

VII. GENERAL OBSERVATIONS

77. In all federal constitutions, it has been found difficult to provide for allocation of resources to correspond to allocation of functions. There is a measure of inter-dependence between the national and State Governments, which becomes more pronounced in a developing economy. Our Constitution takes cognizance of this position in its financial provisions. The division of resources between the Union and the States, embodied in our Constitution, might not, it was considered, make the States viable, and provision had, therefore, been made for the yield of certain taxes being made divisible between the Union and the States. There is provision both for obligatory and permissive participation. Accordingly, the Constitution has made the proceeds of income-tax divisible compulsorily, its yield being (a) substantial and (b) historically it had been a divisible tax earlier. It was recognised also that even with a share in the proceeds of income-tax, a few of the States, which had been formed earlier on political, linguistic and other considerations, might still be in need of additional financial assistance. Accordingly, provision has been made for grants-in-aid of revenue in article 275 of the Constitution. The Constitution provides also for permissive participation in the yield of excise duties either on the whole range of, or of specified, commodities on which the duties have been imposed.

78. The scope and magnitude, which the successive five year Plans will assume for the development of our national economy and the level of social services, could not be fully appreciated when the Constitution was drafted. It became necessary, therefore, from the very beginning, to operate on the permissive provision of participation in the excise duties, and the first Finance Commission made recommendations for division of the yield of excise duties on three commodities in addition to other provisions of devolution and grants-in-aid. The second Commission considered it necessary to expand the list to eight commodities, along with some other adjustments.

79. A general weakness of federal-State financial relations, more particularly in the field of devolution, is that federal assistance tends to be discretionary in character, not necessarily on principles of uniform application. To safeguard the position of the States, our

Constitution provides, therefore, that the assessment of the needs of the States as well as the measure of assistance to be afforded and the form in which this should be given, are determined by an independent Commission to be constituted at intervals of not more than five years. But this role and function of the Finance Commission, as provided in the Constitution, can no longer be realised fully due to the emergence of the Planning Commission as an apparatus for national planning.

80. As a prelude to the formulation of each five year Plan, the Planning Commission has to make an assessment of resources required in their totality, including those to be raised by the Union and the States, both by way of loan and by additional taxation and adjustment of existing levels of taxes, foreign assistance and deficit financing. Based on this assessment, the size of the national plan is determined and is divided into components of industrial and social development, individually for the Union and each State Government, and priorities are also arranged. This overall planning embraces an examination and acceptance of the revenue and expenditure forecasts of the Union and the State Governments; additional tax efforts to be made are similarly pre-determined as requisites of the fulfilment of the Plan. Against this background, the role of the Finance Commission comes to be, at best, that of an agency to review the forecasts of revenue and expenditure submitted by the States and the acceptance of the revenue element of the Plan as indicated by the Planning Commission for determining the quantum of devolution and grants-in-aid to be made; and, at worst, its function is merely to undertake an arithmetical exercise of devolution, based on amounts of assistance for each State already settled by the Planning Commission, to be made under different heads on the basis of certain principles to be prescribed.

81. The second Commission had referred to the overlap of functions of the Planning and Finance Commissions and had urged that there was 'a real need for effectively co-ordinating' the work of the two Commissions. It had also stressed the desirability of eliminating the necessity of making two separate assessments of the needs of the States. Being of the same view, we consider that the acceptance of one of two alternatives we suggest would alone remove the anomalous position.

States, whether by way of loans or devolution of revenues, to enable them both to balance their normal budgets and to fulfil the prescribed targets of the Plans. This would, we consider, be in harmony with the spirit and even express provisions of our Constitution. This would also make the Commission's recommendations more realistic as they would take account of the inter-dependence of capital and revenue expenditure in a planned programme.

