate the fiscal policy implications of annual budget proposals, before the budget is announced. The Union government was advised to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, and consequently, states were also advised to amend their respective state

<sup>88</sup> Report and Recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Fiscal Federalism & Regional Fiscal Reform Loan in the Amount of US\$120 Million to the Russian Federation (2001), available at: <http://documents.worldbank.org/curated/en/855231468304274881/pdf/multi0page.pdf> .

<sup>89</sup> Report of the Twelfth Finance Commission, p. 87.

<sup>90</sup> Report of the Thirteenth Finance Commission, p. 26.

legislations in a similar manner.<sup>91</sup> The FRBM Review Committee which submitted its report in January 2017,<sup>92</sup> proposed an autonomous Fiscal Council with a Chairperson and two members appointed by the Centre, to monitor and recommend changes to fiscal strategy, prepare multi-year fiscal forecasts, improve fiscal data and advise the government to take corrective action for non-compliance with the draft legislation that the Committee had recommended.

The use of conditional transfers to drive institutional and administrative changes has been done effectively by Denmark and Finland, who have used conditional transfers to encourage mergers of small municipalities to make public service delivery more efficient.<sup>93</sup> Finland, which was inspired by a similar experience in Denmark, encouraged municipalities to merge, and present their plans for future service provision. The alternatives to municipal mergers were more widespread co-operation through joint municipal boards, or for small municipalities to buy their services from neighbouring larger municipalities. To encourage the process, the federal government promised to transfer extra financial resources to merged municipalities, with a larger amount if the mergers occurred before the deadline. As a result, several municipalities in Finland's capital region and in seventeen other regional urban centers developed common plans for land use, housing, traffic, and specialised regional services.<sup>94</sup>

Another way in which conditional transfers have been used is to promote inter-jurisdictional coordination, to encourage and coordinate investments, particularly infrastructure investments, that are associated with large inter-jurisdictional externalities. Federal governments make funds available to subnational governments to undertake these investments, but add conditions to encourage coordination across jurisdictions. National governments in Germany, Colombia, and the United States use financial incentives to coordinate such regional infrastructure investments.<sup>95</sup>

In Germany, the federal government makes project coordination across regions and states a condition for accessing certain funds, thereby offering fiscal incentives for

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<sup>91</sup> Report of the Fourteenth Finance Commission, p. 200.

<sup>92</sup> Text of the Report of the FRBM Review Committee available at: <https://dea.gov.in/sites/default/files/Volume%201%20FRBM%20Review%20Committee%20Report.pdf>.

<sup>93</sup> Minassian and Mello, Inter-American Development Bank, "International Experiences and Possible Lessons for Brazil", available at: <https://publications.iadb.org/bitstream/handle/11319/7665/Intergovernmental-Fiscal-Cooperation-International-Experiences-and-Possible-Lessons-for-Brazil.pdf?sequence=1>.

<sup>94</sup> Hallgeir Aalbu, Kai Böhme and Åke Uhlin, Nordregio, Nordic Research Programme (2005-2008), Report 6, Administrative reform - Arguments and values, p. 24.

<sup>95</sup> Taimur Samad, Nancy Lozano-Gracia, Alexandra Panman, World Bank Publications (2012), Colombia Urbanization Review Amplifying the Gains from the Urban Transition, p. 13.

regions and states to cooperate on regional issues.<sup>96</sup> In the United States, funds for federal transportation were made conditional on increasing metropolitan planning and coordination. The Federal-Aid Highway Act, 1962 attached conditions to the federal financial assistance associated with the Interstate Highway System, which required transportation projects in urbanized areas of 50,000 or more people, based on a “continuing, comprehensive, urban transportation planning process” to be undertaken in cooperation between the State and local governments.<sup>97</sup> In addition to this, conditions are also applied to these funds to encourage recipient subnational governments to satisfy technical conditions (budgeting, reporting requirements etc.) and ensure that the money was properly spent.<sup>98</sup>

### (b) Incentivising performance through conditions

Conditional transfers are also used to improve the provision of services by subnational government through performance-based transfers that are conditioned on the achievement of specified outputs and performance targets. Well-designed transfers are able to achieve nationally mandated minimum standards in service provision while also providing flexibility to the local government in the design of programs, and in selecting inputs for achieving these targets.<sup>99</sup> Global experience suggests that the selected performance targets be both measurable and largely under the control of the subnational government, rather than be subject to events outside of their control,<sup>100</sup> thereby ensuring that subnational governments can be held effectively accountable for their performance. A financing system based on these transfers can create responsive, responsible, and accountable governance without undermining local autonomy.

One of the best examples in this regard is Uganda’s Intergovernmental Fiscal Transfer Programme (UgIFT),<sup>101</sup> through which conditional grants are made to local governments for spending on health and education. In keeping with best practices discussed in section B.1, the Programme was designed by the ministries of health and education with the World Bank only after extensive consultations between the line ministries, the Ministry of Finance, Planning, and Economic Development, as well as local governments and the Local Government Finance Commission.

The grants have a formula-based component and a performance-based component. The formula-based component is tailored to the specific requirements of local

<sup>96</sup> Lozano-Gracia, Panman and Rodriguez, Chapter 4-“Interjurisdictional Coordination”, Colombia Urbanization Review Amplifying the Gains from the Urban Transition, p. 147.

<sup>97</sup> Lozano-Gracia, Panman, and Rodriguez, Chapter 4-“Interjurisdictional Coordination”, Colombia Urbanization Review Amplifying the Gains from the Urban Transition, p. 149.

<sup>98</sup> Richard M. Bird, “Transfers and Incentives in Intergovernmental Fiscal Relations”, pp. 29-30.

<sup>99</sup> Anwar Shah, “A Practitioner’s Guide to Intergovernmental Fiscal Transfers”, p. 36.

<sup>100</sup> OECD Territorial Reviews OECD Territorial Reviews: Colombia 2014, p. 185.

<sup>101</sup> World Bank. 2017. *Uganda - Intergovernmental Fiscal Transfers Program Project* (English), available at <http://documents.worldbank.org/curated/en/697291498788132920/Uganda-Intergovernmental-Fiscal-Transfers-Program-Project>.

governments as it (i) matches resources to the target population to reduce disparities in per capita spending, and (ii) captures major differences in needs and costs. The performance-based component incentivises better fiscal management of resources by local governments by rewarding those governments which perform better than the average.<sup>102</sup>

To determine the size of the performance-component of the grant, an annual performance assessment is carried out to assess whether local governments are adhering to budgeting and accountability requirements, and how well they are able to plan expenses and manage resources. The assessment covers: (a) planning, budgeting and execution; (b) human resource management; (c) oversight, transparency, and accountability; (d) revenue mobilization; (e) procurement and contract management; (f) financial management; and (g) social and environmental safeguards.<sup>103</sup> The assessment process is transparent, and each local government receives a “Local Government Performance Assessment Manual”. Further, each district’s performance assessment is well-documented and publically available.<sup>104</sup>

Another performance-based condition which is frequently attached to intergovernmental fiscal transfers, is the requirement to show physical completion of projects and plans before subsequent tranches of money are disbursed by the federal government. Indonesia, through its ‘Dana Alokasi Khusus’ (DAK) conditional (matching) grant, achieves this at the district government level, by including a requirement to show physical completion before subsequent financing tranches are disbursed.<sup>105</sup> Under the DAK-Reimbursement scheme, where local governments can get reimbursed for the matching part of the DAK funding, local governments have to meet the conditions of certain performance indicators for the release of the funds. These indicators include earmarked DAK allocations actually spent, the provision of reference unit costs, the realisation of planned spending outputs and compliance with national procurement guidelines, environmental safeguards, and technical standards. Conditions in this grant system rely on demonstrated past performance to receive reimbursements from the federal government.

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<sup>102</sup> According to the proposed system, LGs with a performance score above the average score received additional funding. In a typical example, an LG with a performance score of 10 percent above the average score will get about 5 percent additional funds compared with the basic formula allocation for the LGs with similar characteristics. In a case with performance 20 percent above the average about 10 percent additional allocations compared to the basic formula allocation (assuming that 50 percent of resources are allocated using the performance weighted formula).

<sup>103</sup> From the ‘performance assessment scores’ of each district in Uganda, available at [http://www.budget.go.ug/fiscal\\_transfers/page/assessment\\_results](http://www.budget.go.ug/fiscal_transfers/page/assessment_results).

<sup>104</sup> From the ‘performance assessment scores’ of each district in Uganda, available at [http://www.budget.go.ug/fiscal\\_transfers/page/assessment\\_results](http://www.budget.go.ug/fiscal_transfers/page/assessment_results).

<sup>105</sup> Program for Results, Indonesia-Supporting Primary Health Care Reform -- I-SPHERE (P164277), Technical Assessment, World Bank, p. 16, available at <http://documents.worldbank.org/curated/en/722581527068052303/pdf/Final-Technical-Assessment-Indonesia-Supporting-Primary-Health-Care-Reform-P164277.pdf> .

### (c) Using a combination of minimum conditions and performance measures

A number of intergovernmental transfer systems use a combination of (prescription of) minimum conditions and performance measures. Minimum conditions are the basic conditions with which subnational governments need to comply in order to access their grants, and they are formulated to ensure that minimum capacities and performance (e.g. in terms of planning, financial management and administration) are in place to effectively manage funds. In conditional grant transfers, the fulfillment of these minimum conditions by subnational governments act as triggers for the release of funds by the federal government. On the other hand, performance measures are more qualitative and variable measures of subnational government performance (the quality of the planning, quality of environmental management, etc.) that are used to reward high-performing governments by adjusting the level of funds made available to subnational governments as and when they have complied with the basic minimum conditions.<sup>106</sup>

There are several examples of such arrangements in OECD countries. One is the Canadian Federal Government's health grants to the provinces, provided only if the provinces observe a set of minimum conditions, such as open and equal access to health facilities, and no billing of clients. Failure to meet these conditions can lead to penalties, including the withdrawal of federal support, or a reduction in the grants.<sup>107</sup> In other countries, federal governments have tried to influence actions by attaching output conditions to certain types of grants. In Japan, for example, road grants come with certain minimum standards, such as the number of lanes that must be built.<sup>108</sup>

The type of minimum conditions also vary across jurisdictions. For instance, the Australian National Competition Policy (NCP) makes performance grants to Australian states that achieve certain reform objectives intended to promote economic growth. In the UK, the initiative on Local Public Service Agreements (LPSA), requires local authorities to select a number of performance indicators, in consultation with the central government, against which their performance is measured: if they comply with the selected standards, they receive up to two point five percent of their total budgets as a reward for good performance. The LPSA is a scheme in which a local authority commits itself to achieving a range of demanding targets, agreed with central government, that reflect national and

<sup>106</sup> UNCDF (2010), "Performance-based grant systems: concept and international experience", pp. 21-23.

<sup>107</sup> Shah, Anwar. 2006, Policy Research Working Paper; No. 4039. World Bank, "A Practitioner's Guide to Intergovernmental Fiscal Transfers".

<sup>108</sup> Library of Congress, "National Funding of Road Infrastructure: Japan", available at <https://www.loc.gov/law/help/infrastructure-funding/japan.php>.

local priorities. An important purpose is to force improvement by ‘stretching’ performance beyond the norm, with additional financial rewards and additional freedoms being made available to successful authorities.<sup>109</sup> However, it must be noted that LPSAs are voluntary agreements, which are negotiated with local authorities by the Government. For instance, the Manchester LPSA is a voluntary agreement entered into between the Manchester Council and the Government, aimed at improving the quality of life for residents in Manchester. The agreement has thirteen specific targets for the Manchester Council to achieve.<sup>110</sup>

Another example in this regard is of the United Nations’ performance-based grants for climate resilience, named Local Climate Adaptive Living Facility (LoCAL),<sup>111</sup> which respond to climate change challenges in least developed countries by providing performance-based grants for climate resilience. These grants aim to provide a financial top-up to cover the additional costs of making investments climate resilient, and are channeled through existing government fiscal transfer systems, from national treasuries to local governments. The minimum conditions attached to these grants are generally linked to public financial management and good governance, while the performance-based conditions are linked to the quality of planning and the quality of climate change management. The implementation of these transfers requires the local governments to submit to performance appraisals, regular audits and performance assessments.

### Our Assessment

The effective design of conditions and financial incentives can lead to the achievement of national policy objectives set by the Union government. From the countries surveyed, we understand that transfer systems are better effected when they are designed and predicated on objective performance metrics, and are output-based, rather than input-based or expense-based, as has been traditionally done in the past. This will ensure that state governments achieve specific outcomes in terms of their performance, and the Union government can seek to achieve a results-based accountable transfer system, through performance-based transfers made to state governments.

<sup>109</sup> Ken Young, *Local Government Studies*, Vol 31, 2005-Issue 1 “Local Public Service Agreements and Performance Incentives for Local Government”.

<sup>110</sup> Manchester City Council, *Public Service Agreement: Outline*, available at: [https://secure.manchester.gov.uk/a\\_to\\_z/service/1656/public\\_service\\_agreement](https://secure.manchester.gov.uk/a_to_z/service/1656/public_service_agreement).

<sup>111</sup> Local Climate Adaptive Living Facility, *Performance Based Grants for Climate Resilience*, available at: <http://www.uncdf.org/local/performance-based-grants-for-climate-resilience>.

### 3. How is performance assessed and measured? - Design conditions based on output-based, measurable indicators of performance

An effective system of performance-based transfers requires instituting credible processes at the levels of the subnational governments to measure and report program activities, input usage, as well as performance on outputs. Creating standardized processes for measuring, monitoring, reporting and evaluating compliance with the conditions of intergovernmental fiscal transfers establishes an environment of: (a) predictability and transparency; (b) safeguards the independence, credibility, and utility of evaluation; and (c) significantly reduces the following risks:

- (i) revocation of commitments made by the federal government;
- (ii) conditions becoming non-credible over time, ensuring that non-compliance is effectively managed; and
- (iii) reliance on individuals or entrenched processes, by instituting a system of checks and balances to ensure accountability and protection.<sup>112</sup>

In order to successfully implement performance-based conditional intergovernmental transfers, it is critical to develop both measurable indicators of performance for subnational governments and processes of reporting on those indicators that are transparent and credible. Governments must also create independent and credible institutional mechanisms to support information exchange and monitoring. Agencies or forums may report performance to the national executive, to a national ministry, across several different agencies, or directly to the public at large; but the reporting structure has significant implications for the institution's effectiveness.<sup>113</sup>

#### **(a) Developing key indicators of performance**

In performance-based transfers across the world, tracking of progress toward expected results is done through indicators, which are negotiated between the federal and subnational governments. Traditionally, recipient subnational governments have focused on reporting the use of inputs (expenditure) to the federal government. However, to support performance-based transfers, governments must develop performance indicators that focus on outputs, reach and outcomes, so as to monitor performance. This incentivises performance on the indicators that governments actually care about and also allows for flexibility in project definition and implementation. In addition, these key indicators of

<sup>112</sup> Paul Bernd Spahn, *Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries*, pp 19-23

<sup>113</sup> Boex and Martínez-Vázquez, *Developing the Institutional Framework for Intergovernmental Fiscal Relations in Decentralizing LDTs*, pp. 6 and 15.

performance should be jointly defined and determined by grantor and recipient governments, that is the federal and subnational governments. This reinforces the values of joint ownership and accountability towards achieving shared goals, as well as highlighting between the grantor and the recipient.<sup>114</sup>

A good example in this regard is that of the Conditional Grants Scheme (CGS) in Nigeria,<sup>115</sup> through which subnational governments could request funding for projects that contribute towards the achievement of the Millennium Development Goals (MDGs) in Nigeria. Each of the eight MDGs was associated with targets, and progress towards these targets was measured by specified indicators. For instance, for the goal of “eradicating extreme poverty and hunger”, the targets included reducing the proportion of people whose income is less than one dollar a day to half, as well as reducing to half the proportion of people who have been suffering from hunger between the years of 1990 and 2015. The indicators for these targets included: (i) the proportion of population subsisting below one dollar a day (1993 PPP); (ii) the poverty gap ratio (incidence\*depth of poverty); (iii) the share of poorest quintile in national consumption; (iii) the prevalence of underweight children who were under five years of age; and (iv) the proportion of population who fell below the minimum level of dietary energy consumption.

Similarly, for the goal of “achieving universal primary education”, the target included ensuring that, by 2015, all children, irrespective of gender were able to complete a full course of primary schooling. The indicators for these targets were: (a) the net enrolment ratio in primary education; (b) the proportion of pupils who were able to reach grade 5, after having enrolled at grade 1; and (c) the literacy rate of 15-24 year olds. The performance of governments who were to receive the CGS was then measured against these specific indicators.<sup>116</sup>

Another example of this kind can be found in Uganda. In Uganda, there are specific Disbursement Linked Indicators (DLIs) for the UgIFT Program.<sup>117</sup> These DLIs are grouped into three results linked areas: (i) one for the health sector; (ii) one for the education sector; and (iii) one for a cross-cutting area, which includes “Performance Assessment and Targeted Performance Improvement” for local governments. The DLIs measure the adequacy and equity of fiscal transfers at the

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<sup>114</sup> Shah, 2010, Policy Research Working Paper 5172, World Bank Institute, “Sponsoring a Race to the Top: The Case for Results- Based Intergovernmental Finance for Merit Goods”, p. 6.

<sup>115</sup> Nigeria’s Conditional Grants Scheme in the Light of the Sustainable Development Goals (SDGs): Lessons and Policy Options in a Post-2015 Era, International Journal of Innovative Research & Development, available at <http://www.ijird.com/index.php/ijird/article/viewFile/100668/72630>.

<sup>116</sup> Federal Republic of Nigeria, Millennium Development Goals Conditional Grants Scheme Implementation Manual, available at: [http://www.sparc-nigeria.com/RC/files/4.2.14\\_CGS\\_Implementation\\_Manual.pdf](http://www.sparc-nigeria.com/RC/files/4.2.14_CGS_Implementation_Manual.pdf).

<sup>117</sup> Uganda - Intergovernmental Fiscal Transfers Program Project, Vol 1, Report no 114260, World Bank, available at <http://documents.worldbank.org/curated/en/697291498788132920/Uganda-Intergovernmental-Fiscal-Transfers-Program-Project>.

central government level, and the fiscal management of resources at the local government level for health and education services. The DLI matrix shows the specific components, baseline and target values for each DLI. Disbursements are then made upon the satisfaction of the following conditions: (a) the World Bank has reviewed verification reports on the achievement of Disbursement Linked Results (DLRs); and (b) the Government of Uganda has requested for a disbursement.<sup>118</sup>

A good example of a grants transfer system that incorporates both technical and performance indicators is the ‘Dana Alokasi Khusus (DAK)’ in Indonesia, which is a conditional (matching) grant for fourteen sectors including those of education and health,<sup>119</sup> and is targeted at spending on areas considered to be a national priority.<sup>120</sup> In 2018, the allocation of health DAK was determined on the basis of both technical (80%) and performance (20%) indicators. While the technical index was largely based on proxies of need, such as provincial and district location, fiscal capacity and service levels; the performance elements were limited to local government level financial realisation and reporting compliance. The Indonesian Ministry of Health claimed that since the performance elements were developed with local governments, reporting compliance vastly improved. Going by this success, the MoH proposes to add more performance elements to the determination of district allocations<sup>121</sup>. The DAK also relies on information and disclosures to track compliance, and since 2016, has been using a “bottom-up” proposal process from districts, to give local authorities more autonomy. For instance, the MoH requires that the aggregation of information across five systems (RS online, e-monev, ASPAK, e-renstra and e-planning) be completed before districts can apply for DAK. MoH reports 90% compliance on these performance elements.<sup>122</sup>

<sup>118</sup> US\$130 million is linked to the achievement of Disbursement Linked Results (DLRs) in Education; US\$55 million is linked to the achievement of DLRs in Health; US\$15 million is linked to the achievement of Cross Cutting DLRs (health and education). See Uganda - Intergovernmental Fiscal Transfers Program Project, Vol 1, Report no 114260, World Bank, available at <http://documents.worldbank.org/curated/en/697291498788132920/Uganda-Intergovernmental-Fiscal-Transfers-Program-Project>.