83. The second is to transform the Planning Commission into Finance Commission at the appropriate time.

84. Most of the States have complained that there is a perceptible trend of centralisation of resources, in addition to centralisation of certain State functions. In evidence, they point out that the recent amendment of Income-tax Act has removed from the definition of income-tax the tax paid by companies and has thereby caused an appreciable shrinkage in the divisible pool to which they are constitutionally entitled. Though the amendment was made to simplify levy and collection, the indirect effect has, in fact, been a diminution in the amount hitherto available for distribution. Similarly, they cite the recent repeal of the Act imposing a tax on railway passenger fares. This, they claim, was an expanding source of revenue to which they were legally entitled in terms of article 269. Though provision has been made for an *ad hoc* grant of Rs. 12.5 crores a year for five years, representing the average yield of the tax in the past two years, they fear that even this amount may not be separately earmarked hereafter to compensate them for loss of entitlement. In any event, it can only be a discretionary grant *in lieu* of a legal right now extinguished. They have also complained that the Union Government had not adjusted the rates of additional excise duties levied on certain commodities *in lieu* of sales-tax, though the basic rates of excise duty on these very commodities had been recently revised upwards. Their grievance is that the benefits of all these measures accrue to the Union at the expense of the States.

85. We mention this as there is a general feeling that the contents of the autonomy of the States are being diluted not only by the prescription of detailed directions on subjects within the State list, but also by unilateral financial decisions taken.

86. A more important and even disturbing feature is that the States are becoming dependent on Central assistance on an ever-increasing scale. This arises partly out of the impact of committed

expenditure of the completed plan projects and partly for other reasons. This increasing dependence is diluting, on the one hand, the accountability of the State Cabinets to their Legislatures; on the other, it is coming in the way of the development of a greater sense of responsibility in their administration.

87. If it were possible to establish a proper balance between the productive and non-productive components of a State's Plan, the productive projects, it might be expected, would generate, though after a time-lag, enough resources to finance the maintenance cost of the non-productive schemes. But due to the uneven development of the social services and their inadequacy generally, these have to be given an important place in planning. As a result, the States are unable even to balance their normal budgets with the tax resources available to them. This is rendered more difficult, as additional taxation measures are earmarked and absorbed for financing the revenue component of the current Plan. It has, therefore, to be considered whether, in the present situation, the treatment now accorded to completed Plan schemes should be continued. The cost of maintaining the schemes, whether viable or not, now becomes automatically a charge on the revenues of the State. Such of these schemes (and many of them fall into this category) as do not produce revenues sufficient to meet their maintenance charges add to the financial liabilities of the States. Instead of creating assets, these schemes create additional financial liabilities in most cases. The question, therefore, arises whether the schemes which have yet to become viable should not appropriately be a first charge on the resources of the immediately succeeding Plan. This arrangement will provide, on the one hand, for a review of the working of the schemes, whether they are being efficiently and economically administered and whether they are fulfilling the purposes for which they were designed, and on the other hand, make it possible to assess the extent to which the different States are endeavouring to balance their 'normal' budgets. We feel that the issue we pose merits examination in all its implications and should appropriately be remitted to the Commission we propose later. The increased need of assistance is not entirely a concomitant of planning; in many cases it is additionally attributable to ineffective expenditure control and laxity in fuller mobilisation of available resources.

88. The earlier Commissions had rightly stressed the importance of efficiency and economy in administration and the tax efforts of

the States. But they were unable to assess the relative efficiency and performance due to inadequacy and often unreliability of statistical and other material. We have also been confronted with the same difficulty. With the limited time and organisation at our disposal, we would have been, even otherwise, unable to undertake either of those reviews, and give recognition in our scheme of devolution to those States which had made the maximum effort in effecting economy in expenditure and raising resources. We have, therefore, been compelled, like our predecessors, to cover the annual budgetary gaps of all the States, whether caused by normal growth of expenditure, the maintenance cost of completed schemes and mounting interest charges or even by a measure of improvidence.

89. Secure in the knowledge that the annual budgetary gap would be fully covered by devolution of Union resources and grants-in-aid, the States are tending to develop, as we have noticed, an allergy to tap resources in the rural sector on many considerations and also a disinclination to make up the leeway in others. They do not also attach the same importance to a proper and adequate control on expenditure in the matter of services and supplies as before. Cadres expand, pay-scales get revised upwards, negligence develops in the procurement of supplies and execution of projects in the absence of proper cost control. While there is a close scrutiny of, and consultation on, the contents of the Plan, there is hardly any on the contents of the annual estimates; there is no counterpart at the national level in regard to non-Plan expenditure which is progressively increasing as a result of planning itself.