<sup>119</sup> Peter Ellis, Cledean Mandri-Perrott and Luis Tineo, “Strengthening Fiscal Transfers in Indonesia Using an Output-Based Approach”, Note no 40, 2011, available at <https://www.gpoba.org/sites/gpoba/files/OBA%20No.40%20Indonesia%201-26-11web.pdf>.

<sup>120</sup> Peter Vujanovic, OECD Economics Department Working Papers No. 1380, (2017), OECD “Decentralization to promote regional development in Indonesia”, p. 25, available at <https://www.oecd-ilibrary.org/docserver/d9cabd0a-en.pdf?expires=1539290748&id=id&accname=guest&checksum=DC273A36CEDE47686673901726ED713D>.

<sup>121</sup> World Bank, Program for Results- Indonesia: Supporting Primary Health Care Reform I-SPHERE (P164277)- Technical Assessment (May 2018), p 23 available at: <http://documents.worldbank.org/curated/en/722581527068052303/pdf/Final-Technical-Assessment-Indonesia-Supporting-Primary-Health-Care-Reform-P164277.pdf>.

<sup>122</sup> World Bank, Program for Results- Indonesia: Supporting Primary Health Care Reform I-SPHERE (P164277)- Technical Assessment (May 2018), p. 71.

Also in Indonesia, the World Bank intends to roll out its “Program-for-Results (PforR)” financing instrument to support and expand national governance, service delivery and financing reforms. The PforR program aims to focus on supporting key aspects of the “Healthy Indonesia Program”<sup>123</sup> to improve performance of primary health care service delivery across Indonesia. The World Bank in this program intends to link disbursements to the achievement of results that are tangible, transparent, and verifiable, in order to shift focus towards achievement of results by the central and subnational government. For example, in the PforR program in Indonesia, specifically for the program on immunisation, the indicators are complete basic immunization for infants, and the percentage of universal child immunization (which is the benchmark indicator). This data is based on the reports from districts, which are submitted to the program. Further, there are detailed system indicators, and an elaborate framework of performance monitoring to increase accountability of the subnational government.<sup>124</sup>

### **(b) Developing standardised reporting and accounting standards**

International jurisprudence on the subject generally recommends that all subnational governments be required to manage financial matters in accordance with standard procedures, maintain adequate and current accounts, and conduct public audits regularly. Subnational governments are encouraged to maintain up-to-date and complete information on local finances, and make such information available publicly. In the world of intergovernmental fiscal relations, better information, through reporting, auditing, and accounting is an essential component of a well-functioning system.<sup>125</sup>

With regards to capacity constraints, subnational governments frequently suffer from significant shortcomings in their capacity to manage both revenues and expenditures. The main weaknesses in revenue administration include limited audit capacities, delays in enforcing overdue tax payments, and, especially at the local level, incomplete and outdated property records. Weaknesses in expenditure management frequently include unrealistic budget projections, inadequately developed budget classifications, underdeveloped analysis of fiscal risks, a lack of medium-term frameworks and transparency of future spending obligations, a lack

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<sup>123</sup> The Government of Indonesia introduced the flagship “Healthy Indonesia Program” in 2015, aimed at improving the health and nutritional status of the community through health and community empowerment efforts, backed by financial protection and the equitable distribution of health services. The Healthy Indonesia program is an umbrella program that encompasses the entire public health expenditure, through central and local governments.

<sup>124</sup> The World Bank Indonesia - Supporting Primary Healthcare Reform (P164277), Report No: PIDA148665, March 2018, available at <http://documents.worldbank.org/curated/en/425621522066651938/text/Appraisal-Stage-Program-Information-Documents-PID-Indonesia-Supporting-Primary-Healthcare-Reform-P164277.txt> .

<sup>125</sup> Bird and Smart, World Development Vol. 30, No. 6, (2002), pp. 899-912, “Intergovernmental Fiscal Transfers: International Lessons for Developing Countries”.

of uniform accounting and reporting standards, and weak internal and external control and auditing systems.<sup>126</sup>

There are several ways to address this. One way is for federal governments through legal means, or otherwise, to require or encourage subnational governments to adopt common accounting norms, consistent with relevant international standards, and standards of fiscal transparency. For example, in the aftermath of the Euro crisis, the increasing emphasis EU institutions have placed on adopting common accounting standards for all entities in the general government, underscores the importance of this point. In Mexico, the Comisión Permanente de Funcionarios Fiscales monitors the conformity of the states' fiscal accounting and reporting practices with the standards mandated by the recently passed fiscal responsibility legislation.<sup>127</sup>

Another way in which States achieve compliance with common reporting standards, is by negotiating reporting responsibilities, and making them a part of the funding process for each subnational government. A good example of this is Galicia, in Spain, which like other ACs<sup>128</sup> availing regional incentives, has strict reporting requirements, with a report being furnished to the Directorate General of Community Funds within thirty days of the completion of each semester, on the degree of implementation of the projects in accordance with the conditions laid down. All projects in Galicia (and elsewhere in the ACs accepting regional incentives) are required to comply with the European Commission Directive. They are also required to collaborate with the administrations involved. Adequate monitoring of the objectives are set out in the Royal Decree, and in regional policy guidelines.<sup>129</sup> Further, indicators are being developed for all investment policies in order to measure and improve budgetary management, and to identify inefficient expenditures.<sup>130</sup>

In South Africa, most conditional grants have defined reporting requirements at regular intervals of the grant period. The Comprehensive Agricultural Support

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<sup>126</sup> Minassian and Mello, Inter-American Development Bank, International Experiences and Possible Lessons for Brazil, p. 17 available at <https://publications.iadb.org/bitstream/handle/11319/7665/Intergovernmental-Fiscal-Cooperation-International-Experiences-and-Possible-Lessons-for-Brazil.pdf?sequence=1>.

<sup>127</sup> Teresa Ter-Minassian and Luiz de Mello, "Intergovernmental Fiscal Cooperation - International Experiences and Possible Lessons for Brazil", p. 16 available at <http://www.ijf.hr/upload/files/file/Mihaljek-radovi/Ter-Minassian.pdf>

<sup>128</sup> Autonomous Community of Spain

<sup>129</sup> Royal Decree of Galicia (161/2008) available at <https://www.global-regulation.com/translation/spain/1444623/royal-decree-161-2008%252c-of-8-february%252c-which-delimits-the-area-of-economic-development-of-the-autonomous-community-of-galicia.html>.

<sup>130</sup> "Public Investment across Levels of Government: The Case of Galicia, Spain", OECD 28th Territorial Development Policy Committee (2012), pg. 20, available at [http://www.oecd.org/cfe/regional-policy/Galicia\\_edited.pdf](http://www.oecd.org/cfe/regional-policy/Galicia_edited.pdf).

Programme (CASP) Grant<sup>131</sup> in South Africa requires subnational governments to submit three kinds of reports: (i) monthly financial reports fifteen days after the end of each month; (ii) quarterly non-financial reports thirty days after the end of each quarter; and (iii) annual evaluation reports two months after the end of the financial year on the progress and achievements of the programme. In addition to the reporting requirements, provincial departments are expected to adhere to the conditions laid down in the approved CASP standard operating procedure framework, monitor the implementation of the programme, evaluate the impact of projects in achieving CASP goals, and submit quarterly project performance reports to the Department of Agriculture.<sup>132</sup>

In Australia, conditional grants of financial assistance are provided to the Australian States and Territories under an agreement<sup>133</sup> entered into between the Commonwealth of Australia and the States. These grants are given to support the delivery of the National School Chaplaincy Programme (NSCP) by various Australian States and Territories, with the reporting responsibilities of schools being negotiated for each State. Acquittal of funding<sup>134</sup> is a part of the reporting process. Part IV of the Agreement provides year wise (2015-2018) milestones for the project, their relationship to the outputs, milestone due dates, relevant reporting dates and expected payments for school funding to be made, subject to reports demonstrating that milestones have been met.<sup>135</sup> States are then required to produce annual performance reports<sup>136</sup> in accordance with these milestones, to demonstrate that agreed outputs, as measured by achievement against performance milestones, have been met.

<sup>131</sup> Schedule 5, Part A of the Division of Revenue Act, 2018 South Africa. See also Progress Report on the Implementation of the CASP, Department of Agriculture (2004), available at: [https://www.nda.agric.za/docs/casp/CASP%20Report\\_31%20August.pdf](https://www.nda.agric.za/docs/casp/CASP%20Report_31%20August.pdf).

<sup>132</sup> Progress Report on the Implementation of the CASP, Department of Agriculture (2004), available at: [https://www.nda.agric.za/docs/casp/CASP%20Report\\_31%20August.pdf](https://www.nda.agric.za/docs/casp/CASP%20Report_31%20August.pdf).

<sup>133</sup> Project agreement for the National School Chaplaincy Programme, entered into between the Commonwealth of Australia and the States and Territories of New South Wales, Victoria, Queensland, Western Australia, South Australia, Tasmania, the Australian Capital Territory and the Northern Territory, available at [http://www.federalfinancialrelations.gov.au/content/npa/education/project-agreement/nat\\_school\\_chaplaincy.pdf](http://www.federalfinancialrelations.gov.au/content/npa/education/project-agreement/nat_school_chaplaincy.pdf).

<sup>134</sup> An acquittal of funding involves providing documentation to show how the money received was spent in accordance with the funding deed or agreement, and accurately reporting on the funded activities.

<sup>135</sup> For instance, for the year 2017, the specific milestones included the provision of the list of schools that had chaplaincy services delivered under the NSCP in 2017, confirmation of the requirements set out in clause 9(c) of the Agreement that were met during 2017 (Clause 9 (c) of the Agreement specified the responsibility of the States to put in place appropriate processes to ensure a number of things like ensuring that the participation of schools was voluntary, chaplains being from any faith, and meeting the NSCP's minimum qualification requirements), continued operation of the cross sector panel and selection methodology, and the provision of the list of schools selected for funding in 2018.

<sup>136</sup> States are also required to provide a final performance report covering the 2018 school year, by 31 March 2019, which had to include: (a) the list of schools that had chaplaincy services delivered under the NSCP in 2018; and (b) confirmation that the requirements set out in clause 9(c) of this Agreement were met during 2018.

The Uganda UglIFT, which was described above also establishes a number of institutional and reporting procedures to ensure the smooth implementation of the program. These institutional means include:

- (i) *Managing Transfers at the Central Government level* - Ministry of Finance, Planning, and Economic Development (MoFPED) and the Ministries of Education and Health are responsible for the Program grants, as well as the budgeting, planning, and the funds release processes.
- (ii) *Managing Transfers at the Local Government level* - The local government accounting officer is responsible for overseeing the planning and budgeting for transfers, preparing and submitting warrants to MoFPED, based on which funds are released to Districts, as well as to the health and education facilities under the existing government program; and quarterly budget reporting.
- (iii) The *Local Government annual performance assessment framework* is used to measure fiduciary capacity and compliance with systems and processes. The Office of the Prime Minister coordinates the assessment process.
- (iv) *Targeted Performance Improvement and Inspection*- The Ministry of Local Government coordinates a process of targeted support to poor performing local governments, and also carries out the functions of inspection, monitoring and advocating for Local Governments.
- (v) *Financial Statements and Audit* - A Program Financial Statement is prepared annually, to include International Development Association and the Government of Uganda revenues, transfers made to local governments and national expenditures as set out in the expenditure framework. An annual audit of this statement is conducted by the Office of the Auditor General (OAG), within the OAG's existing framework.

### **Our Assessment**

We understand that for performance-based transfer systems to function effectively, credible processes will need to be instituted to measure and report program activities to the forum responsible for managing the transfer, monitor the usage of inputs, and also measure the performance on outputs. We believe that having transparent processes; measurable indicators of performance like clear targets, goals, indicators and outputs; and standardised processes of reporting will make the transfer system predictable, and induce higher compliance amongst state governments. We believe that an intergovernmental forum will be useful in carrying out the functions of performance assessment and measurement on a continual basis, supporting information exchange, and effectively gauging state government performances.

#### 4. Who should monitor performance and compliance - Establishing institutional arrangements for monitoring and evaluation of subnational governments.

To create a more conducive environment for compliance by subnational governments, fiscal transfers should incorporate transparent mechanisms, processes for consultation and dialogue with subnational governments, as well as establish certain minimum standards that are to be achieved by subnational governments. This reduces the cost of compliance *ex-ante*. Jurisprudence on the subject of compliance suggests that while traditional efforts to monitor performance and verify compliance traditionally included inspections and audit, better designed performance-based grants now focus on feedback, redress, and a comparison of baseline and post-grant data on quality and access. Similarly, as opposed to traditional penalties for non-compliance (including audit observations on financial compliance), better designed conditional grants are now increasingly relying on public censure and competitive pressures for penalising non-compliance<sup>137</sup>.

National standards can be fostered in a variety of ways, and most States, instead of relying on the courts, prefer legislative remedies. For instance, in Brazil, the Constitution specifies the funding pool and the broad criteria for revenue-sharing transfers, and the Senate serves as the primary decision-making body for establishing the formula for allocation of grants and monitoring compliance.<sup>138</sup> The section below details some of the more widely used institutional mechanisms to monitor performance, and compliance of conditions by subnational governments.

##### **(a) Intergovernmental forum for monitoring and grievance redressal**

There are multiple institutional forms through which countries implement monitoring, compliance, and grievance redressal. These forms include, amongst others, the formation of an intergovernmental forum, either through the creation of subnational government finance commissions or forums, composed of regional and subnational governments (a vertical arrangement), or subnational government finance commissions or forums, composed of different national government stakeholders (a horizontal arrangement).<sup>139</sup> This ensures that both the federal, and the subnational government are involved as stakeholders in the process, and allows for wider consultation and shared decision making. An intergovernmental forum

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<sup>137</sup> Boadway and Shah, *Intergovernmental Fiscal Transfers and a Framework for Evaluation*, The World Bank, pp. 13.

<sup>138</sup> Shah, World Bank Policy Research Working Paper 3785, December 2005, “A Framework for Evaluating Alternate Institutional Arrangements for Fiscal Equalization Transfers”, p. 3

<sup>139</sup> Jameson Boex and Jorge Martinez-Vázquez, “Developing the Institutional Framework for Intergovernmental Fiscal Relations in Decentralizing LDTs” (Atlanta: Georgia State University, 2001).

also ensures adequate representation of regional interests in decision making and could thus be particularly effective for federal States. These forums seek to “enable participating governments representing competing interests and varying commitments on equalization to reach a broader consensus,” and this consensus is generally simple and durable.<sup>140</sup> It must be noted that the new institutional economics perspective suggests that an intergovernmental forum is a far better mechanism than an independent grants agency or commission, for having far lesser participation and monitoring costs, agency costs, and uncertainty costs, while driving more feasible, and politically astute reforms.<sup>141</sup>

States have a variety of ways in which they approach the design of such forums. They generally do so by assigning authority for determining fiscal transfer policy to forums consisting of representatives from different levels of government (e.g., Canada, Germany, Indonesia, Nigeria, Pakistan); or through intergovernmental forums reviewing and deciding on the recommendations of independent agencies (e.g., Australia, South Africa). These forums are usually chaired by a national minister (of finance, home affairs, etc.) and can also include other national ministers, ministers from various subnational levels, and civil society members.<sup>142</sup>

In Australia, when financial incentives were introduced for the Australian states as part of a redesign of special purpose transfers to make them more performance-oriented, the changes were agreed to under the aegis of the top intergovernmental forum, the Council of Australian Governments (COAG). The implementation was monitored by the independent Reform Council, established by the COAG in 2006.<sup>143</sup> From 2010 to 2014, the COAG Reform Council (CRC) produced annual reports summarising the joint performance of Australian subnational governments.<sup>144</sup> The performance was measured against agreed benchmarks and indicators.<sup>145</sup> The independent CRC reported directly to the COAG on reforms of national significance, including healthcare, infrastructure, water management and gender equity.

Canada in its ‘Canada Health Transfer’ programme, monitors conditional transfer programmes through the Fiscal Arrangement Committee, an intergovernmental forum consisting of representatives of both national and subnational governments

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<sup>140</sup> Boadway and Shah, Institutional Arrangements for Intergovernmental Fiscal Transfers and a Framework for Evaluation, The World Bank, pp. 306-307.

<sup>141</sup> Boadway and Shah, Intergovernmental Fiscal Transfers and a Framework for Evaluation, The World Bank, pp. 308-309.

<sup>142</sup> Boadway and Shah, Intergovernmental Fiscal Transfers and a Framework for Evaluation, The World Bank, pp. 300- 304 and 296-300.

<sup>143</sup> Information on the COAG is available at <https://www.coag.gov.au/about-coag> .

<sup>144</sup> It is to be noted that the CRC ceased operations on 30th June, 2014, with its functions taken up by other departments and ministries.

<sup>145</sup> Performance Reporting Dashboard, Productivity Commission, Australian Government, available at <https://performancedashboard.d61.io/aus> .

that collectively decide on fiscal transfers in the country. In Canada, even though the primary legal responsibility for the design of fiscal transfers to provinces and territories rests with the federal government (the Ministry of Finance); the federal government nevertheless places strong emphasis on intergovernmental consultation and shared decision making on intergovernmental fiscal transfers, mainly through the Fiscal Arrangements Committee. Particularly for the administration of the Canada Health Act, the Federal Minister of Health is assisted by the Health Canada staff, and the Department of Justice.<sup>146</sup>

In Germany, the Stability Council is a joint body of the German Federation and the federal states. It was established in 2010 as part of the second stage of Germany's federal reforms and is enshrined in Article 109a of the Basic Law (Grundgesetz), Germany's Constitution. Together with Germany's debt brake rules, the Stability Council strengthens the institutional framework for safeguarding the long-term sustainability of public budgets on the Federation, and federal state levels. One of the main tasks of the Council is to assess compliance with the EU requirements for budgetary discipline. In particular, the Council monitors the budgets of the Federation, federal states, local authorities and social insurance funds, to make sure that these, taken together, comply with the conditions stipulated in the Budgetary Principles Act. In its function, the Council is assisted by the Stability Council advisory board comprised of an independent body of experts. The advisory board assists the Council in carrying out its task of monitoring and compliance.<sup>147</sup>

Intergovernmental consultative bodies also exist in Italy, where the two bodies, namely, the Conferenza Stato-Regioni and the Conferenza Stato-Regioni Città,<sup>148</sup> are coordinating bodies, which also conduct evaluation of all central government decisions and laws impacting the subnational governments. Both conferences are also required to agree unanimously on the yearly allocation of grants to each level of government.<sup>149</sup>

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<sup>146</sup> Canada Health Act Annual Report 2016-2017, Administration and Compliance, available at <https://www.canada.ca/en/health-canada/services/publications/health-system-services/canada-health-act-annual-report-2016-2017.html#a4>.

<sup>147</sup> Information on the Stability Council, available at [http://www.stabilitaetsrat.de/EN/Home/home\\_node.html](http://www.stabilitaetsrat.de/EN/Home/home_node.html).

<sup>148</sup> The former is made of representatives of the central government and of the Governors of all regions (who can appoint substitutes with reference to the issues dealt in meeting). The second conference is constituted by representatives of the central government, by the chairmen of the municipal and provincial government and Mountainous Communities associations, by 15 mayors (of which 5 are from metropolitan cities) and by 6 presidents of provincial governments.

<sup>149</sup> Giorgio Brosio and Stefano Piperno, Paper prepared for the Seminar on expenditure needs to be held in Copenhagen, September 13 and 14, 2007, Assessing Regional and Local Government Expenditure Needs in Italy. Small Achievements and Big Prospective Issues, available at: <https://english.oim.dk/media/14341/giorgio-brosio-and-stefano-piperno.pdf>.

## (b) Appointment of Administrators

Another way for States to induce compliance, and conduct regular monitoring functions, is by having administrative agents, who monitor compliance of conditions by subnational governments. An example in this regard is that of Uganda, where the Local Government Finance Commission, mandated under the 1995 Constitution, serves as an advisory body to the national government on all matters relating to the transfer of resources to local governments. It also advises local governments on the appropriate levels of local revenues, and mediates financial disputes among local governments.<sup>150</sup>

## (c) Use of administrators and an intergovernmental forum

Some countries combine the benefits of the office of an independent ‘Administrator’, and the consultative benefits of an intergovernmental forum. A relevant example of this is Australia, where the National Health Reform Agreement, National Health Reform Act, 2011, and the corresponding state and territory national health reform legislations created the role of the ‘Administrator’, who is a single, independent statutory office holder, appointed by the Standing Council on Health. The Commonwealth and state legislations detail the collaborative process between all jurisdictions to select the Administrator, to establish the position of the Administrator, and also provide for her appointment. The role of the Administrator is to administer the National Health Funding Pool (the Pool), to oversee payments into and out of the Pool account for each state and territory, and to report on various funding and service delivery matters. The National Health Funding Body (NHFB), a Commonwealth inter-jurisdictional agency was created to assist the Administrator in the discharge of these requirements. The NHFB performs a number of functions in this regard, including calculating and advising the Commonwealth Treasurer about the contribution to hospital funding in each state and territory, making payments from each State Pool Account in accordance with the directions of the state concerned, and developing and providing to the Commonwealth, the three year data plans submitted by the states and territories.<sup>151</sup>

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<sup>150</sup> Mandate and Functions of the LGFC, available at <http://www.lgfc.go.ug/?q=content/mandate-and-functions-lgfc>

<sup>151</sup> Information on the National Health Funding Body, available at <https://nhfb.gov.au/health-reform/>

## Our Assessment

We believe that for the effective functioning of transfer systems from the Union government to the state governments on a continual basis, an intergovernmental forum with due representation from both the Union, and the state governments would be essential for instituting credible processes in the system. It is advisable for the forum to be a body that survives through the life-cycle of the transfers with responsibilities of monitoring the performance of grant conditions, taking action on non-performance, and managing conflict between the Union and the state government, when necessary. We believe, that the intergovernmental forum should act as a multilateral, intergovernmental, grant-monitoring, and implementation body. The forum may be assisted by a group of experts on various facets of grant transfer systems, and will enable smooth functioning of transfers to state governments. The forum, as has been seen in other countries like South Africa, could be an executive intergovernmental forum, rather than having both politicians and bureaucrats, since keeping political, and bureaucratic influences in the same forum might have the potential effect of inviting interferences and politicisation of issues. In case the forum has political appointees, it could be supported by separate administrative intergovernmental forums to provide the political structures with technical support, and to promote intergovernmental co-operation and consultation at the administrative level. It is also advisable for the forum to be a statutory body with a dedicated legislation governing the form, structure, and functions of the members, as has been done in several countries including South Africa, which has the Intergovernmental Relation Framework Act, 2005, detailing the functions of the intergovernmental forum. Further, the forum may also be supported by other measures at the state and local government level, by having state, and district advisory forums, like the model followed in South Africa, where there are Provincial and District Advisory Forums, supported by other technical committees. The bilateral agreements can also identify the intergovernmental forum as the appropriate body for all these functions. Amongst others, the intergovernmental forum will perform the following functions.

- (i) Provide a platform to the Union and state governments to negotiate bilateral agreements on intergovernmental transfers.
- (ii) Organise intergovernmental conferences to arrive at negotiated strategies of implementation needed at both levels of the government, as is done in the European Union to assist in the development of treaties, by having intergovernmental conferences amongst member countries.
- (iii) Develop integrated intergovernmental policy guidelines for implementation of transfers.
- (iv) Assist in performance assessment, and measurement of state governments on a regular basis, while supporting information exchange between the Union and the state governments.
- (v) Identifying points of conflict, and assisting in negotiations and deliberations during times of conflict between the Union and the state governments.
- (vi) For continued non-compliance of agreed grant conditions, impose penalties.
- (vii) Be supported by technical forums, and other regional forums, for any additional assistance that the forum may require for performance measurement.

## 5. What should be done if States fail to comply with the conditions - Taking steps to dis-incentivise non-compliance with conditions, and taking action to deal with non-compliance when it occurs

In spite of designing adequate processes and systems of fiscal transfer that encourage compliance with grant conditions, subnational governments may fail to comply with the required conditions and standards for multiple reasons.

In such cases, the first step in addressing non-compliance should be to assess whether the design of the performance-based grant was effective in the first place in encouraging compliance with nationally specified standards. It is widely accepted that getting the performance targets right is, in many ways, a more important exercise than prescribing rules for addressing non-compliance.<sup>152</sup> In fact, in a study investigating the effects of (non-)compliance with national numerical fiscal rules on fiscal policy in eleven EU member States with twenty-three fiscal rules in place from 1994 to 2012, it has been demonstrated that the introduction of fiscal rules did significantly change the behaviour of fiscal policy. The results show that fiscal rules acted as a benchmark for policy makers and the public, and that in spite of non-compliance with the rule, there was still an adjustment in fiscal policy towards the rule.<sup>153</sup>

Nonetheless, in cases of non-compliance with the conditions of a fiscal transfer, several jurisdictions prescribe financial responses such as reduction of grant amount, withholding subsequent payments, demanding repayments of grant money commissioned in previous tranches, and requiring reallocation of resources.

### (a) **Reduction, withholding, and repayment of grant**

In Canada, the Canadian Health Transfers program of the federal government enables the various subnational governments at provinces to ensure universal access to high-quality health care to all residents regardless of their income or place of residence. Under this program, the federal government provides per capita transfers for health to the provinces, with the rate of growth of the transfers tied to the rate of growth of GDP. No conditions are imposed on spending, but several conditions are imposed on access to health care.<sup>154</sup> As part of the agreement to receive transfers from the federal government, the provinces

<sup>152</sup> Delgado-Tellez, Lledo, Perez, IMF Working Paper Series 1705, “On the determinants of fiscal non-compliance: An empirical analysis of Spain’s Regions”.

<sup>153</sup> W.H Reuter, National numerical fiscal rules: Not complied with, but still effective?, European Journal of Political Economy, Vol. 39, (2015), pp 67-81.

<sup>154</sup> Section 13, Canada Health Act, 1985, Universality; comprehensiveness; portability; accessibility; and, public administration; available at <http://laws-lois.justice.gc.ca/eng/acts/C-6/page-2.html#h-7>.

undertake to abide by five access-related conditions, including universality, portability, no extra billing, and public insurance.<sup>155</sup> Breaches of conditions then result in penalties, which are expressly stated in the Canada Health Act<sup>156</sup>.

Penalties include the threat of discontinuation of the grant program if the conditions are breached, and dollar for dollar reduction of grant funds for the breach of specific conditions.<sup>157</sup> The Canada Health Act also details a consultation process<sup>158</sup> with the minister responsible for health care, and referral to the Governor in Council in case of defaults, with the conditions set out in the Act. Where no consultations can be achieved, the Act<sup>159</sup> also prescribes orders reducing or withholding contribution to the provinces and local governments by the federal government. The program has largely been seen as a success, enabling Canadian provinces to ensure universal access to a high quality health care to all residents regardless of their income or place of residence. This is also a way for the federal government to promote consistency across the various provincial health plans, ensuring that certain common standards are maintained.<sup>160</sup>

A similar process is also followed in the “Canada Social Transfer” grant programme, which is a federal block transfer to provinces and territories in support of post-secondary education, social assistance and social services, early childhood development, and early learning and childcare.<sup>161</sup> The Federal-Provincial Fiscal Arrangements Act, 1985 prescribes resolving compliance issues through consultation and bilateral discussions<sup>162</sup> between the Governor in Council and local/provincial Ministers, following which, if non-compliance continues, grant money may be reduced or withheld.<sup>163</sup>

This is also reflected in the US ‘Grants to States for Medical Assistance Programs’,<sup>164</sup> where the conditions or federal requirements for receiving the grant, and the consequent indicators for tracking non-compliance with these conditions

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<sup>155</sup> Boadway and Shah, World Bank, 38077, “Public Sector Governance and Accountability Series”, pp. 37-39.

<sup>156</sup> Department of Finance Canada, Information on Canada Health Transfer, available at <https://www.fin.gc.ca/fedprov/cht-eng.asp>.

<sup>157</sup> Anwar Shah, Sponsoring a Race to the Top The Case for Results-Based Intergovernmental Finance for Merit Goods (2010), p. 24.

<sup>158</sup> Section 14, Canada Health Act.

<sup>159</sup> Sections 15, 16, and 17, Canada Health Act, available at <http://laws-lois.justice.gc.ca/eng/acts/C-6/page-3.html#docCont>.

<sup>160</sup> Canada Health Act and its Principles Introduction, Summary of Input on the Conversation on Health, Government of Canada, available at [https://www.health.gov.bc.ca/library/publications/year/2007/conversation\\_on\\_health/PartII/PartII\\_HealthAct.pdf](https://www.health.gov.bc.ca/library/publications/year/2007/conversation_on_health/PartII/PartII_HealthAct.pdf).

<sup>161</sup> Information on Canada Health Transfer, Department of Finance Canada, available at <https://www.fin.gc.ca/fedprov/cst-eng.asp>.

<sup>162</sup> Federal-Provincial Fiscal Arrangements Act, 1985, sections 24.3 and 25.2.

<sup>163</sup> Federal-Provincial Fiscal Arrangements Act, 1985, Canada Health Transfer, Canada Social Transfer and Wait Times Reduction Transfer, section 24.9.

<sup>164</sup> Grants to States for Medical Assistance Programs, CFR 2000 Title 42, Vol 3, Part 430, available at <https://www.gpo.gov/fdsys/pkg/CFR-2000-title42-vol3/pdf/CFR-2000-title42-vol3-part430.pdf>.

or federal requirements are detailed in the Social Security Act, 1956. In case of non-compliance, grant money can be withheld by the federal government, which means that there would be no further payments for aspects of the program that were non-compliant, and that the total or partial withholding will be continued till the Administrator is satisfied about compliance. Thus, withholding,<sup>165</sup> reduction,<sup>166</sup> and repayment<sup>167</sup> of federal funds are all used as penalties for non-compliance. Repayment of funds is mandated when Federal payments are made for claims that are later found to be unallowable. Thus, the subnational government may be directed to repay the federal funds, by installments, if certain conditions are met. The repayment schedules, amounts, procedures etc. are clearly specified in the Social Security Act.

### **(b) Return or refund of grant**

Under the Public Health Ring-Fenced Grant<sup>168</sup> to local bodies in the United Kingdom, if there are discrepancies in expenditure reporting, or non-compliance with grant conditions, the local governments may not only have their future amounts withheld, but may also be required to refund previous disbursements made to them.

In Germany, ‘Consolidation Assistance’<sup>169</sup> by the federal government to five Länders (states) is given in two tranches, to reduce their fiscal deficit. On the 1st of July every year, two-thirds of the annual amount is paid to the Länders. The remaining one-third is paid only if the grant conditions or targets have been adequately met. In case of non-compliance, the initial amount is required to be returned or refunded to the federal government.

### **(c) Reallocation of resources and financial corrections**

Another penalty for non-compliance is to direct subnational governments to reallocate certain resources. For instance, in France, under the CPER programme, where the European Commission reviews the performance, for programmes and priorities that have not achieved their milestones, Member States are required to propose a reallocation of resources across priorities having achieved their milestones, consistent with the thematic concentration requirements and minimum allocations. In addition, where there is evidence based on financial and output indicators of a serious failure in achieving a priority’s milestones due to implementation weaknesses, the European Commission may suspend all or part of interim payments for this priority. In addition to these penalties, Financial

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<sup>165</sup> Section 430.35 of the Social Security Act, 1956.

<sup>166</sup> Section 430.45 of the Social Security Act, 1956.

<sup>167</sup> Section 430.48 of the Social Security Act, 1956.

<sup>168</sup> Public Health Ring- Fenced Grant 2018/19, Local Authority Circular LAC(DH)(2017) 2 LA, United Kingdom.

<sup>169</sup> Consolidation Assistance Act of 10 August 2009 (Federal Law Gazette I, p. 2705).

corrections (FC) may also be applied at the end of programming period if there is a serious failure to achieve targets.<sup>170</sup> FCs are essentially withdrawals of funding that take place when payments to EU-backed projects have been made in error due to irregularities such as fraud. Deployment of financial corrections could include cancelling all or part of an EU contribution to an operational programme.<sup>171</sup> For all EU grants given to Member States, the States have the primary responsibility for investigating irregularities and imposing financial corrections. The Commission may make FCs if there is a serious deficiency in the effective functioning of the management and control system of the programme. Thus, the Member State's failure to comply with its obligation to investigate irregularities and impose FC is seen as a serious failure to achieve the targets set out in the performance framework by the European Commission. In such a case, the Commission carries out FC by cancelling all or part of the EU contribution to the programme in question.<sup>172</sup>

### Our Assessment

In our assessment, the design and negotiation of terms and conditions through agreements, and a continual system of monitoring by the intergovernmental forum with representations from both the Union and the state governments should induce greater compliance of transfer conditions by state governments. In case of conflicts, or instances of non-compliance at the first instance, the intergovernmental forum should be used as a means to initiate discussions, and negotiations with the aim of reducing conflict. However, in case of continuing non-compliance with grant conditions, the forum should also be empowered to prescribe various kinds of financial responses, including the reduction, withholding, repayments, and reallocations of grant amount and resources made to state governments. These should be predetermined and identified in the formal agreement between the Union and the state preceding the transfer.

<sup>170</sup> European Commission, European Structural and Investment Funds (2014-2020), p 22, available at [http://ec.europa.eu/regional\\_policy/sources/docgener/guides/blue\\_book/blueguide\\_en.pdf](http://ec.europa.eu/regional_policy/sources/docgener/guides/blue_book/blueguide_en.pdf).

<sup>171</sup> European Commission, Glossary of Terms, available at [http://ec.europa.eu/regional\\_policy/en/policy/what/glossary/f/financial-corrections](http://ec.europa.eu/regional_policy/en/policy/what/glossary/f/financial-corrections).

<sup>172</sup> European Court of Auditors, Protecting the EU Budget from Irregular Spending (04/2017), Special Report No. 4/2017, Annex II, available at <http://publications.europa.eu/webpub/eca/special-reports/financial-corrections-04-2017/en/#chapter0>.

## 6. How should conflict be managed- Setting out Institutional Mechanisms to address conflict that incorporate due process

Intergovernmental fiscal transfers often create conflicts, between various subnational governments, or between the federal, and the subnational governments. On the one hand, conflict can be *ex-ante* reduced by following principles of design of effective intergovernmental transfers as detailed in the previous sections. In particular, the following principles can substantially reduce conflict:

- (i) setting clearly defined policy objectives;
- (ii) establishing enabling legislations, bilateral agreements and policy guidelines for better fiscal policy coordination; and
- (iii) developing tools to manage implementation, measuring, monitoring, and reporting on standards.<sup>173</sup>

In the event of conflict, this section details principles for determining the manner in which negotiations are brokered during times of fiscal conflict, and the various ways in which disputes are resolved in such time. This section also provides recommendations on the incorporation of principles of due process of law, to establish and protect the rights of all parties involved. This has been explained below in more detail through specific country examples.

In most countries surveyed in this report, intergovernmental consultations and negotiations precede the levying of penalty for breach or non-compliance of conditional grants. For instance, in the United States, under the ‘Grants to States for Medical Assistance Programs’, issues of federal-state finances are often resolved in practice at official levels with a formal understanding reached between the Minister of Finance and the Chief Minister of the state concerned. All disputes, and appeals by the states in case of any issue is attempted to be resolved between the Health Care Financing Administration (HCFA)<sup>174</sup> and the appropriate state by way of negotiations. The Social Security Act also details the procedure for filing appeals, designation of a presiding officer for hearing, notice of hearing and opportunity afforded to the State, authority of the Presiding officer, rights of the parties etc.

In Malaysia, to coordinate important matters of federal and state finance, the Constitution provides for a National Finance Council consisting of the Prime

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<sup>173</sup> Paul Bernd Spahn, Managing Fiscal Conflicts in “Unity in Diversity: Learning from Each Other”, Vol. 2 (2008), p. 70.

<sup>174</sup> HCFA is a federal agency within the United States Department of Health and Human Services that administers the Medicare program and works in partnership with state governments to administer Medicaid, the Children’s Health Insurance Program (CHIP), and health insurance portability standards.

Minister, such other Ministers as the Prime Minister may designate, and one representative from each of the Malaysian states, appointed by the Ruler or Yang di- Pertua Negeri.<sup>175</sup> It is chaired by the Prime Minister of Malaysia, which includes the Minister of Finance and the Chief Ministers of each state of the federation. Problems of federal-state finances are often resolved in practice at official levels with a formal understanding reached between the Minister of Finance and the Chief Minister of the state concerned.<sup>176</sup>

The UgIFT grants program in Uganda sets out institutional arrangements to manage the strengthened process and systems being established. The approach involves consolidating and strengthening existing institutions and coordination mechanisms to deliver the reform, rather than the creation of parallel processes. This includes a high level Fiscal Decentralization Steering Committee, a Fiscal Decentralization Technical Committee, and a series of task forces dealing with grant management, assessment and targeted support. Further, UgIFT<sup>177</sup> fiduciary arrangements are implemented at the Central Government and Local Government levels, with the Central Government being responsible for the program grants, budgeting, planning and funds release processes, and the local government being responsible for the accounting processes, planning, budgeting for transfers, based on which funds are further released to districts.

For the CPER in France, Regions conduct discussions with departmental councils. Grants are awarded on the basis of expenditure justifications provided by the project owners. They can be restored in case of non-compliance with the operation of the program. The Regions and States in France ensure the effective and efficient implementation of operations of the multi-year investment plan of the institution. The investment capacity generated by the valuation of the domain of the State, entrusted to that establishment is supposed to be fully mobilized to promote sustainable development of the capital region. Monitoring is done by a steering committee, which meets the Prefect and the President of a particular Region regularly, and also coordinates the preparation of annual updates on the operational progress of projects.

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<sup>175</sup> Article 108 of the Constitution of Malaysia, available at: <http://www.commonlii.org/my/legis/const/1957/7.html>.

<sup>176</sup> Asian Organization of Supreme Audit Institutions, Legislative Requirements for Financial Management and Control, available at [http://www.asosai.org/asosai/R\\_P\\_financial\\_accountability/chapter\\_8\\_malaysia.htm](http://www.asosai.org/asosai/R_P_financial_accountability/chapter_8_malaysia.htm).

<sup>177</sup> Uganda Intergovernmental Fiscal Transfer Program (UgIFT), established under the Intergovernmental Fiscal Transfers Reform Program (IFTRP).