90. A disturbing feature is not only the effect of unsound financial policies of a State on its own development, but its impact on neighbouring States also. We have noticed that in one State the pay-scales of one of the services were being substantially increased, backed by the recommendations of a high-powered commission, even when the scales were one of the highest in India. Sufficient thought does not seem to have been given to the effect of this pay revision on other departments of the State itself, much less on its impact on the neighbouring States.

91. A similar situation obtains in the field of taxation and considerable disparities exist in the fields of land revenue, sales-tax, motor vehicles tax, etc. Though it is generally accepted that the rural sector could make a greater contribution to national economy, there is an understandable reluctance to revise even the rates of

land revenue in operation, even when they have not been reviewed in the last 30 to 60 years. In one State, when a limited operation indicated that the rates could be raised considerably on old accepted and established principles of assessment, the Government considered it inadvisable to continue the settlement operations. In another State, in real need of resources, the collection of betterment levy already introduced had to be suspended just because the neighbouring State had done so in a more prosperous contiguous area. All these induce a chain reaction of enforced under-taxation on the one hand, and avoidable increase in public expenditure on the other.

92. It is becoming increasingly evident that there should be arrangements for national or, at least, zonal economic co-ordination, both of tax levies and expenditure programmes, to introduce a measure of uniformity. It should ensure optimum mobilisation of resources and re-introduce a greater sense of responsibility in expenditure control. It is not our intention to suggest that absolute uniformity in various tax levies could be effected even on a zonal basis. The tax potential of even contiguous states is not always the same and their tax structure may need differing degrees of adjustments.

93. We consider that a comprehensive examination should now be undertaken to assess the tax potential of each State, to review its tax structure and to recommend rates under different heads of levies in the State list. This examination should appropriately be entrusted to an independent Commission which would naturally take note of the widening gap between resources and functions of the States brought about mainly by the planning process and consider what adjustments, if any, should be made in Union-State financial relations which would add strength both to the Union and the States.

94. We should, at this stage, stress, as our predecessors did, the importance and necessity of arranging for the compilation of reliable statistics relevant for the determination of needs of the States, their taxable capacity and the efficiency of their administration. This would prove invaluable not only to the enquiry we suggest, but also to the agency which will advise on devolution of taxes to be made and other forms of assistance to be afforded to the States.

95. The acceptance of the rates recommended by this Commission and efficiency in effecting recoveries would provide a suitable yardstick for assessment of comparative efficiency and give a better and

more acceptable guide for assessing the assistance justified from the Centre. This will, in our opinion, bring about the optimum mobilisation of resources by all the States. Equally, it will put a stop to the present undesirable system of affording assistance by covering the revenue gaps, howsoever they have arisen or been caused. Under the present dispensation, it is likely that the States, which have done the least, may receive more than they would have otherwise deserved.

96. To complete the picture of financial assistance afforded by the Union to the States, we should refer to the present system of dual allocation of grants, grants-in-aid of revenue made on the recommendations of the Finance Commission under article 275 and grants for specific purposes made at the discretion of the Union Government under article 282. Though the assistance given under article 282 was 48.7 per cent of the total in the year 1952-53, it has now assumed the proportions of 80.2 per cent in the budget for 1961-62. In other words, discretionary grants account for a substantial part of total assistance.

97. We invited the views of the State Governments on the system of dual allocations. Some of the States advocated that the grants in their totality should be covered by the recommendations of the Finance Commission as being in accordance with the basic principles of the Constitution and that grants should not be left to be made at the discretion of the Union Government. Some other States suggested that the bulk of the grants should be covered by the recommendations of the Finance Commission leaving the residue to be made by the Union Government. This, they suggest, is necessary as the Plan itself is flexible and a margin should, therefore, be left for effecting adjustments should they become necessary. It is claimed, however, by the proponents of full devolution that having regard to the needs of our economy there is no scope for curtailment of the Plan except in an emergency. In evidence, they drew attention to the fact that the Plan itself lays down a physical target higher than the present financial target.