### Our Assessment

As discussed in the section above, in our assessment, conflict should be managed at both the levels of design, and implementation. At the stage of design, the agreements executed between the Union, and the state governments, apart from clearly setting out the policy objectives, should also incorporate principles of due process of law- notice of hearing, appointment of presiding officers, right of appeal; and also adequately protect the rights of both the parties involved. In the event of conflict, the intergovernmental forum should be used to broker negotiations between the Union and state governments, and should also be used as a means to initiate deliberations over the terms of the agreement, and points of conflict.

## C. RECOMMENDATIONS - OVERVIEW

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The objective of an effective performance-based intergovernmental transfer system is to establish nationally set minimum standards of performance, to reward high performance in a competitive setting, while at the same time respecting local autonomy and allowing for flexibility in tailoring policies to local contexts and constraints. In order to effectively implement such transfers, governments must also establish transparent and credible processes for measuring, reporting and monitoring performance. Institutional mechanisms must also be established to deal with non-compliance, grievances, and conflict between different levels of government.

Given the principles of good design outlined in previous sections of this Chapter, we emphasise the following recommendations for the effective design and implementation of a system of conditional intergovernmental fiscal transfers.

### 1. Recommendations for effective design of conditional transfers

- (i) Allow for the joint development of objectives, conditions, outcomes and performance metrics by the federal government and the individual state governments. Transfer systems should be designed to accommodate the particular needs of the state, and afford them sufficient autonomy and regional flexibilities and requirements to be built into the transfer system. This can be done by capturing the national policy objectives into individual state legislations, or through contractual arrangements entered into between the central and the subnational government. The conditions can then be enshrined in the state legislations or the contracts, to support the federal goals, and may include setting specific milestones for projects to be achieved by the states.

In the context of India, we recommend that formal arrangements, in the form of bilateral agreements, or in any other form, be executed between the Union and state governments. This will effectively encapsulate the individual requirements of the state, and explicitly stipulate grant conditions and terms to be fulfilled by the states. The intergovernmental forum can be used as an appropriate means to negotiate and execute such agreements.

- (ii) Conditions should be performance-based and should ensure that subnational governments meet minimum national standards. Further, the framework should reward high-performing governments. This includes designing key indicators of performance, which are measurable, credible and under the control of the subnational government, as well as the development of

standardised reporting and accounting mechanisms. Once again, the performance measures and reporting systems should be commonly agreed between governments.

For India, we recommend that conditional transfers be designed and predicated on objective performance metrics, and be output-based, to ensure states have specific outcomes to achieve, and the Union has a results-based, accountable transfer system.

## 2. Recommendations for effective implementation of conditional transfers

- (i) An intergovernmental forum should be created to implement any system of intergovernmental transfers, and should include representatives of the federal government, subnational and local governments, and other national stakeholders. Alternatively, this can be achieved through the appointment of independent Administrators to oversee implementation and assess compliance.

For India in particular, conditional transfer schemes differ, depending on the policy objectives sought to be achieved (for instance, transfers to incentivise better sanitation outcomes would differ from transfers to incentivise better public finance management by local bodies). We believe that an institutional structure that lives through the lifecycle of the grant, would be more conducive to providing a basis for negotiation, monitoring, assessment, and compliance of the grant conditions. While the Finance Commission can play an instrumental role in envisioning and designing effective transfer systems that allow the Union and state governments to meet their shared objectives, we believe that the Finance Commission cannot be the appropriate forum to manage the conditional transfers on an ongoing basis, since it is not a permanent body. To ensure standardised, reliable, and credible mechanisms of transfers, we believe that an intergovernmental forum, or other such appropriate body be institutionalised to adequately represent both the Union and state governments, and their respective interests and needs. Accordingly, such a body can be used not just for measuring and reporting performance to the Union government on a regular basis, but also serve as a means to manage conflicts, and undertake any other function to ensure compliance, and foster fiscal co-operation between the two levels of governments.

Thus, we recommend the use of an intergovernmental forum, supported by technical groups, and also state and district forums if necessary, to carry out the functions of performance assessment, measurement, supervision on compliance with grant conditions and reporting, information exchange, and

identifying and managing conflict on a continual basis, through the life-cycle of the grants.

- (ii) Achieving compliance is largely a function of transfer design - setting the right conditions, performance targets and incentives. In case of non-compliance with grant conditions even after taking effective design into account, various methods of penalties may be adopted, including reduction, withholding, repayment, return or refund, reallocation of funds, or instituting financial corrections.

For India, we recommend the use of the intergovernmental forum as a means to conduct negotiations and discussions during times of conflict between the Union and the states, and also empowering the intergovernmental forum to impose the aforementioned penalties for continued non-compliance with grant conditions, by the states.

- (iii) Approaches to managing fiscal conflict and grievance redressal should involve intergovernmental consultations and negotiations, typically before levying penalty for non-compliance with conditional grants. These negotiations can take place through a number of institutional arrangements such as steering committees, at all levels of government, inter-ministerial councils, and intergovernmental forums.

We recommend, that for India, the intergovernmental forum be instituted with due representation from both the Union Government and the states, to provide a platform for negotiations to arrive at negotiated reforms, develop integrated intergovernmental policy guidelines for implementation of transfers, identify points of conflict, and reduce instances of conflict.

- (iv) Grievance redressal processes must incorporate principles of due process of law which establishes and protects the rights of all parties involved, designates presiding officers for hearing, provides notice of hearing, provides opportunities to the recipient government to make submissions, and allows for a system of appeals.

For India, we recommend that the bilateral agreements to be executed between the Union and the states, which govern the design and implementation of the conditional transfer, also provide for processes to address the grievances of states. These should incorporate principles of due process of law, and adequately safeguard the rights of both the Union and the relevant state. We also recommend for the intergovernmental forum to be used as a means to initiate deliberations over the terms of agreements, and points of conflict.

The section below summarises the findings from this Chapter, with relevant examples in **Table 2** below.

**Table 2: Summary of Recommendations**

	Principle	Recommendations	Examples
1.	<u>Who Designs the Transfers</u> - Encouraging greater collaboration and compatibility between central and subnational policy preferences	<p>Allowing for the joint development of objectives, conditions, outcomes and performance metrics by the federal government and the individual state governments by:</p> <p>(i) Enabling legislations at subnational levels;</p> <p>(ii) Bilateral agreements between the central and the subnational government.</p> <p><b>For India</b>                      Allowing for formal agreements between the Union government and the relevant states, containing grant terms and conditions, based on individual state requirements. Intergovernmental forum to be used to negotiate and execute agreements.</p>	<p>(i) National Health Reform in Australia, where the principal federal legislation is the National Health Reform Agreement, which is adapted into state legislations in various states.</p> <p>(ii) Germany, through the Consolidation Assistance Act, 2009, states/local governments required to sign bilateral administrative agreements with the federal government; Spain- Royal Decrees signed between Autonomous Communities and federal government; France - Contrat de plan Etat Région (CPER) or state region plan contracts signed between federal and state governments.</p>
2.	<u>What conditions should be set</u> - Designing conditional transfers to create incentives for establishing nationally mandated minimum standards and improving performance by subnational governments.	<p>Designing conditions to incentivise fiscal reforms and performance by:</p> <p>(i) Effective use of conditions to drive fiscal reforms</p> <p>(ii) Establishing inter-jurisdictional</p>	<p>(i) Russian Regional Fiscal Reform Fund - funds awarded to regions undertaking significant fiscal reforms; India - Fiscal Responsibility and Budget Management Act, 2003, to set targets for the government to reduce fiscal deficits; Denmark, Finland - conditional transfers used to encourage mergers of small municipalities.</p>

		<p>coordination</p> <p>(iii) Designing performance-based transfers that are conditioned on the achievement of pre-specified outputs and performance targets.</p> <p>(iv) Using a combination of minimum conditions and performance measures.</p> <p><b>For India</b> Design of intergovernmental transfers on objective performance metrics, and being output-based to help states achieve specific outcomes in terms of their performance.</p>	<p>(ii) Germany, Colombia, and the United States - use of financial incentives to coordinate regional infrastructure investments.</p> <p>(iii) Uganda’s Intergovernmental Fiscal Transfer Programme (UgIFT); Indonesia’s Dana Alokasi Khusus’ (DAK) conditional (matching) grant.</p> <p>(iv) Canadian Federal Government’s health grants; Japanese road grants; Australian National Competition Policy- performance grants to states that achieve certain reform objectives intended to promote economic growth; UK- Local Public Service Agreements requiring local authorities to select performance indicators against which performance is measured; UN performance-based grants for climate resilience - LoCAL.</p>
<p>3.</p>	<p><u>How is performance assessed and measured</u></p>	<p>Instituting credible processes at the levels of the subnational governments to measure and report program activities, input usage, and performance on outputs by:</p> <p>(i) Developing key indicators of performance</p> <p>(ii) Developing standardised reporting and accounting standards</p> <p><b>For India</b> Instituting credible processes for measuring, and reporting program activities, monitor inputs and measure performance on outputs.</p>	<p>(i) Nigeria -Conditional Grants Scheme, monitored by the UN for the achievement of Millennium Development Goals; Uganda - UgIFT Program’s using ‘Disbursement Linked Indicators’ and ‘Disbursement Linked Results’; Indonesia - DAK using technical and performance indicators; Indonesia - World Bank’s Program-for-Results (PforR).</p> <p>(ii) EU institutions - common accounting standards for all entities; Mexico- Comisión Permanente de Funcionarios Fiscales monitoring the conformity of the states’ fiscal accounting and reporting practices; Spain - Autonomous Communities availing regional incentives have strict reporting standards; South</p>

		Also having clear targets, goals, indicators, outputs, and standardised reporting. Use of an intergovernmental forum to drive functions of performance assessment and measurement.	Africa - reporting under Comprehensive Agricultural Support Programme; Australia- reporting under National School Chaplaincy Programme; Uganda - UglIFT program.
4.	<u>Who should monitor performance and compliance</u> - Establishing institutional arrangements for monitoring and evaluation of subnational governments	<p>Encouraging design of performance-based grants that focus on feedback, redress, and a comparison of baseline and post-grant data on quality and access, and establishing institutional means to implement monitoring, compliance, and grievance redressal.</p> <p>(i) Intergovernmental forum for monitoring and grievance redressal</p> <p>(ii) Appointment of administrators</p> <p>(iii) Use of Administrators and an intergovernmental forum</p> <p><b>For India</b> Using an intergovernmental forum to continuously monitor performance and compliance, with representation from both Union and state governments. Forum may be assisted by a group of experts.</p>	<p>(i) Australia - Council of Australian Governments (COAG) is the intergovernmental forum, and implementation monitored by COAG Reform Council (CRC); Canada - 'Canada Health Transfer' monitoring of conditional transfer programmes through the Fiscal Arrangement Committee; Germany- Stability Council which is a joint body of the German Federation and the federal states; Italy - intergovernmental consultative bodies include Conferenza Stato-Regioni and the Conferenza Stato-Regioni Città.</p> <p>(ii) Uganda - Local Government Finance Commission, an advisory body to the national and local governments, and also mediates financial disputes among local governments.</p> <p>(iii) Australia - National Health Reform Agreement, National Health Reform Act 2011 and corresponding state and territory national health reform legislation created the office of an Administrator. Administrator assisted by National Health Funding Body (NHFB), a Commonwealth inter-jurisdictional agency.</p>
5.	<u>What should be done if states fail to</u>	Introduction and review of fiscal rules in place	(i) Canada - Canadian Health Transfers program, and

	<p><u>comply with the conditions</u> - Taking steps to dis-incentivise non-compliance with conditions and taking action to deal with non-compliance when it occurs</p>	<p>and prescribing financial responses for cases of non-compliance.</p> <p>(i) Reduction, withholding, and repayment of grant</p> <p>(ii) Return or refund of grant</p> <p>(iii) Reallocation of resources and financial corrections</p> <p><b>For India</b> Use of intergovernmental forum to initiate discussions and negotiations between Union and state governments at the first instance. Forum to also be empowered to impose financial responses - withholding, reduction, repayments, and reallocations of grant made to states; as predetermined in bilateral agreements between the Union and the states.</p>	<p>Canada Social Transfer where penalties include the threat of discontinuation of the grant program and reducing or withholding contribution; US- Grants to States for Medical Assistance Programs.</p> <p>(ii) UK - Public Health Ring-Fenced Grant to local bodies - withholding, and refund of previous disbursements; Germany - Consolidation Assistance by the federal government to five <i>Länders</i> (states).</p> <p>(iii) France - CPER programme, reallocation of resources across priorities having achieved their milestones, suspension of interim payments, and financial corrections by the European Commission.</p>
<p>6.</p>	<p><u>How should conflict be managed</u> - Setting out Institutional Mechanisms to address conflict that incorporate due process</p>	<p>Encouraging the incorporation of principles of due process of law, to establish and protect the rights of all parties involved, and institutional means to manage fiscal conflict.</p> <p><b>For India</b> Agreements between the Union and state governments to contain principles of due process of law, and provisions to protect the</p>	<p>US - Grants to States for Medical Assistance Programs, resolution of fiscal conflicts through intergovernmental formal understandings. Health Care Financing Administration handles all disputes and appeals by the states. Social Security Act establishes due process; Malaysia- Revenue Growths Grant, the National Finance Council to manage disputes, and through intergovernmental formal understandings; Uganda - UgIFT- Fiscal</p>

		rights of the parties. Intergovernmental forum to be used to broker negotiations, and resolve conflict.	Decentralization Steering Committee, a Fiscal Decentralization Technical Committee, and a series of task forces; France - CPER - discussions with departmental councils, and monitoring by steering committee.
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## PART III

## CHAPTER IV - KEY PRINCIPLES OF INTERGOVERNMENTAL CONDITIONAL TRANSFERS-THE INDIAN EXPERIENCE

The purpose of this Chapter is to demonstrate the manner in which the key principles for the effective design of conditions set out in Chapter III above, are complied with in the conditions associated with certain Finance Commission grants and important CSS in India.

### A. EVALUATING SELECTED FINANCE COMMISSION GRANTS AND CENTRALLY SPONSORED SCHEMES

In order to understand how various CSS have been designed, we have reviewed several 'core' and 'core of the core' schemes such as MGNREGP, the Rashtriya Swasthya Bima Yojana (RSBY), the PMGSY, and the Umbrella Scheme for the Development of Scheduled Tribes. In the section below, we have attempted to extract key features of these CSS programmes and weigh them against the principles of design set out in the previous Chapter. Our analysis also includes instances of specific conditions which are present in the grants made by the Finance Commission in order to compare them to the suggested design principles. It is also important to note that some of the examined schemes and grants may not include all the listed design principles, and therefore it would not be possible to analyse them on this basis.

#### 1. Who Designs the Transfers

As discussed in the previous Chapter, greater collaboration between the Union and the states can minimise discretion and promote transparency in the implementation of a conditional transfer scheme. In the absence of this collaboration, there may be ambiguity regarding the objective of the scheme, and the respective roles that the Union and the state are to play in its design and implementation. The Fourteenth Finance Commission had recognised that there was a need to review existing arrangements of transfer between the Union and the states in order to minimise discretion, to improve the designs of transfers, and to promote the spirit of cooperative federalism.<sup>178</sup>

#### (a) **Enabling Legislations at the subnational level**

<sup>178</sup> Chapter 12, Report of the Fourteenth Finance Commission, p. 165, available at: [https://www.thehinducentre.com/multimedia/archive/02321/Fourteenth\\_Finance\\_Commi\\_2321247a.pdf](https://www.thehinducentre.com/multimedia/archive/02321/Fourteenth_Finance_Commi_2321247a.pdf).

As a means to increase objectivity, it has been suggested in the previous Chapter that having a principal legislation at the Union level, with states having individual enabling legislations would allow states to incorporate their own needs and considerations into the enabling state legislations. This could perhaps be implemented in India as well. For instance, the MNREGP originates from the Mahatma Gandhi National Rural Employment Guarantee Act, 2005 (MNREGA). The mandate of the MNREGA is to provide at least hundred days of guaranteed wage employment in a financial year to every rural household whose adult members volunteer to do unskilled manual work.<sup>179</sup> This legislation sets out all the conditions which the state governments must comply with. Therefore, state governments have little flexibility in adjusting the Scheme in order to suit their own needs. All directions come from the Union. States' flexibility is limited to determining the nature of the projects undertaken under the Scheme as this is done on the basis of the recommendations made by the Gram Sabhas.<sup>180</sup> Perhaps a better way forward would be to permit states to crystallise their specific needs in the form of individual state legislations, or some other form of bilateral arrangement undertaken between the Union and the state government.

Similarly, the RSBY is one of the schemes present in the Schedule of the Unorganised Workers Social Security Act, 2008 (Social Security Act).<sup>181</sup> The purpose of the RSBY is to provide for the social security and welfare of unorganized workers. There is some ambiguity regarding the uniform application of this scheme across states, as they are free to not participate in this scheme if they already have an equivalent health insurance scheme in place.<sup>182</sup> Having multiple schemes in place for the same purpose would lead to significant overlap. Furthermore, assessing the effectiveness of discrete schemes with entirely different parameters is a very difficult exercise. It could be argued that once a particular CSS has been identified as necessary, allowing for a state specific legislation in this regard, or some other form of bilateral agreement or arrangement between the Union and the states could prove useful in providing some uniformity in determining its terms and application.

## 2. What conditions should be set?

As discussed in the previous Chapter, output-based or performance-based conditional transfers are the most effective way to promote a better standard of

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<sup>179</sup> MNREGA Operational Guidelines (2013), available at: [http://nrega.nic.in/Circular\\_Archive/archive/Operational\\_guidelines\\_4thEdition\\_eng\\_2013.pdf](http://nrega.nic.in/Circular_Archive/archive/Operational_guidelines_4thEdition_eng_2013.pdf).

<sup>180</sup> MNREGA Operational Guidelines (2013), p. 50, available at: [http://nrega.nic.in/Circular\\_Archive/archive/Operational\\_guidelines\\_4thEdition\\_eng\\_2013.pdf](http://nrega.nic.in/Circular_Archive/archive/Operational_guidelines_4thEdition_eng_2013.pdf).

<sup>181</sup> Schedule I, Unorganised Workers Social Security Act, 2008.

<sup>182</sup> Public Health Foundation of India, A Critical Assessment of Existing Health Insurance Models in India, available at: [http://planningcommission.nic.in/reports/sereport/ser/ser\\_heal1305.pdf](http://planningcommission.nic.in/reports/sereport/ser/ser_heal1305.pdf).

service provision by state and local governments. By focusing on measurable outputs rather than inputs, such transfers would be able to incentivise progress on the indicators that governments care about while giving a sufficient amount of flexibility to subnational governments to take into account their own contexts and constraints. Performance-based incentives can be combined with minimum conditions for fund transfer to ensure a minimum standard of budgetary accountability, and public finance management processes.

An example of performance-incentives in Finance Commission grants is that of the grants given to local bodies as per the recommendations made by the Thirteenth Finance Commission. The Finance Commission, at the urging of the Ministry of Panchayati Raj, made recommendations which would enable Panchayati Raj Institutions to provide basic services to their constituents by bolstering the finances of urban and local bodies. The grant given to local bodies has two components- a basic component, and a performance-based component. While the basic grant is a percentage of a divisible pool, which is accessible to all states, only those states which meet certain stipulations would be able to access the performance grant.<sup>183</sup> These stipulations are detailed, and form the incentive framework for the general performance grant.<sup>184</sup> For the first year (in 2010), the general basic grant was to be released subject to the submission of a utilisation certificate. Thereafter, from the years 2011 to 2015, state governments would be able to draw their share of the grants only upon satisfying these conditions:

- (i) maintenance of accounts by Panchayati Raj Institutions and urban local bodies, which also includes supplementary budget documents and certification of accounting systems;
- (ii) implementation of audit systems by state governments for all local bodies, where certification from the Comptroller and Auditor General is necessary to demonstrate compliance;
- (iii) instituting an independent local body ombudsman to look into complaints of corruption and maladministration against functionaries of local bodies, where self-certification of the same would indicate compliance;
- (iv) creation of a system to electronically transfer local body grants to respective local bodies within 5 days of receipt from the Central Government;
- (v) specification of the necessary qualifications of persons suitable for appointment as members of State Finance Commissions by way of legislation;
- (vi) enabling local bodies to collect property tax;
- (vii) establishment of a state level property tax board;

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<sup>183</sup> Report of the Thirteenth Finance Commission, pp. 173-175.

<sup>184</sup> Report of the Thirteenth Finance Commission, p. 178.

- (viii) establishment of standards for the delivery of all essential services provided by local bodies; and
- (ix) implementation of fire hazard response plans.<sup>185</sup>

As per the Finance Commission recommendations, states are also given guidelines to demonstrate compliance. The use of such a large number of varied performance conditions implies widely differing objectives for a single conditional transfer scheme, and it is not clear what action should be taken should some of the conditions be fulfilled and not the others. While the responsibility for monitoring and verifying compliance is clearly located for some of the objectives (for example, implementing audit systems is to be verified by the CAG's office), it is far less clear for others. Moreover, there does not appear to be a clear process for continual monitoring of the local bodies as they progress towards meeting their performance conditions.

An issue which has been noted with many CSS is that the Union Government sets out detailed guidelines regarding the manner in which the state should implement the programme, often over-burdening the implementing entities with conditions to fulfil prior to the receipt of grants. The guidelines are frequently very complex and process-oriented, rather than output-oriented. The design of these transfers reveal a “take-it or leave-it” attitude on the part of the Union government, and frequently leads to the state governments failing to comply with the exacting terms of the grant and forfeit all or a part of the grant.

For instance, the PMGSY is a CSS which aims to provide connectivity by way of all-weather roads to unconnected habitations in rural areas having a population above 1,000 individuals.<sup>186</sup> The PMGSY is funded by grants which are shared between the Union and the states on a 75:25 basis and on a 90:10 basis for special areas such as the North Eastern States.<sup>187</sup>

Under this scheme, funds are released as two instalments. The first instalment amount is equivalent to 50% of the value of the projects which have been cleared by the National Rural Road Development Authority (NRRDA). In order to receive the second tranche of payment, the following conditions have to be satisfied: the utilisation of 60% of the available funds; the completion of at least 80% of the works awarded in the previous year; and 100% of the work awarded prior to that.<sup>188</sup>

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<sup>185</sup> Report of the Thirteenth Finance Commission, pp. 178-180.

<sup>186</sup> Pradhan Mantri Gram Sadak Yojana Scheme and Guidelines, available at: <http://www.pmgysy.nic.in/pmg31.asp>

<sup>187</sup> Manual for District Level Functionaries, Pradhan Mantri Gram Sadak Yojana, available at: [https://darpg.gov.in/sites/default/files/PMGSY\\_0.pdf](https://darpg.gov.in/sites/default/files/PMGSY_0.pdf)

<sup>188</sup> Manual for District Level Functionaries, Pradhan Mantri Gram Sadak Yojana, p. 12, available at: [https://darpg.gov.in/sites/default/files/PMGSY\\_0.pdf](https://darpg.gov.in/sites/default/files/PMGSY_0.pdf).

The operational guidelines issued under the PMGSY provide a set of highly detailed instructions regarding how this program must operate. It involves creation of categorical plans, and proposals. For instance, at the district level, there is the district rural roads plan which indicates the entire existing road network system in the district, and identifies the proposed roads which will provide connectivity to unconnected habitations. The district rural roads plan must also identify the core network, which is the minimum network of roads required to provide basic access to essential social and economic services to all eligible unconnected habitations.<sup>189</sup> The district road plan is to be prepared at the Block level. The Block level master plan and the core network are then placed before the Intermediate Panchayat for consideration. Upon approval by the Intermediate Panchayat, the master plan and core network then go to the District Panchayat for approval. Thereafter, it goes to the (state-level) State Rural Roads Development Agency (SRRDA) and then to the NRRDA.<sup>190</sup> The District Panchayat must also prepare Block and District Connectivity Priority Lists (CNCPL) of proposed road links under the PMGSY. The approved list of road works and proposals are finalised by the District Panchayat in accordance with the allocation of funds which are provided to that district. At the state level, once the SRRDA vets the proposals and places them before the State Level Standing Committee, a detailed project report must be prepared. The PMGSY guidelines also set out a lot of instruction on the manner in which the report must be prepared, including details that it must contain, such as technical specifications, requirements regarding drains, embankments and culverts and so on.<sup>191</sup> At the Union level, annual projects which are received from the state Governments by the NRRDA are forwarded to the Ministry of Rural Development for final approval.

The PMGSY Guidelines also set out an indicative list of timelines and project targets which must be achieved at various times of the year.<sup>192</sup> The date for final execution of all work is set at nine months from the date of the work order. Failure to complete according to timelines could have a detrimental effect on the release of funds, but the manner in which this Scheme is designed, gives states little autonomy or flexibility in determining how to manage expenditures.<sup>193</sup> For instance, under the PMGSY Guidelines, once the core network is prepared and the

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<sup>189</sup> Pradhan Mantri Gram Sadak Yojana, Programme Guidelines (January 2015), p. 3, available at: [http://pmgsy.nic.in/PMGSY\\_E\\_J\\_2015.pdf](http://pmgsy.nic.in/PMGSY_E_J_2015.pdf).

<sup>190</sup> See Pradhan Mantri Gram Sadak Yojana, Programme Guidelines (January 2015), available at: [http://pmgsy.nic.in/PMGSY\\_E\\_J\\_2015.pdf](http://pmgsy.nic.in/PMGSY_E_J_2015.pdf) and the District Manual, Pradhan Mantri Gram Sadak Yojana.

<sup>191</sup> See Pradhan Mantri Gram Sadak Yojana, Programme Guidelines (January 2015), p. 8, available at: [http://pmgsy.nic.in/PMGSY\\_E\\_J\\_2015.pdf](http://pmgsy.nic.in/PMGSY_E_J_2015.pdf).

<sup>192</sup> See Pradhan Mantri Gram Sadak Yojana, Programme Guidelines (January 2015), pp. 9-10 available at: [http://pmgsy.nic.in/PMGSY\\_E\\_J\\_2015.pdf](http://pmgsy.nic.in/PMGSY_E_J_2015.pdf).

<sup>193</sup> District Manual, Pradhan Mantri Gram Sadak Yojana, available at: [https://darpg.gov.in/sites/default/files/PMGSY\\_0.pdf](https://darpg.gov.in/sites/default/files/PMGSY_0.pdf).

length of roads for which connectivity is required is estimated, the state governments must allocate the funds received in a ratio of 80:20 on the basis of road length required for connectivity to the road length required for existing roads.<sup>194</sup>

From the above, it is quite evident that states are obligated to comply with a large number of exacting conditions in order to demonstrate compliance. Therefore, rather than setting a large number of fulfilling conditions for compliance, the Union could consider using a combination of minimum conditions linked to accountability for the release of funds and performance-based conditions to reward high-performing districts, as suggested in the previous Chapter. Output could be assessed through a performance audit, such as constructing a certain length of road of a specified quality, rather than simply linking to inputs such as expenditure, such as the condition that PMGSY has in place- disbursing fresh funds only upon the expenditure of 60% of the previously released fund amount.<sup>195</sup>

Another example of performance-based conditions can be gleaned from the Development of Particularly Vulnerable Tribal Groups (PVTG) scheme, which falls under the Umbrella Scheme for Development of Scheduled Tribes. Particularly vulnerable tribal groups constitute the most vulnerable section among tribals and they inhabit isolated, remote, and difficult to access areas in small and scattered hamlets. The PVTG scheme's aims include promoting socio-economic development of these groups while retaining the culture and heritage of the community, so that a visible impact is made in their quality of life.<sup>196</sup>

The scheme is implemented via a Conservation-cum-development (CCD) plan prepared by the State Government for the particularly vulnerable tribal groups in each state on the basis of requirement, which is assessed via baseline and other surveys. The CCD plan will be implemented via agencies of the state governments such as Integrated Tribal Development Projects (ITDPs) or Integrated Tribal Development Agencies (ITDAs) or Panchayati Raj Institutions (PRIs). This scheme is funded completely by the Union government. Funds are disbursed to the states once or twice a year, on the basis of need. There do not appear to be many specific conditions which must be fulfilled before money is granted. However, the CCD plan must indicate yearly physical targets and outcomes such as the improvement in the enrolment rates in schools, the reduction of dropout rates, increase in infant immunisation and the increase in the health coverage of

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<sup>194</sup> District Manual, Pradhan Mantri Gram Sadak Yojana, available at: [https://darpg.gov.in/sites/default/files/PMGSY\\_0.pdf](https://darpg.gov.in/sites/default/files/PMGSY_0.pdf) .

<sup>195</sup> Information available at [http://planningcommission.gov.in/reports/sereport/ser/stdy\\_flwfnds.pdf](http://planningcommission.gov.in/reports/sereport/ser/stdy_flwfnds.pdf).

<sup>196</sup> Ministry of Tribal Affairs, Revised Scheme of "Development of Particularly Vulnerable Tribal Groups" (F. No. 22040/37/2012-NGO), March 20, 2015.

expectant mothers.<sup>197</sup> Implementation is monitored by officials of the Ministry of Tribal Development, and the state governments. The continuation of funding depends on the satisfactory progress made by the respective state governments. Therefore, this scheme appears to give states greater autonomy in deciding which aspects of socio-economic development require financial aid. The states also appear to have greater flexibility in deciding how to obtain the targeted results as they are not weighed down by performance of strict conditions. Further, the performance targets appear more qualitative in nature as the scheme encourages broad achievements for overall socio-economic welfare.

### 3. How is performance measured, reported and monitored?

#### (a) **Standardised reporting and accounting standards**

Accountability to the public is ensured through standardised reporting and accounting systems that allow for the transparent flow of information about programme implementation, and through the creation of institutional mechanisms that monitor performance and ensure that public institutions are held to account.<sup>198</sup> The CSS schemes reviewed for this report all incorporate reporting requirements to improve transparency, as well as social audits. In addition, they create monitoring mechanisms to verify compliance, generally through vertical structures where state governments report to the Union government.

For instance, most CSS in India have clearly defined reporting requirements which require the state and district level units to regularly report progress and expenditure. An example of this is the PMGSY's online monitoring system (Online Management, Monitoring and Accounting System or OMMAS). The PMGSY Guidelines stipulate that the head of project implementation units are responsible for entering all relevant master data regarding the road plans as well as for ensuring the accuracy of data relating to the progress of the work done into OMMAS. Information regarding the records of quality control tests and payments made must also be entered using this online accountability system.<sup>199</sup> Other modes of monitoring performance include institutional mechanisms of monitoring such as that done by a dedicated District Development Coordination and Monitoring

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<sup>197</sup> See Annexure II, Ministry of Tribal Affairs, Revised Scheme of "Development of Particularly Vulnerable Tribal Groups" (F. No. 22040/37/2012-NGO), March 20, 2015.

<sup>198</sup> Salimah Samji and Yamini Aiyar, Improving the Effectiveness of National Rural Employment Guarantee Act, Vol. 41, No. 4 (2006), citing Goetz, A M and Jenkins (2004): 'Accountability' in Adam Kuper and Jessica Kuper (eds), The Social Science Encyclopedia, Routledge, New York, available at: <https://www.epw.in/journal/2006/04/perspectives/improving-effectiveness-national-rural-employment-guarantee-act.html>.

<sup>199</sup> The Pradhan Mantri Gram Sadak Yojana Guidelines (2012), p. 37, available at: [http://omms.nic.in/ReferenceDocs/PMGSY\\_Guidelines.pdf](http://omms.nic.in/ReferenceDocs/PMGSY_Guidelines.pdf).

Committee at the District level<sup>200</sup> and by the Standing Committee at the state level.<sup>201</sup>

Similarly, the PMGSY also mandates external audits which must be conducted at regular intervals. For instance, the SRRDA has the responsibility to ensure that accounts are audited within six months of the end of the year by a Chartered Accountant approved by the CAG of India. The CAG may also undertake to audit the accounts of the program on various aspects of performance and expenditure.<sup>202</sup>

Like the PMGSY, the MNREGA also creates certain institutional bodies whose functions, among others include the monitoring and assessment of the implementation of the rural employment guarantee programmes. For instance, it creates Central and State Employment Guarantee Councils, which must monitor the implementation of the legislation.<sup>203</sup> Interestingly, the MNREGA also provides for conducting social audits of the work done at the Gram Panchayat level by the Gram Sabha.<sup>204</sup> Further the rural employment legislation indicates transparency and accountability measures which may be followed at the district and state levels regarding the utilisation and management of funds, the maintenance of books and accounts etc.<sup>205</sup> Additionally, the programme requires the publication of performance report to assess its effectiveness. This report is to be submitted to the Ministry of Rural Development in accordance with the prescribed format.<sup>206</sup>

## (b) Monitoring Performance

Almost all schemes studied for the purpose of this report envisage some method of monitoring performance of the schemes, and compliance with any funding conditions. These generally involve vertical monitoring schemes whereby the state government reports to the Union government. The specific monitoring requirements are unique to individual schemes. For instance, under the Umbrella Scheme for the Development of Scheduled Castes, the State Tribal (Nodal)

<sup>200</sup> District Manual, Pradhan Mantri Gram Sadak Yojana, p. 12, available at: [https://darpg.gov.in/sites/default/files/PMGSY\\_0.pdf](https://darpg.gov.in/sites/default/files/PMGSY_0.pdf).

<sup>201</sup> Pradhan Mantri Gram Sadak Yojana Guidelines (2005), available at: <http://pmgsy.nic.in/downloads/dom.pdf>.

<sup>202</sup> Report of the Comptroller and Auditor General of India on the Performance Audit of Pradhan Mantri Gram Sadak Yojana (Report No. 23 of 2016), available at: [https://cag.gov.in/sites/default/files/audit\\_report\\_files/Union\\_Civil\\_Rural%20Development\\_Report\\_23\\_2016\\_Performance\\_Audit.pdf](https://cag.gov.in/sites/default/files/audit_report_files/Union_Civil_Rural%20Development_Report_23_2016_Performance_Audit.pdf).

<sup>203</sup> Sections 11(1)(e) and 12(2)(e), Mahatma Gandhi National Rural Employment Guarantee Act, 2005.

<sup>204</sup> Section 17, Mahatma Gandhi National Rural Employment Guarantee Act, 2005.

<sup>205</sup> Section 23, Mahatma Gandhi National Rural Employment Guarantee Act, 2005.

<sup>206</sup> Performance Report Card, available at: [http://nrega.nic.in/netnrega/writereaddata/Circulars/1616PERFORMNACE\\_REPORT\\_FORMAT\\_MGNREGA.pdf](http://nrega.nic.in/netnrega/writereaddata/Circulars/1616PERFORMNACE_REPORT_FORMAT_MGNREGA.pdf).

Development has the responsibility to coordinate the progress of various schemes and design a comprehensive monitoring framework with well-defined indicators covering criteria such as fund allocation, release and expenditure of funds and service delivery standards.<sup>207</sup> Additionally, concerned line departments are to specifically monitor Tribal Sub Plan (TSP) progress and their performance. Monthly or Quarterly Performance Review reports of State TSPs are communicated to the Ministry of Tribal Affairs (MoTA).<sup>208</sup>

Similarly, under the fiscal reform facility which was introduced under the Eleventh Finance Commission, five indicators were recognised as a measure of the fiscal performance of the states. These were: (i) growth of tax revenue; (ii) growth of non-tax revenue; (iii) growth of non-plan revenue expenditure on salaries and allowances; (iv) interest payments; and (v) reduction of subsidies. Different weights were given to each indicator. Additionally, the Eleventh Finance Commission also recommended the setting up of a monitoring agency in order to review the progress of utilisation of the grants given by the Finance Commission. This monitoring committee is to be headed by the Secretary (Expenditure), Ministry of Finance. Based on the guidelines issued by the Ministry of Finance, each state was to draw up a Medium Term Fiscal Reform Programme (MTFRP) and enter into a Memorandum of Understanding with the central government.<sup>209</sup>

The mandate of the Twelfth Finance Commission included drawing up a monitorable fiscal reform programme<sup>210</sup> which was aimed at reducing the revenue deficit of states and recommending the manner in which grants to states intended to cover the deficit in their non-plan revenue amount could be linked to progress in implementing the programme.<sup>211</sup>

#### 4. Addressing non-compliance by states and managing conflict

##### (c) **Grievance redressal**

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<sup>207</sup> The purpose of the various programmes under the umbrella scheme is to bridge the gap between the ST population and others by ensuring human resource development by enhancing their access to education and health services; improving the quality of life by providing basic amenities to tribal areas; substantially reducing poverty and unemployment; enhancing the capacity to avail opportunities, rights, and improved facilities which are at par with other areas; and providing protection against exploitation and oppression. It is also important to note that such grants address the need of plugging critical gaps. It is intended to act as an additive to State efforts for tribal development.

<sup>208</sup> Ministry of Tribal Affairs, Guidelines for Inter-State Allocation of Funds and Implementation of Programmes/ Activities under Special Central Assistance to Tribal Sub Plan (TSP) during 2016-2017 onwards (F.No. 1105/06/2016-SG II), dated 17 June 2016, available at: <https://www.tribal.nic.in/DivisionsFiles/sg/8scan0004.pdf>.

<sup>209</sup> Report of the Twelfth Finance Commission, pp. 198-200.

<sup>210</sup> The monitorable fiscal reforms programme is a programme by which states are scored on their basis of the ability to raise revenue and curtail expenditure.

<sup>211</sup> Annexure I.IA, Report of the Twelfth Finance Commission, p. 124.

As described in the previous Chapter, an effective grievance redressal system should involve consultation between the Union and the state governments in order to ensure adequate representation of the states in decision making. Such collaboration is not immediately apparent from the schemes examined for the purpose of this report.

Some schemes such as the MNREGP vest state governments with the power to determine appropriate grievance redressal mechanisms at the Block and District levels.<sup>212</sup> Ombudsmen are appointed in each state in order to listen to complaints and redress grievances of individuals and take disciplinary and corrective actions.<sup>213</sup> These grievance redressal measures appear to be limited to aggrieved individuals who are covered by the programme and do not address any conflict between the state and the Union.

Similarly, the PMGSY guidelines also provide for enquiry of complaints received through the Ministry/NRRDA to the State Quality Coordinator for enquiry and necessary action. A report of all actions taken is to be discussed by the State-level Standing Committee.<sup>214</sup> However, this protocol is again for the benefit of individual complaints against the programme and does not serve to address the lack of a grievance redressal mechanism between the states and the Union.

#### **(d) Reduction, withholding and repayment of grant**

The reduction or withholding of funding from grants to the CSS as a penalty for failure to perform adequately or satisfy the conditions set have been noted in a few CSS. For instance, MNREGA contains provisions which give the Union Government the power to suspend further disbursement of funds to the states upon receipt of a complaint that the allocated funds are being used improperly.<sup>215</sup>

However, this provision has also been criticised as an abrupt suspension of funds, while successfully penalising the state for non-performance or misuse, could also have a detrimental impact on the individuals who are beneficiaries of the scheme through the provision of employment.<sup>216</sup>

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<sup>212</sup> Section 19, Mahatma Gandhi National Rural Employment Guarantee Act, 2005.