98. It has also been urged that article 282 is outside the provisions of the Constitution governing 'Distribution of Revenues between the Union and the States', and is one of the several 'Miscellaneous Financial Provisions'; that it is only a permissible provision to meet a possible contingency and is not intended to be used in the manner it is now being used.

99. Another important matter, which deserves a mention, is the need for overhauling the administrative, technical and executing agencies to make them more efficient, quick in movement and effective in execution. We have noticed that in their natural anxiety to obtain larger State plans, there is a tendency to overstate resources, current and additional, and promise economies which are not susceptible of realisation. We should like to stress the importance of 'non-Plan' expenditure pertaining, more particularly, to administration, even in a planned economy. Unless a balance is struck between Plan and non-Plan outlays and the need is recognised of refashioning the machinery of government, we fear that the Plan itself will be in jeopardy. In any event, it will be difficult to secure completion of projects to schedule or to obtain value for money expended. In this connection, we have mentioned earlier that we consider that it would be useful if the States were to set up a machinery to draw up their own development plans and also to undertake a review, at suitable intervals, of the progress of execution of projects and also other non-Plan programmes. In other words, it should be a planning apparatus with added functions of audit of performance.

100. Article 280(3) (c) empowers the President to call upon the Commission to make recommendations on any matter which he considers to be in the interests of sound finance. Under this provision three questions have been referred to us which we have dealt with elsewhere. There is one other important point, which, though not specifically referred to the Commission, has been stressed before us by the States and we feel that we should make some observations on it. It is in regard to the mounting interest liability which is devolving on the States both on loans raised by themselves and loans granted by the Union Government. The importance of this question lies in the fact that in most cases this liability alone absorbs a substantial portion of their current revenues. The position will worsen in the foreseeable future. As our devolution must take account of the revenue gaps, partly attributable to interest charges, we consider that it would not be out of place if we were to give our appreciation of the position.

101. A general complaint, more particularly of the States which have large multi-purpose river valley projects with considerable financial outlays, (in some cases several times their total annual revenues) is that the loans made to them bear interest charges from the dates on which they are drawn. This liability has, of necessity,

to be met out of additional interest-bearing loans. This not only leads to the over-capitalisation of the projects but also makes these additional loans attract compound interest levies. It has to be considered whether it would not be advisable to have a period of moratorium depending on the character and scope of each productive project, with a weighted rate of interest to compensate the Union Government for the interest foregone over the period of moratorium. This is the principle, we understand, on which World Bank loans are made for projects. It has also to be appreciated that the interest recovered from the States at present is, in the main, met out of the assistance given by the Union Government itself. The position is far from satisfactory and requires, in our opinion, analysis and review.

102. As our observations above relate mainly to multi-purpose river valley and other major irrigation projects, we made a detailed examination of their financial working. We were disappointed to find that in a number of cases the returns are insufficient to meet even the working expenses and in the majority of cases insufficient to cover the additional incidence of interest liability. The power components of the multi-purpose projects are generally remunerative, though marginally because of the statutory ceiling of 5 per cent return. They are not so where agreements were made for supplies at concessional rates either to attract industries to the States concerned, or to find an outlet at the time for power generated or both. But the irrigation components of these projects and also other major irrigation projects are unproductive in most cases. The reasons are two-fold: (a) the reluctance of the agriculturists to avail themselves of irrigation facilities and (b) the unwillingness of States to levy suitable water rates. There is also a marked hesitation to impose and collect betterment levies as an offset to capital expended. The question, therefore, is whether States, which have failed to make their agriculturists irrigation-conscious and/or to levy appropriate taxes, should be encouraged or even allowed to undertake additional irrigation projects.

103. We have felt impelled to raise these issues of a general character, though these are not directly related to our terms of reference. Nevertheless, we consider that they are relevant in the context of the recommendations we make and important enough to merit consideration in the interests of our national economic growth and the introduction of a minimum acceptable standard of social services in all the States.