<sup>213</sup> Appointment of Ombudsman and Formulation of Grievance Redressal Rules (No. 11011/21/2008-RE 7), available at: [http://nrega.nic.in/netnrega/writereaddata/Circulars/2060redersal\\_10-03-2017.pdf](http://nrega.nic.in/netnrega/writereaddata/Circulars/2060redersal_10-03-2017.pdf).

<sup>214</sup> Pradhan Mantri Gram Sadak Yojana, Programme Guidelines (2012), available at: [http://omms.nic.in/ReferenceDocs/PMGSY\\_Guidelines.pdf](http://omms.nic.in/ReferenceDocs/PMGSY_Guidelines.pdf).

<sup>215</sup> Section 27(2), Mahatma Gandhi National Rural Employment Guarantee Act, 2005.

<sup>216</sup> UNDP, Rights-Based Legal Guarantee and Development Policy: the Mahatma Gandhi NREGA, pp. 34-35, available at:

Similarly, the provisions under the PMGSY provide for the forfeit of allocation of funds if there is a failure to meet the required conditions of preparing the master plans and the annual action plans.

Under the Finance Commission grants, the grants to urban local bodies and Panchayati Raj Institutions are granted only if the requisite conditions are met. These institutions will be able to avail their basic grants, but will have to forfeit their share of the performance grants, of which half will be redistributed amongst all states, and the other half will be distributed only to the performing states as a reward for compliance.<sup>217</sup>

#### **(e) Conflict Management**

At present there does not seem to be a clearly defined mechanism provided under CSS for intergovernmental coordination and conflict management.

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[http://www.in.undp.org/content/dam/india/docs/rights\\_based\\_legal\\_guarantee\\_as\\_development\\_policy\\_mgnrega.pdf](http://www.in.undp.org/content/dam/india/docs/rights_based_legal_guarantee_as_development_policy_mgnrega.pdf).

<sup>217</sup> Report of the Thirteenth Finance Commission, pp. 180-181.

## B. CONCLUSIONS

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From the detailed evaluation done in the preceding section, we find that CSS in India already incorporates several of the key principles of design as set out under Chapter III. However, certain schemes have been identified wherein specific design principles could be incorporated to make them more robust, and efficient. These are set out below:

- 1. Design of Transfers-** At present, there is limited collaboration between the Union government and state governments in the design of these CSS. From our analysis of some core and core of the core schemes, it appears that the Union government designs the schemes as they relate to matters of national importance, and the role of the state government is limited to implementing the scheme at ground level. This may not be conducive to the state as they incur expenditure in creating the mechanisms for implementation, without having the flexibility to tweak the scheme in a manner best suited to their interest. With respect to those schemes which have central legislation, we note that there is no equivalent state level legislation which would give states the opportunity to crystallise their policy preferences, and the mechanism for implementation.
- 2. Setting of Conditions-** Over the years, many Finance Commissions have noted that states have raised the issue of conditions being too onerous and difficult to comply with. Many of them are related to expenditure conditions, and procedure-oriented conditions which must be fulfilled before grants are disbursed. We recommend that conditions should be oriented towards encouraging progress in social and economic welfare and measurable outcomes. The design of conditions should take into account the constraints faced by states, to ensure better compliance with grant conditions.
- 3. Measuring, Reporting, and Monitoring Performance-** Most schemes have unique reporting requirements in place. However, reporting requirements vary from scheme to scheme, and could lead to some difficulty in assessing the effectiveness of schemes in a uniform manner. We recommend the setting of objective measuring and reporting metrics, which while making compliance easier for states, will also assist in tracking progress by the Union Government.

Similarly, almost all CSS which have been analysed in this report have performance monitoring mechanisms in place. Most of the CSS analysed above rely on vertical monitoring mechanisms which involve state governments reporting to the Union. Monitoring mechanisms should exist through the life of the conditional transfer, and allow state governments sufficient time to

course-correct in case they find themselves falling behind the timelines.

4. **Dealing with non-compliance** - From an overview of various CSS in India, a consultative effort between the Union and the states in order to ensure adequate representation of the states in the decision-making process seems to be lacking. While some schemes do have grievance redressal mechanisms in place, these are limited to addressing the grievances of individuals who are covered under the schemes, rather than the grievances of the states against the Union. Similarly, while reduction and withholding of funds as means of imposing penalty are used across the board for non-compliance of conditions, this has been criticised by the states for being arbitrary. It has also been criticised for hurting individuals who are to be benefited by these schemes.
  
5. **Managing Conflicts**- At present, the biggest shortcoming that has been noticed in CSS is that there is no institutional mechanism in place to address intergovernmental conflict. It seems to be limited to the reports that state governments place before the Finance Commissions at the time of preparation of their recommendations. We recommend that due processes and institutional mechanisms be adopted to manage such conflicts better.

## ANNEXURE I- CONDITIONAL GRANTS UNDER GRANTS-IN-AID BY THE FINANCE COMMISSIONS

### Introduction

“The Finance Commission transfers are predominantly in the form of tax devolution and, to a lesser extent, grants. The grants include non-Plan revenue deficit grants, grants to local bodies, grants for disaster management, sector-specific grants and state-specific grants.”<sup>218</sup> These grants are made under Article 275 and Article 280 (3) of the Constitution. Discussing the possibility of attaching conditions to such grants, the 1st FC was of the view that, “scope of Article 275 and Article 280 (3) (b) should not be limited solely to grants-in-aid which are completely unconditional; grants dedicated to broad but well-defined purpose could reasonably be considered as falling within their scope.” In a follow-up to this interpretation, Finance Commissions have over the course of seventy years given out grants-in-aid with four main considerations:<sup>219</sup>

- 1) To meet their residuary budgetary needs after taking the devolution of taxes into account
- 2) To facilitate the upgradation of standards of administrative and social services and to ensure minimum expenditures on such services across the country.
- 3) To meet the special needs, burdens and obligations of the States and also to address the specific sectors of national importance
- 4) To augment expenditures, rather than for substituting what a State Government is already spending

We list below conditions applied to these grants from the 10th to the 14th Finance Commissions. We have limited ourselves to the last five Commissions because of relevance.

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<sup>218</sup> Report of the Fourteenth Finance Commission, Para 5.5

<sup>219</sup> Report of the Fourteenth Finance Commission, Para 11.4

## Grants to Local Bodies

The introduction of rural and urban local self government through the 73rd and 74th amendment, expanded the scope of work for the Finance Commission. Starting from the 10th to the 14th, each Finance Commission has imposed some form of conditions to release or expenditure of such grants. These have been discussed in Table 1 below.

FC	TABLE 1: GRANTS TO LOCAL BODIES				
	Conditions	Objectives of the Conditions	Monitoring & Operations	Distribution Formula	Total Amount
14th <sup>220</sup>	<ol style="list-style-type: none"> <li>1) Grant to be spent only on basic services.</li> <li>2) Submit audited annual accounts.<sup>221</sup></li> <li>3) Show an increase in revenues of the local body over the preceding year.</li> <li>4) Additional conditions for municipalities: must publish service level benchmarks relating to basic urban services each year and make it publically available.<sup>222</sup></li> <li>5) No further conditions other than those above should be imposed either by the Union or the State</li> </ol>	<p>Collating reliable data on local bodies' receipt and expenditure through audited accounts.</p> <p>Enhancement of revenue of local bodies.</p>	<p>State Governments and local bodies to put in place implementation mechanism.</p> <p>The operational criteria, including the quantum of incentive to be given, is left to the discretion of the State Governments.</p> <p>Leftover amount of performance grant to be distributed on an equitable basis among all the eligible gram panchayats.</p>	<p>2011 population data with weightage of 90 per cent and area with weightage of 10 per cent.</p>	<p>Total Rs. 2,87,436 crore for the period 2015-20.<sup>223</sup></p> <p>Conditional grants (Gram panchayat: 10%.</p> <p>Municipalities: 20%)</p>

<sup>220</sup> Report of the Fourteenth Finance Commission, Chapter 9;

<sup>221</sup> Audited accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant.

<sup>222</sup> The service level benchmarks of the Ministry of Urban Development may be used for this purpose.

<sup>223</sup> Constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs. 2,00,292.2 crore and that to municipalities is Rs. 87,143.8 crore.

	Government for the release of funds.		Details to be notified by State Governments latest by March 2016.		
13th <sup>224</sup>	<p>General Performance Grant Criteria:</p> <ol style="list-style-type: none"> <li>1) The state government must put in place a supplement to the budget documents for local bodies (separately for PRIs and ULBs) furnishing the details.</li> <li>2) The state government must put in place must put in place an audit system for all local bodies (all categories of ULBs (urban local bodies) and all tiers of PRIs (panchayati raj institutions)).</li> <li>3) The state government must put in place a system of independent local body ombudsmen who will look into complaints of corruption and maladministration against the functionaries of local bodies, both elected members and officials, and recommend suitable action</li> <li>4) The state government must put in place a system to electronically transfer local body grants provided by this Commission to the respective local bodies within five days of</li> </ol>	The conditions imposed are prudential rather than output-based; they are concerned with processes rather than being expenditure-directed and they are aimed at putting in place a credible framework for analyzing the performance of all local bodies as well as making them responsible for their service levels.	In case the performance criteria are not met the performance grant for the state will be divided into PRI & ULB components in the proportions indicated against that state. If a state becomes ineligible to draw from the performance grant, In such a case, the PRI & ULB components of the general performance grant forfeited will be aggregated separately across all such non-performing states. It shall be disbursed in the following manner: <ol style="list-style-type: none"> <li>1) 50% of the amount to be dispersed across all states (performing and non-performing).</li> <li>2) 50% grants will be distributed only amongst the performing states which have complied with the</li> </ol>	<p>Weightage allotted for disbursement of grants to Panchayati raj institutions (Population 50%; Area 10%; Distance from highest per-capita sectoral income (10%); Index of devolution (15%); SC/STs proportion in the population (10%); FC local body grants utilization index (5%);</p> <p>Weightage allotted for disbursement of grants to urban local bodies (Population 50%; Area 10%; Distance from highest per-capita sectoral income (20%); Index of devolution (15%); FC local body grants utilization index (5%);</p>	<p>INR 29,826 crores for performance grant and INR 56,335 for General Basic grant.</p> <p>INR 798.3 crores for Special Areas Basic Grant and INR 558.8 crores for Special Areas Performance Grant</p>

<sup>224</sup> Report of the Thirteenth Finance Commission, Chapter 10

	<p>their receipt from the Central Government.</p> <ol style="list-style-type: none"> <li>5) The state governments must prescribe through an Act the qualifications of persons eligible for appointment as members of the SFC (state finance commission) consistent with Article 243I (2) of the Constitution. The passage of relevant legislation and its notification will demonstrate compliance with this condition.</li> <li>6) All local bodies should be fully enabled to levy property tax.</li> <li>7) State Governments must put in place a state level Property Tax Board.</li> <li>8) State Governments must put in place standards for delivery of all essential services provided by local bodies. Passage of such notification will be published in the State Government gazette and the fact of publication will demonstrate compliance with this condition.</li> <li>9) All municipal corporations with a population of more than 1 million (2001 census) must put in place a fire hazard response and mitigation plan for their respective jurisdictions</li> </ol> <p>Special Area Performance Grant.</p> <ul style="list-style-type: none"> <li>● States will be eligible to draw</li> </ul>		<p>stipulations.</p>		
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	<p>from their Special Area Performance Grant if:</p> <ol style="list-style-type: none"> <li>1. States to prepare a supplement to budget documents detailing transfers (conditionals and otherwise) to local bodies and other agencies.</li> <li>2. Agencies other than local bodies to also have updated accounts. These accounts should be up-to-date, the audit of these accounts should be completed by the C&amp;AG, and the audit reports tabled, wherever so mandated. Compliance will be demonstrated by a certificate from the C&amp;AG to this effect.</li> <li>3. District level officers are brought under the suggested ombudsman</li> <li>4. Funds to be transferred under certain timeline (as defined in point 4 above)</li> </ol>				
12th <sup>225</sup>	<ol style="list-style-type: none"> <li>1. PRIs (Panchayati raj institutions) should be encouraged to take over the assets relating to water supply and sanitation and utilize the grants for repairs/rejuvenation as also the operation and management costs. <ol style="list-style-type: none"> <li>a. The PRIs should,</li> </ol> </li> </ol>	Improving the standards of civic services provided by the local bodies.	<p>Releases to a state to be made only after it certifies that the previous releases have been passed to local bodies.</p> <p>State governments should not take more than 15 days in transferring the grants</p>	<p>Criterion Weight (per cent)</p> <ol style="list-style-type: none"> <li>1. Population: 40%</li> <li>2. Geographical area: 10%</li> <li>3. Distance from highest per</li> </ol>	<p>INR 20,000 crore for the Panchayati raj institutions (PRI) and INR 5,000 crore for</p>

<sup>225</sup> Report of the Twelfth Finance Commission, Chapter 8

	<p>however, recover at least 50 percent of the recurring costs in the form of user charges.</p> <p>2. At least 50 percent of the grants provided to each state for the urban local bodies<sup>226</sup> should be earmarked for the scheme of solid waste management through public-private partnership.<sup>227</sup></p> <p>3. The central government should not impose any condition other than those prescribed by us, for release or utilization of these grants</p>		<p>to local bodies after these are released by the central government.</p> <p>The normal practice of insisting on the utilization of amounts already released before further releases are considered, may continue</p>	<p>capita income: 20%</p> <p>4. Index of deprivation: 10%</p> <p>5. Revenue effort: 20%<sup>228</sup></p>	urban local bodies
11th <sup>229</sup>	<p>1. Grant for local bodies to maintain civic services.</p> <p>2. The grant should be untied, but should not be used for payment of salaries and wages</p> <p>3. An amount of Rs.4,000 per panchayat per annum, on an average, to meet the expenditure on maintenance of accounts on contract basis, if the staff/facilities are not</p>	-	The two Union Ministries- the Ministry of Rural Development and the Ministry of Urban Development- have to ensure that the local bodies function as institutions of self-government and all impediments to the realisation of this ideal are	<p>1) rural/ urban population of the State: 40%</p> <p>2) Index of decentralisation: 20%</p> <p>3) Distance from the highest per capita income: 20%</p> <p>4) Revenue</p>	<p>INR 9,860.72 Lakhs (earmarked for maintenance of accounts)</p> <p>INR 1,600 crore for</p>

<sup>226</sup> Towns of population over 100,000 by 2001 census

<sup>227</sup> The six mega cities of Delhi, Mumbai, Kolkata, Chennai, Bangalore and Hyderabad may be excluded for the purpose of grants-in-aid, as it should be possible for them to generate their own resources for this important service.

<sup>228</sup> Revenue Effort 20% component to be split: (a) with respect to own revenue of states: 10% (b) with respect to GSDP: 10%

<sup>229</sup> Report of the Eleventh Finance Commission, Chapter 11

	<p>available within the panchayat.<sup>230</sup></p> <p>4. The amounts indicated for maintenance of accounts, audit of accounts and for the development of database (Rs.1,600 crore for the panchayats and Rs.400 crore for the municipalities), would be the first charge on these grants and would be released by the concerned Ministries of the Government of India, after the arrangements suggested become operational. Shares in respect of the scheduled, tribal and other excluded areas should be made available to the respective States only after the relevant legislative measures are taken extending the provisions of the 73rd and 74th amendments to such areas.</p>		removed.	<p>effort of the local bodies: 10%</p> <p>5) Geographical area: 10%</p>	<p>the panchayats and Rs.400 crore for the municipalities (for maintenance of accounts and audits)</p>
10th <sup>231</sup>	<p>1. Not be spent on salaries and wages</p> <p>2. The local bodies should be required to provide suitable matching contributions by</p>	Augment and supplement resources for the local bodies.	Details of the grant contribution to be made known to the State Finance Commissions.	Ad hoc provision of INR 100 per capita for the rural population; and INR 1000 crores for municipal bodies;	INR 5,380.93 crores <sup>232</sup>

<sup>230</sup> This amount may be paid from the grants that FC is recommending for the rural local bodies. The amount of Rs. 4,000 indicated by FC is only suggestive, and may be different for different States and for different panchayats within a State, depending on local conditions. Any additional funds required for this purpose should be met from the grants given to the States for the panchayats. Where a panchayat has got staff available for upkeep of accounts, these funds need not be so earmarked. As for the urban local bodies, they generally do have accounts staff on their pay rolls. However, if any municipality does not have a regular staff for this purpose, the grants provided to it may also be so earmarked.

<sup>231</sup> Report of the Tenth Finance Commission, Chapter 10

<sup>232</sup> Includes INR 1,000 crores for urban local bodies and INR 4,380.93 crores for panchayati raj institutions

	raising resources.				
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### Sector-Specific Grants

Starting from the 1st Finance Commission, grants have been given to states on specific sectors such as education, health and administration to help strengthen funding and expenditure in these areas. The Thirteenth Finance Commission recognises three principles to determine such grants, namely to reduce disparity in social service delivery across states, enable states to meet financial burdens emerging from their special circumstances and provide resources for specific national priorities.<sup>233</sup> The Fourteenth Finance Commission decided to discontinue sector-specific grants due to discontinuity and irregularity in flow of fund across different Commissions and overlap of funding with other schemes of Central government.<sup>234</sup>

Most sector-specific grants are earmarked grants intended to be spent on sectors identified by the Finance Commissions. We map these and additional conditionals that have been imposed by the last five commission in the table below.

TABLE 2: SECTOR SPECIFIC GRANT				
FC	Grants	Conditions	Amount	
<b>13th Finance Commission<sup>235</sup></b>				
13th	Grant for	1) 75% can be used for development purposes; 25% in the three years is	INR	Rs. 5000

<sup>233</sup> Report of the Thirteenth Finance Commission, Chapter 12; Report of the Fourteenth Finance Commission, Para 11.25

<sup>234</sup> “For instance: FC-XI recommended upgradation grants for general administration, but the FC-XII discontinued it. Similarly, a maintenance grant for public buildings was recommended by the FC-XII but not by the FC-XIII. The FC-XIII discontinued grants-in-aid for protection of heritage sites that both the FC-XI and the FC-XII had recommended”. Report of the Fourteenth Finance Commission, Para 11.29 to 11.31.

<sup>235</sup> Report of the Thirteenth Finance Commission, Chapter 12

	Forest Management:	<p>for preservation of forest wealth and development of forestry and wildlife.</p> <p>2) Three years of the award period shall be subject to the following release and monitoring mechanism: grants shall be linked to progress on approval of working plans. The entire amount should be released after approval of more than 80 per cent of the working plans of the state. If not, releases shall be in the ratio of number of working plans approved to 80% of the number of working plans for the state.</p>	crore
13th	Grant for Grid Connected Renewable Energy:	1) Incentive is to be based on states' achievement in renewable energy capacity addition in MW from 1 April 2010 to 31 March 2014.	INR Rs. 5000 crore
13th	Water Sector Management	<p>1) States should set up the Water Regulatory Authority by 2011-12, to be notified latest by 31 March 2012.<sup>236</sup></p> <p>2) States are required to achieve the projected recovery rates to become eligible for grants.</p> <p>3) Expenditure on guidelines including:</p> <p>a) Spent only on non-salary maintenance items for public MMI (Major and Medium Irrigation Project) and MI (Minor Irrigation) irrigation schemes.</p> <p>b) Spent only for meeting the non-plan revenue expenditure only under the heads 2700 ("Major Irrigation"), 2701("Medium Irrigation") and 2702 ("Minor Irrigation")</p>	INR Rs. 5000 crore
13th	Better Targeting of Subsidies Through the	<p>1) States may use this grant either to directly assist the intended beneficiaries or create convenient facilities for them such that the cost of registration of beneficiaries is minimal.</p> <p>2) The assistance, if provided, will be restricted to beneficiaries of</p>	INR Rs. 2989.10 crores

<sup>236</sup> However, due to the small size of the irrigation sector, this condition would not be applicable to the north-eastern states, except Assam.

	UID Grant	<p>NREGS, RSBY, PDS, old-age pensioners and other welfare schemes of the State and Central Governments targeted at persons below the poverty line.</p> <p>3) The grant will be released in five annual instalments, with two tranches per year, on 1 July and 1 January of each year. The first tranche, amounting to one-tenth of the state's allocation will be released on 1 July 2010 without any conditions. All subsequent instalments will be released on a reimbursement basis as per certification of number of people enrolled by the UIDA.</p>	
13th	Incentives for Improvement in Infant Mortality Rates (IMR)	<p>1) States will be provided incentives for, both, improvement in the parameter as well as the level at which the improvement is made</p> <p>2) The incentive (or penalty) will be determined with 2010-11 IMR figures as the baseline.</p> <p>3) The incentive amount will be calculated based on formula determined by the Finance Commission</p>	INR 5,000 crores
13th	Improving Justice Delivery	<p>1) Earmarked grants for</p> <ol style="list-style-type: none"> <li>a) Operation of morning/evening/special judicial-metropolitan magistrate/shift courts</li> <li>b) Establishing ADR centres and training of mediators/conciliators:</li> <li>c) Support to Lok Adalats</li> <li>d) Support to Legal aid</li> <li>e) Support to State Judicial Academies</li> <li>f) Training of public prosecutors:</li> <li>g) Creation of posts of court managers:</li> <li>h) Maintenance of heritage court buildings</li> </ol> <p>2) Release of all earmarked grants conditional on states put in place a State Litigation Policy</p>	INR 5,000 crores
13th	District	1) Earmarked grant to be spent on strengthening public infrastructure.	INR 616 crores

	Innovation Fund (DIF)	<p>2) The first instalment will be released in 2011-12 after the State Government finalises detailed guidelines for implementation of the scheme and notifies the authority at the district level which would sanction the projects under the scheme.</p> <p>3) The second instalment would be released after the State Government submits a report on the end use of the first instalment detailing the benefits created</p>	(1 crore per district)
13th	Improving Statistical Systems in State Governments	<p>1) At least 75 percent of the grant will be utilised for strengthening statistical infrastructure at the district level not covered by the India Statistical Project and the proposed CSS pertaining to Basic Statistics for Local Level Development.</p> <p>2) A maximum of 25 per cent of the grant can be used for improving statistical infrastructure at state headquarters.</p>	INR 6161 crores (1 crore per district)
13th	Setting up a DataBase for Government Employees and Pensioners	<p>1) Earmarked grant to set up an employee and pensioners database.</p> <p>a) Initial INR 2.50 crore during 2010-11 can be drawn without any precondition which is to be completed in three years.</p> <p>b) The balance INR 7.50 crore, will be released after the state certifies that it has created a database containing employee details.</p>	INR 10 crore to each general category state and INR 5 crore to each special category state
13th	Grants for Maintenance of Roads and Bridges	1) Earmarked grant for maintenance of roads and bridges	INR 19,930 crores
<b>12th Finance Commission<sup>237</sup></b>			
12th	Grant for	1) Earmarked grant for education to be spent under the major head	INR 10,171.65

<sup>237</sup> Report of the Twelfth Finance Commission, Chapter 10

	Education and Health Sector	<p>2202 (“General Education”) and for health under the major heads 2210 (“Medical and Public Health”) and 2211 (“Family Welfare”).</p> <p>2) While there will be no pre-condition for release of the first instalment in any year, the second instalment will be released only if budgetary estimates for these heads are higher than the projected non-plan revenue expenditure in the same year.</p> <p>3) No further conditions should be imposed by the central government for the release of these grants.</p>	crore over the award period 2005-10 for 8 states
12th	Maintenance of Roads & Bridges and Buildings	<p>1) These grants should be spent on non-salary maintenance items for Roads &amp; Bridges and for Buildings.</p> <p>2) The grants meant for buildings should be spent only on public buildings other than residential.</p> <p>3) These grants should be budgeted and spent for meeting the non-plan revenue expenditure under specified heads:</p> <p style="padding-left: 20px;">a) Major head 3054: “Roads and Bridges”</p> <p style="padding-left: 40px;">i) sub-head 03 (State Highways)</p> <p style="padding-left: 40px;">ii) sub-head 04 (“District and Other Roads”);</p> <p style="padding-left: 20px;">b) For public buildings major head 2059 (“Public Works”) and minor head 053 (“Maintenance and Repair”)</p> <p>4) The grants may be allocated in two equal instalments in a financial year. While there will be no pre-conditions for release of the first instalment in any year, the second instalment will be released only if budgetary estimates for these heads are higher than the projected non-plan revenue expenditure in the same year.</p>	<p>INR 15,000 crore over the period 2006-10 for maintenance of roads &amp; bridges;</p> <p>INR 5000 crore over the period 2006-10 for maintenance of public buildings</p>
12th	Forest Conservation	<p>1) Earmarked grants to be spent for preservation of forest wealth.</p>	INR 1,000 crore spread over the period 2005-10
12th	Heritage Conservation	<p>1) Earmarked grant for preservation and protection of historical monuments, archaeological sites, public libraries, museums and</p>	INR 625 crore spread over the

		archives, and also for improving the tourist infrastructure to facilitate visits to these sites.	period 2005-10
<b>11th Finance Commission<sup>238</sup></b>			
11th	District Administration	<p>1) Earmarked grant for district administration includes construction of residential and non-residential buildings, provision of furniture, equipment and vehicles, training infrastructure, survey of lands, improvement of land records management, and creation of infrastructure in the newly created districts and sub-district units.</p> <p>2) States have been provided 50 per cent of the amounts requested (and limited to INR 10 crore per district), subject to the provision of matching grant by the respective.</p>	
11th	Police Administration	<p>1) Earmarked expenditure for upgradation of police administration which include:</p> <p>a) Police buildings: Funds for construction of police station for each state but limited to a maximum of 100 units for a State.</p> <p>b) Forensic Science Laboratories: Equipment grant of Rs.53 lakh to each State for upgradation of the existing State Forensic Science Laboratories</p> <p>c) Police equipment: INR 79.16 crore</p> <p>d) New weapons: INR 152.57 crore</p> <p>e) Facilities for women police personnel: INR 52.36 crore for the construction of a restroom-cum-toilet</p>	INR 509 crores
11th	Prisons administration	<p>1) Earmarked grant for upgradation of the existing arrangements for security in the prisons and for vocational training and medical facilities for the inmates.</p>	INR 116 crore

<sup>238</sup> Report of the Eleventh Finance Commission, Chapter 7

11th	Fire services	1) Earmarked grant for setting up of fire stations <sup>239</sup>	INR 201 crores
11th	Judicial Administration	1) Earmarked grant for creation of additional courts specifically for the purpose of disposing of the long-pending cases.	INR 502.90 crore
11th	Fiscal administration	1) Earmarked grant for computerisation of Treasuries & Accounts departments a) This amount should be utilised for procurement of computers, installation of hardware and software and related training activities.	INR 200 crore
11th	Health Services	1) Earmarked grant for regional diagnostic centres	INR 432 crores
11th	Elementary Education	1) Earmarked grants to be utilised first for construction of school buildings/classrooms where the schools are currently being run in the open. After meeting this basic requirement, the remaining amount can be utilised for provision of toilet and drinking water facilities in the existing schools.	INR 506 crores
11th	Computer training for school children	1) Earmarked grant for setting up computer training centres for school children in each district	INR 245.53 crore
11th	Public libraries	1) Earmarked grant of INR 1 crore for the State level public library in each State. In addition INR .20 lakh per district for upgradation of public libraries in the mofussil and rural areas.	

<sup>239</sup> In selecting the towns for providing this facility, preference should be given to those district headquarters which do not have any fire station. After meeting that need, the next preference should be given to the towns with a population of 50,000 or more, that do not have a fire station.

11th	Heritage Protection	1) Earmarked grant for restoration, protection and preservation of historical monuments and museums for all the States	INR 122 crore
11th	Augmentation of traditional water sources	1) Earmarked grant for rejuvenated and augmented of traditional water sources	INR 500 crore
<b>10th Finance Commission<sup>240</sup></b>			
10th	District Administration	<p>1) Earmarked grant for:</p> <p>a) Police:</p> <p>i) Building: INR 28.76 crores for police station building</p> <p>ii) Housing for police personnel and their family INR 375.61 crores</p> <p>iii) Training: INR 54.47 crores upgrading facilities for training of subordinate police</p> <p>iv) Telecommunication: INR 94.38 crores</p> <p>b) Upgrade fire services: INR 100 crores</p> <p>c) Jails:</p> <p>i) Repair of accommodation for prisoners: INR 50 crore</p> <p>ii) Medical equipment, consumable items and sanitation: INR 30 crores</p> <p>d) Record rooms:</p> <p>i) Construction of record rooms and modernization of equipment: INR 100 crores</p> <p>ii) Not to be spent on staff</p> <p>e) Treasuries and accounts:</p> <p>i) Computerization of district level treasuries: INR 23.10 crores</p>	INR 85,832 Lakhs

<sup>240</sup> Report of the Tenth Finance Commission, Chapter 8

10th	Education	1) Earmarked grant for: <ul style="list-style-type: none"> <li>a) Promoting girls education: INR 182.50 crores</li> <li>b) Drinking water facilities for upper primary schools and toilets for girls: INR 116.93 crores</li> <li>c) Drinking water in primary schools: INR 456.32 crores</li> </ul>	INR 75575.10 Lakhs

### State-Specific Grant

State-specific grants are made to address special needs of the states. These grants are requested by the states on projects or priority areas identified by them. 13th Finance Commission noted that such grants are intended to address “deprivation, generate significant externalities (especially environmental externalities), meet the needs of the marginal groups or areas and encourage policy innovations.”<sup>241</sup> The 14th Finance Commission discontinued such grants.

These grants are earmarked to be spent on the pre-defined project areas by the state. We discuss the conditions imposed over and above that by the last five Finance Commissions in the table below.

TABLE 3: STATE SPECIFIC GRANT	
FC	Conditions
13th <sup>242</sup>	1) No funds from any of the state-specific grants may be used for land acquisition by the states. 2) State specific grants and the state’s share of the GST incentive grant be withheld for the period during which a state is in violation of the agreement. 3) States to amend/enact FRBM Acts to build in the fiscal reform path.

<sup>241</sup> Report of the Fourteenth Finance Commission, Para no. 11.26

<sup>242</sup> Report of the Thirteenth Finance Commission, Chapter 12

12th 243	No such conditions were imposed on the disbursement of the grant
11th 244	1) The States should send quarterly progress reports to the Ministry of Finance (MoF) of the Government of India, to facilitate release of grants. Finance Commission suggested that the State Governments undertake evaluation through professional agencies so as to bring out the strengths and weaknesses of the programme which may help in introducing necessary improvements.
10th 245	1) While no conditions were imposed, the FC recommended creation of an Inter-ministerial empowered committee to track progress and fund transfers across the country.

### Grants for State Disaster Response Fund

The last five commissions have made major adjustments to funding relief during a calamity. Finance Commissions, from the Second to the Eighth, set amount under ‘margin money’ scheme as grants-in-aid’ to meet expenditures for disaster relief.<sup>246</sup> Sixth Finance Commission discussed the possibility of a national fund with contributions from each state but rejected the idea saying that it could be difficult to manage fund disbursements at times of national calamity with each state demanding resources due to them.<sup>247</sup> It was the Ninth Finance Commission that set up the Calamity Relief Fund (CRF) in each state where the central government would contribute three-quarters of the fund while the states will contribute the remaining amount.<sup>248</sup> The Tenth Finance Commission, in addition to the CRF, set up the National Fund For Calamity Relief (NFCR) with contributions from both centre and the state.<sup>249</sup> While the Eleventh Finance Commission continued with the CRF, it discontinued the NFCR and

<sup>243</sup> Report of the Twelfth Finance Commission, Chapter 10

<sup>244</sup> Report of the Eleventh Finance Commission, Chapter 7

<sup>245</sup> Report of the Tenth Finance Commission, Chapter 8

<sup>246</sup> Report of the Fourteenth Finance Commission, Para no. 11.23

<sup>247</sup> Report of the Ninth Finance Commission, Para no. 6.8

<sup>248</sup> Report of the Ninth Finance Commission, Para no. 6.17

<sup>249</sup> The size of the corpus would be 700 crores. For the initial contribution of 200 crores, centre will provide 150 crores and states will provide 50 crores. For the subsequent years, centre and state will contribute 75 crores and 25 crores respectively; Report of the Tenth Finance Commission, Para no. 9.18 to 9.20

set up a National Calamity Contingency Fund (NCCF) (with an initial corpus of INR 500 crores to be provided by the centre). The amount for the NCCF were to be recouped by levying a special surcharge on Central taxes.<sup>250</sup> The arrangement of the Eleventh Finance Commission was continued by the Twelfth Finance Commission. The Thirteenth Finance Commission merged the CRF with the State Disaster Relief Fund, and the NCCF with the National Disaster Response Fund (NDRF). While the former has been financed through grants-in-aid, the latter is funded through special surcharges on Central Taxes.<sup>251</sup> The Fourteenth Finance Commission has continued on the set up established by the Thirteenth Finance Commission.

The table below lists the conditions imposed on these grants by the last five Finance Commissions.

FC	TABLE 4: GRANT FOR STATE DISASTER RESPONSE FUND (SDRF)		
	Conditions	Total Amount	Conditional Amount
14th <sup>252</sup>	1) States contribute 10% to the SDRF during 2015-20, and remaining 90% to come from Union Government 2) Upto 10% of the funds available under the SDRF can be used by a State for occurrences which it considers to be 'disasters' which are not in the notified list of disasters of the Ministry of Home Affairs <sup>253</sup>	INR 61,219 crore for 2015-20 <sup>254</sup>	Applicable to the entire fund

<sup>250</sup> Report of the Eleventh Finance Commission, Para no. 9.22

<sup>251</sup> Report of the Thirteenth Finance Commission, Chapter 11; Report of the Fourteenth Finance Commission, Para no 11.23

<sup>252</sup> Report of the Fourteenth Finance Commission, Chapter 10

<sup>253</sup> However, this flexibility would be applicable only after the State has listed the disasters for inclusion and notified clear and transparent norms and guidelines for disaster relief for such disasters with the approval of the State Authority. Any amount spent by the State for such disasters over and above the ceiling would be borne out of its own resources and would be subject to the same accounting norms.

<sup>254</sup> Inclusive of contribution from the centre and state

13th 255	<ol style="list-style-type: none"> <li>1) States contribute 25% to the SDRF during 2010-15, and remaining 75% to come from Union Government (for special category states the centre will contribute 90% of the amount)</li> <li>2) Mitigation and reconstruction activities to be kept out of the schemes funded through FC grants and be met out of overall development plan funds of the Centre and the states.</li> <li>3) The list of disasters to be covered under the scheme financed through Finance Commissions grants to remain as it exists currently. However, manmade disasters of high-intensity may be considered for NDRF funding once norms have been stipulated and requisite additional allocations made to the NDRF</li> <li>4) States to switch over to new accounting arrangement from 1 April 2010. The second instalment of 2010-11 as well as subsequent instalments should be linked to strict adherence to the new accounting norms.</li> </ol>	INR 33,581 crore for 2010-15 <sup>256</sup>	Applicable to the entire fund
12th 257	<ol style="list-style-type: none"> <li>1) Besides cyclone, drought, earthquake, fire, flood and hailstorm, the definition of natural calamity, as applicable at present, may be extended to cover landslides, avalanches, cloud burst and pest attacks.</li> <li>2) States contribute 25% to the CRF during 2005-10, and remaining 75% to come from Union Government</li> <li>3) The provision for disaster preparedness and mitigation needs to be built into the state plans, and not as a part of calamity relief</li> <li>4) A committee consisting of scientists, flood control specialists and other experts be set up to study and map the hazards to which several states are subject to.</li> </ol>	INR 21333.33 crore for 2005-10 <sup>258</sup>	Applicable to the entire fund

<sup>255</sup> Report of the Thirteenth Finance Commission, Chapter 11;

<sup>256</sup> Inclusive of contribution from the centre and state

<sup>257</sup> Report of the Twelfth Finance Commission, Chapter 9

<sup>258</sup> Inclusive of State's contribution of INR 5,333.33 crores and INR 16,000 crores Centre contribution

11th 259	<ol style="list-style-type: none"> <li>1) States contribute 25% to the Calamity Relief Fund (CRF) during 2001-2005, and remaining 75% to come from Union Government</li> <li>2) Only the natural calamities of cyclone, drought, earthquake, fire, flood and hailstorm should be eligible for relief expenditure</li> <li>3) Expenditure on restoration of infrastructure and other capital assets, except those which are intrinsically connected with relief operations and connectivity with the affected area and population should be met from the plan funds on priority</li> <li>4) The CRF should be kept out of the Public Account of the State and should be invested in a manner approved by the Ministry of Finance. If for some reasons, it is not possible to keep the Fund in a nationalised bank or invest in a manner approved by the Ministry of Finance, it may be kept in the Public Account of the State, on which interest should be payable by the State Government at a rate which is not less than the market rate of interest as indicated by the Reserve Bank of India</li> <li>5) The State level Committee constituted under the existing scheme may continue to function and take all decisions related to the financing of relief expenditure subject to general guidelines issued by the Ministry of Agriculture</li> <li>6) The release of the funds from the Centre to the CRF of each State may be done in two instalments, viz. on 1st of May and 1st of November, each year. The instalment due on 1st May should be released only after receiving from the State Government a certificate indicating that the amount received during the preceding financial year has been credited to the CRF, accompanied by a statement giving the updated expenditure and the balance amount available in the CRF. This statement itself should be treated as utilisation certification.</li> </ol>	INR 11,007.59 crore for the period 2000-15 <sup>260</sup>	Applicable to the entire fund
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<sup>259</sup> Report of the Eleventh Finance Commission, Chapter 9

<sup>260</sup> This includes the Centre's share of Rs.8,255.69 crore and the States' share of Rs.2,751.90 crore.

	7) Every State should prepare an Annual Report on natural calamities relating to the preceding financial year, and submit it to the Union Ministry of Agriculture by 30th September every year. The Centre's contribution to the CRF of a State, due on 1st November, will be released only after this report has been received.		
10th 261	<ol style="list-style-type: none"> <li>1) States contribute 25% to the states' Calamity Relief Fund (CRF) during 1995-2000, and remaining 75% to come from Union Government;</li> <li>2) Before crediting amounts from second year onwards, the centre will ensure that the states have credited the initial amount to the CRF.</li> <li>3) A committee (of both representatives from states and centre, and experts) should decide eligible expenditure areas for the CRF.</li> <li>4) All expenditures to be charged under head 2245 - Natural Calamity</li> <li>5) Ministry of Agriculture to monitor the fund (with its committee) and rules set up on the fund by it.</li> </ol>	INR 6304.27 crores for the period 1995-2000 <sup>262</sup>	Applicable to the entire fund

### Non-Plan Revenue Deficit (NPRD)

The purpose of NPRD is to provide states with funds to cover their deficit after due assessment of their revenue and expenditure. While in most cases these grants are unconditional in nature, Eleventh Finance Commission tied up a part of the grant to fiscal performance of states. We discuss the details below.<sup>263</sup>

- **The Incentive Fund:** The Eleventh Finance Commission created an '*incentive fund*', comprising of contributions from two areas: (a) 15% of the amount of the NPRD designated for the states to be held and transferred to the '*incentive fund*' (b) a contribution by the centre i.e. 15% of the amount designated for NPRD. The total amount of the fund is INR 10,607.72 crores.
- **Release of Funds:** The amount from the designated '*incentive fund*' will be available for the states in proportion to their

<sup>261</sup> Report of the Tenth Finance Commission, Chapter 9

<sup>262</sup> Out of this the Centre to contribute INR 4728.19 crores and states to contribute 1576.08 crores

<sup>263</sup> Report of the Eleventh Finance Commission on the Additional Term of Reference

performance on the ‘*monitor able fiscal reforms programme*’<sup>264</sup> each year.

- **For Non-Compliance:** If a state is unable to draw from the ‘*incentive fund*’, such amount will not lapse but will continue to be available in subsequent years to the same state. For the first four years, no amount earmarked for a state in the ‘*incentive fund*’ would be transferred to another state/states. However, if any state is unable to draw from the ‘*incentive fund*’ in the first four years, the undisbursed amount will form a part of the common pool and would be distributed to the performing states in the 5th year on a pro-rata basis in addition to the amount to which they are entitled.
- **Monitoring:** A group consisting of representatives from the Planning Commission, Ministry of Finance of the Union of India and representatives of the state government to be constituted to monitor the ‘*incentive fund*’.

### OTHER CONDITIONAL GRANTS GIVEN BY THE FINANCE COMMISSIONS

Other than the conditional grants under ‘grants-in-aid’, Finance Commissions have also given incentives for better fiscal management and providing debt relief to states. We discuss such incentive schemes given by the last five Finance Commissions.

	Performance Metric/Conditions	Measuring Formula and Incentive/Award
12th 265	<ol style="list-style-type: none"> <li>1) Enacting the fiscal responsibility legislation will be a necessary precondition for availing of debt relief.</li> <li>2) States will need to reduce their revenue deficit.</li> </ol>	<ol style="list-style-type: none"> <li>1) The quantum of write off of repayment will be linked to the absolute amount by which the revenue deficit is reduced in each successive year during the Finance Commission’s award period. If the revenue deficit is brought down to zero, the entire repayments during the period will be written-off.</li> <li>2) Under the scheme, the repayments due from 2005-06 to 2009-10 on central loans contracted upto 31.3.04 and recommended to be consolidated will be eligible</li> </ol>

<sup>264</sup> The ‘*monitorable fiscal reforms programme*’ is a program that scores states based on their ability to raise revenue and curtail expenditure. The weightage in the program is as follows: (A) Revenue Receipts (1) Growth of tax revenue (30%) (2) Non-tax revenue (20%); (B) Revenue Expenditure (non-plan) (1) Salaries and allowance (30%) (2) Interests (10%) (3) Reduction of subsidies (10%);

<sup>265</sup> Report of the Twelfth Finance Commission, Chapter Twelfth

		for write off
11th 266	1) States will need to enact better fiscal management schemes to be eligible for the benefits.	<p>Scheme as determined by the 10th FC to continue with the following changes:</p> <ol style="list-style-type: none"> <li>1) If the state's performance improves by <math>(r-r^*)</math> 2.5% , they will be eligible for 12.5% relief; (<i>i.e.</i>: relief will be 5 times the improvement score )</li> <li>2) The minimum and maximum limits of relief are zero and 25% respectively.</li> <li>3) In the calculation of revenue receipts the revenue deficit grant under Article 275 recommended by the Finance Commission should not be included.</li> </ol>
10th 267	1) States will need to enact better fiscal management schemes to be eligible for the benefits.	<ol style="list-style-type: none"> <li>1) Improvement in fiscal performance will be measured by comparing the ratio of revenue receipts (including devolutions and grant from the centre) to the total expenditure in a given year (r) with the average of corresponding ratios (<math>r^*</math>) in the three immediately preceding year. Thus states are considered against its performance in the past. <ol style="list-style-type: none"> <li>a) If the state's performance is improved by <math>(r-r^*)</math> 2.5% , they will be eligible for 5% relief; (<i>i.e.</i>: relief will be 2 times the improvement score)</li> </ol> </li> <li>2) The minimum and maximum limits of relief are zero and 10% respectively.</li> </ol>

<sup>266</sup> Report of the Eleventh Finance Commission, Chapter 11

<sup>267</sup> Report of the Tenth Finance Commission, Chapter 12 and Appendix 6

## ANNEXURE II - RECOMMENDATIONS OF SARKARIA AND PUNCHHI COMMISSIONS WITH REGARD TO CSS

### A. INTRODUCTION

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A number of committees have examined the issues of Centre-state relations in India. Some of the most prominent ones include the Administrative Reforms Commission, constituted by the Government of India in 1969, focusing on the steps to be taken for maintaining harmonious Centre-State relations. The Commission noted that there ought not to be excessive involvement of the Centre in the plans of the states, and that there was a need for adequate consultation between the two levels in planning. Accordingly, the Administrative Reforms Commission had recommended, among other things, for the number of Centrally Sponsored Schemes (CSS) to be kept to a minimum, and strict criteria to be laid down for determining which projects are to be considered as CSS.

Later, a Committee set up by the Planning Commission under the Chairmanship of Shri K. Ramamurti suggested a set of criteria to form the basis of a policy for CSS. The Committee had suggested that CSS should form an integral part of the National Plan, while satisfying one of the following criteria for being taken up as a CSS.

- (a) It should relate to demonstration, pilot projects, survey and research;
- (b) It should have a regional or inter-State character;
- (c) It should aim at building up institutional framework for the country as a whole or a region; and
- (d) It should be in the nature of pacesetter with a definite time frame within which the objectives outlined should be realised.

In evolving the above criteria, the Ramamurti Committee sought to identify the areas in which the Union Government's initiative was justified. The committee also took into consideration the set of four criteria evolved by the National Development Council earlier and tried to remove ambiguity with respect to them.

In 1971, the Rajamannar Committee, appointed by the Government of Tamil Nadu, also examined similar issues, and recommended giving greater autonomy to the states in legislative and fiscal matters, following the requests of several states demanding a review of the overall Constitutional scheme of Centre-state relations.

Around the same time that the Rajamannar Committee was set up, there were demands for total autonomy of Jammu & Kashmir by some quarters, which prompted the then Prime Minister, Smt. Indira Gandhi, to announce in the

Parliament on March 24, 1983, the constitution of the first Commission on Centre-State Relations, to be headed by Justice R.S. Sarkaria, a retired Judge of the Supreme Court of India.

The National Development Council also appointed a High Level Committee in 1985 under the chairmanship of the then Minister for Human Resource Development, Shri. P.V. Narasimha Rao to go into all the issues concerning the CSS. As per the criteria suggested by the Committee, the CSS should fulfill an important national objective, such, as poverty alleviation, should have a regional or inter-State character and should be in the nature of a pacesetter or should relate to demonstration, survey or research.

While all of these Committees deliberated on important matters of Centre-state fiscal relations, the Sarkaria and Punchhi Commission made some very important recommendations. The section below describes the deliberations and recommendations of the Sarkaria Commission in more detail. The last section sets out the recommendations of the Punchhi Commission, which was set up in 2007.

## B. SARKARIA COMMISSION

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As mentioned in the section above, the agitation for state autonomy led to the creation of Sarkaria Commission by the Central Government to recommend changes to Centre-state relations. The Commission submitted its report in 1988. The Commission was asked to examine and review existing arrangements between the Centre and the states in all spheres, and recommend appropriate changes and measures. In spite of the large size of its reports - the Commission recommended, by and large, status quo in the Centre-state relations, especially in the areas, relating to legislative matters, role of Governors, and the use of Article 356.

While it made the general observation that the Constitution was sound and there was no need for drastic changes in the basic character of the Constitution, it nevertheless gave the following recommendations:

- (i) Prior consultation with the states, individually and collectively, in respect of overlapping and concurrent jurisdictions, should be adhered to, except in rare and exceptional cases of extreme urgency or emergency, though it may not be necessary to make such consultation a matter of constitutional obligation;
- (ii) The Union should occupy only that much field of a concurrent subject on which uniformity of policy and action is required in the larger interest of the nation, leaving the rest of the details for state action, within the broad framework of the policy laid down in the Union Law.

The report, also strove to situate the 'Union of States' framework of the Indian Republic and its polity in a living design that would lead to 'striking a fair balance'

between autonomy and integration in the declared mold of ‘Federation with a strong Centre’. It attempted to find workable and mutually acceptable resolution mechanisms on several issues in the sensitive domain of the federal government’s prerogatives and states’ rights and Constitutional claims in the spirit of cooperative federalism, but within the overall framework of the Constitutional prescriptions. Further, the Sarkaria Commission advanced persuasive arguments on the advantages of: (i) ‘decentralization’ in the context of maintenance of diversities and pluralistic identities; (ii) establishment and adherence to conventions outside the Constitutional stipulations for smoothening the federal fabric; and (iii) development of mutual trust, confidence and understanding between the two tiers of polity.

### 1. Statutory vs. Discretionary Transfers

On the particular issue of transfers made to states (leaving aside the transfer through devolution of taxes under Article 270), the Commission noted that a distinction had been made in the Constitution between grants made under Article 275, and those made under Article 282. The former (except those covered by the proviso to Article 275) were made in accordance with the recommendations of the Finance Commission. However, under Article 282, which governs CSS, the Union as well as the States may make grants for any public purpose. The use of the word ‘may’ in this Article has been taken to signify the discretionary nature of these grants. Hence, the bulk of the transfers made for the Plan and other purposes under Articles 282 and 293 are ‘discretionary’, and by implication allow free play to the Union Government’s choice in respect of their magnitude and allocation. In this regard, the Commission noted that financial assistance to states, apart from the ones determined by the Finance Commission, fell into the categories of ‘plan’ and ‘other’ transfers.

So far as the Plan transfers were concerned, the size of Central assistance for the Plan was determined as a part of the exercise for the financing of the Five-Year Plan, which was approved by the National Development Council on which all the states were represented. Any increase in the actual devolutions to the states over the Five-Year Plan estimate corresponded to the assessed needs for the Plan on an annual basis. This was affected on the advice of the Planning Commission. Therefore, there was not much criticism from the states on increasing the flow of Central Plan assistance to them as compared to the Five-Year Plan estimate, or on its inter-state allocation. So far as the allocation of Central assistance for the State Plans was concerned, a bulk of it was decided in terms of the Modified Gadgil Formula and other objective determinants and special investments which were also approved by the National Development Council and also subject to review by that body. These did not leave any significant discretion to the Planning Commission, which was confined to only 10 per cent allocation of Central assistance under the Modified Gadgil Formula.

So far as the category of 'other transfers' (for natural calamities, etc.) was concerned, the variety of purposes for which they were made by their very nature could not be sufficiently anticipated by either the Finance Commission or the Planning Commission. Such transfers were purpose-specific and had to cater to the contingent problems, which arose from time to time. These transfers being mostly on revenue account did not carry much repayment liability on the part of the states, and the states did not raise any serious complaints against these transfers.

For CSS in particular, the Commission noted that the pattern of financing, viz., Central assistance vis-a-vis States' own contribution, for the various schemes was determined and known well in advance, and hence the states had not objected to it. However, the thrust of the complaints of the states was on the system of matching contribution and their allegedly inadequate involvement in the formulation of these schemes. In this regard, the Commission noted that the controversy between statutory vs. discretionary transfers to the states was based more on theoretical, rather than realistic considerations. They noted that it was not humanly possible to devise foolproof formulae, which would make the totality of Central transfers conform fully to the ideal of 'automatic and free-from-interference' devolutions. Some amount of flexibility and room for subjective judgment would have to be left to the concerned institutions to deal with the specific situations as they arose. What was really important was that the institutions involved functioned in a fair and non-partisan manner, and took decisions with due discernment and expertise, which were implicitly acceptable to the states.

## 2. Complaints of States

The Sarkaria Commission was very particular about noting the complaints raised by states. The Commission noted that in case of CSS, the conditions imposed by the Union Ministries compelled the state governments to make special efforts to get the Central assistance released. Often the Central component of financial allocations for CSS was communicated late in the financial year. As the states continued incurring expenditure on the basis of previous years amount, they felt serious pressure on finances. The Commission noted that there were several other problems as well, including the fact that states were not involved sufficiently in national planning. Further, there were factors which adversely affected states' initiatives in planning in their constitutionally defined spheres, including the fact that CSS had made deep in-roads into states' sphere of activity and had affected their initiative and priorities; and that states' crucial dependence on Central assistance for the Plan and the mechanism of earmarking of outlays had restricted their maneuverability to allocate resources among the development heads.

Further, the Commission noted that CSS had been criticised on a number of specific grounds, namely:

- (a) Lack of consultation with states before the introduction of CSS;
- (b) Arbitrariness or discretion introduced in the transfer of resources on this account;
- (c) Examination of even the minutest detail by the Union Government instead of leaving the detailed formulation to the states within broad guidelines;
- (d) Distortions introduced in the State Plans on account of the matching principles. For instance, the lure of 50 per cent of Central assistance was used to induce states to accept some of the schemes;
- (e) Union Ministries build their own empires supported by the concerned Departments of the state governments, in opposition to those responsible for coordination of planning and finding resources for the accepted plan;
- (f) The uniform approach and contents generally followed in the case of CSS did not take into account the wide diversity in the local situations.

### 3. Recommendations of the Sarkaria Commission

Taking these complaints into account, the Sarkaria Commission recommended that the number of schemes be kept to a minimum. While the Commission recognised that such schemes sometimes had state, inter-state, regional or overall countrywide significance with a high national priority, they recommended that the schemes be formulated in prior consultation with the states. They stated that once a programme had passed the pilot stage and was accepted as desirable for implementation on a larger scale, it should appropriately form part of the State Plan. In this regard, the Commission followed the recommendations of the Administrative Reforms Commission, which had also recommended that the number of CSS be kept to the minimum and the criteria laid down for determining which projects CSS should be applied to, be strictly followed. The Commission also noted that there was no need for the Union Government to initiate pilot projects, especially those in the remit of the states' sphere. However, when it is necessary to have CSS, the Union Government should formulate the schemes in prior consultation with the states.

With regards to the initiation of CSS, the Sarkaria Commission recommended that the schemes should not be ordinarily started during the middle of a Five Year Plan, as they put unforeseen burden on the finances of the states by requiring them to provide for the matching funds. If it becomes necessary to initiate any CSS during the course of a Five Year Plan, its approval by the Standing Committee of the National Economic and Development Council should be obtained, and the entire expenditure on such a scheme, at least till the expiry of that Five Year Plan, should be borne by the Union Government.

With regards to the involvement of states, the Commission felt it very important for the state governments to be fully involved in determining the contents and coverage of the CSS, so that local variations and likely difficulties in their implementation are taken care of. Even after formulation of the scheme, sufficient flexibility should be allowed to the state, in adapting them to local conditions. The Commission recommended that the schemes be discussed with the states, individually, along with their Five Year Plans, and again during the Annual Plan discussion.

Lastly, the Commission recommended for a periodic review of CSS. They also recommended that the process of decentralisation in respect of formulation and evaluation of CSS be pursued further, and differences in local conditions be given proper weightage, especially with reference to agriculture and poverty alleviation programmes.

### C. PUNCHHI COMMISSION

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The next big Commission, which was set up to review Centre-state relations, was the Punchhi Commission. The Government of India constituted a Commission on Centre-State Relations under the chairmanship of Justice Madan Mohan Punchhi, former Chief Justice of India on 27th April 2007 to follow-up on the changes and new issues of Centre-state relations keeping in view the changes that have taken place in the polity and economy of India since the Sarkaria Commission. The Punchhi Commission examined and reviewed the working of the existing arrangements between the Union and states, various pronouncements of the Courts in regard to powers, functions and responsibilities in all spheres including legislative relations, administrative relations, role of governors, emergency provisions, financial relations, economic and social planning, Panchayati Raj institutions, sharing of resources including inter-state river water etc. The Commission made 273 recommendations in its seven-volume report presented to Government on 30 March 2010.

It is important to note that the Commission's terms of reference had a significant number of issues that were lined up for their examination. The focus of the Commission was on the framework of relationship between the Centre and the states, to strengthen the unity and integrity of the country and ensure India's stability, security and economic growth, and the welfare of her people. This included, amongst other issues, examining the role, responsibility and jurisdiction of the Centre vis-à-vis states in linking Central assistance of various kinds with the performance of the states.

It was noted by the Punchhi Commission, that states were, by and large, in a much more financially difficult situation than the Union Government, because of which,

the Union Government followed a trend of allocating and disbursing to states, money for various schemes relating to socio-economic development. Prominent examples of this included the Sarva Shiksha Abhiyaan, and the National Rural Employment Guarantee Scheme. In view of the disparity in financial resources between the Centre and states, the Commission found this trend to be welcome. However, the Commission also paid heed to several criticisms raised by the states, including the increase in the contribution expected from states for schemes, lack of flexibility and the space to incorporate regional and local specificities, increase in the number of such schemes, conditions frequently encroaching upon the legislative autonomy of states, and a lack of consultation with states during the conception, design, and rule making.

### Recommendations of the Punchhi Commission

The Punchhi Commission acknowledged that there had been a considerable increase in the transfers through CSS and other schemes over the years. The Commission noted that though the schemes were largely funded by the Central Government, there were implications for states in terms of higher expenditure commitments, since there was cost sharing by states in a number of schemes. For instance, under the Sarva Shiksha Abhiyaan, there had been an increase in the matching contribution of states from 15 to 40 per cent, with proposals to increase the share further to 50 per cent.

On the question of conditions attached to CSS, the Commission agreed to a lot of criticism raised by the states, and suggested that funds earmarked for states should not be tied to rigid conditions, or extremely high performance targets. They also added that a better approach would be to make these funds available to the states, and trust that the democratic process will ultimately penalise those states that fail to utilise the funds for the purposes of meaningful development.

The Commission recognised that fiscal transfers under CSS to states were problematic, and acknowledged that such schemes tended to erode state powers, and resulted in skewed fiscal relations between the Centre and states. It was also emphasised that while for certain schemes the intentions and importance in selected areas ought to be acknowledged, states should be given more control on the design and execution of the schemes, to give priority to states and local initiatives, which are often ignored under rigid guidelines.

The Commission, while recognising the importance of CSS, recommended that a system be designed under which the federal balance can be strictly maintained, and accountability established. The design of such a system could vary as per the scheme, where sometimes the entire money could be transferred to states, and in other cases, flexibility could be built in to let the states control the design and

implementation. To ensure coordination and direction, the Commission suggested a periodic review jointly by the Centre and the states to ensure co-ordination and the direction necessary to achieve the national purpose, while correcting inefficiencies, leakages and corruption. The Commission stated that the mere fact that the Centre was in a position to provide a greater share of funds for projects pertaining to social and economic development ought not to give it a right to dictate terms to states on matters that otherwise fall within the Constitutional domain of states.

Lastly, the Commission noted that there was a need to provide more untied funds to the states. In particular, funds earmarked for states should not be tied to rigid conditions prejudicial to good Centre-state relations. Further, it was also recommended that in setting performance targets, some flexibility had to be provided to accommodate location specific problems and challenges. Thus, the Commission recommended that the Centre should bestow greater authority and trust on states in centrally sponsored schemes, and allow the democratic and Constitutional processes to ensure greater accountability on money spent in the name of development.