

### MINUTE BY PROF. BHABATOSH DATTA

The Report we have presented recommends an integrated scheme of devolution and grants-in-aid based upon the general principles we have formulated in Chapter II. The field covered by these recommendations is defined by the relevant provisions in the Constitution and our terms of reference. I have felt, however, that there are certain allied questions which deserve urgent consideration at the present stage, in view of the changes that have been taking place in our economic and financial situation since the introduction of the present system of Union-State financial relations. The following paragraphs seek to indicate some of the very important problems that have already arisen and are likely to become crucial in the not very distant future.

2. The principles of devolution of taxes adopted in this Report and the resulting scheme of distribution have led to surpluses for some States and deficits neutralised by grants under article 275 for others. In a few cases, the surpluses are substantial and, similarly, there are cases in which the deficits and the consequential grants are quite large.

3. The surpluses do not create any problem, because these amounts will be taken into account in determining the sizes and patterns of the State Plans. In the case of the deficit States, however, while there should be no difficulty regarding the Plan outlays if the Central assistance for Plan purposes is appropriately adjusted, there will remain the difficulties and problems arising from the dependence of their normal revenue budgets on large grants-in-aid. Apart from the adverse psychological effects of such large grants, both to the giver and to the taker, there is the fact that a relatively large grant element in the total amount of transfer to a State deprives that State, relatively to others, from the benefit arising from the buoyancy of the Central revenues.

4. The position created by the devolution scheme recommended by us is the unavoidable result of the constitutional provisions as they stand now. The position would not have been very much different even if any other alternative principle of devolution (within the framework of the Constitution) had been adopted, including the schemes recommended by the earlier Commissions. In fact,

there is one State which would have got a large surplus, even if the shares of income tax and Union excises allotted to it were only nominal. At the other extreme, there is another State which would still have experienced a large deficit (requiring a large grant-in-aid) even if disproportionately large transfers were made to it out of the income tax and Union excise receipts.

5. If a change in the distribution of functions between the Union and the States is ruled out, the situation can be remedied by widening the base of tax-sharing, i.e. by including a larger number of items in the devolution scheme. With a number of sharable taxes, it will be possible to devise a scheme which will involve a uniform principle for each sharable tax but different principles for different taxes, making the whole scheme of distribution more flexible than it is now. Many States suggested that the receipts from the Corporation Tax should be divided between the Centre and the States. Some of them argued, with some force, that if estate duty receipts from property other than agricultural land are divisible, the same logic should make the receipts from the gift tax also sharable. A plea has often been made to include expenditure tax in the divisible pool, because, basically, this tax and income tax together represent an integrated method for securing progressive contributions from rising incomes.

6. We could not recommend any positive step in this regard within our terms of reference which, in their turn, are circumscribed by the provisions of the Constitution as they exist now. It is, however, difficult to ignore the fact that the fifteen years that have elapsed since the adoption of the Constitution have seen very large changes in the economic and financial background on which the original provisions regarding the Union-State financial relations were based. It is time now to re-examine the whole scheme of devolution without excluding from the purview of such re-examination the possible need for changes in the Constitution.

7. The need for widening the base of devolution is imperative not only for enabling the Finance Commission and the Government of India to devise and adopt a more flexible scheme of devolution than is possible now, but also because of the rate of increase in the financial requirements of the States *vis-a-vis* the prospects of revenues from the two major divisible taxes under the present Constitution. The requirements of the State Governments are increasing rapidly because of the increasing numbers that have to be served by the social services (particularly education and health),

18. It is clear to my mind that article 282 was not intended to enable the Union to make a grant to a State as such. I venture to say that while article 282 may continue to stay for the purpose for which it was originally intended, a specific constitutional provision may be added to enable the Union Government to make conditional grants to States for implementation of any project, whether falling within or without the Plan scheme on terms and conditions which will ensure a proper utilisation of the grants.

19. After fifteen years of working the provisions of the Constitution, during which period four Finance Commissions have been appointed, I think the time is ripe to have a review of the Union-State financial relationship, particularly in view of the setting up of the Planning Commission. This review should be made by a special Commission who can approach the several problems that have arisen in the past and that are likely to arise in the future objectively and realistically. Some of the questions which may fall to be decided by this Commission, I shall mention briefly:—

(1) The scope and purpose of grants under articles 275 and 282 of the Constitution may be clarified and defined. A dual scheme of transfer of resources from the Centre to the States should completely avoid duplication and overlapping. If need be, a separate provision in the Constitution may be added, apart from article 282, which I pointed out, earlier on, was not intended for that purpose, to enable the Central Government to make grants for implementation of plan and non-plan schemes, imposing terms and conditions to ensure a proper utilisation of the grants. Such grants may be made after considering the recommendation of a body like the Planning Commission. I only venture to suggest that the Planning Commission may be given the status of an independent permanent statutory body.

(2) A scheme may be devised to avoid uncertainty and speculation as to the allocation of divisible taxes and duties like Income-tax and excise duties. Several States have pleaded before successive Finance Commissions for varying proportions of allocation, some going to the extent of an allocation of 100 per cent. to the States in the case of income-tax proceeds. A definitive allocation by way of percentages of shares of the Union and States respectively may be fixed by the Constitution itself.

20. As regards distribution *inter se* among the several States, the general principles and criteria may be laid down by the Constitution. Here again, there has been a great divergence in the sugges-

tions put forward by the States before the Finance Commissions. Population, contribution, collection, relative financial weakness, social and economic backwardness, *per capita* income are some of the different criteria urged by one or other of the States. In respect of such an important matter as the determination of the resources which will be available to each State as a result of a scheme of devolution, there should not be a gamble on the personal views of five persons, or a majority of them. I say this without intending any disparagement of the eminence, equipment and impartiality of the Members of the Commissions. After all these provisions are made in the Constitution what remains is an examination of the forecasts of Revenue and Expenditure made by the States to determine the grants-in-aid of the revenues to such States as may be necessary under article 275(1). This task may be assigned to a Finance Commission, or to a consultative institution, such as we have recommended in the Report, or to a wing of the Planning Commission itself. Periodical reviews by an independent Commission would guarantee justice to the States and the continuation of such a Commission is an essential feature of our Constitution.

21. A suggestion similar to mine for a review of the constitutional provisions dealing with financial relations between Union and States is to be found in the reports of both the second and third Finance Commissions.

22. There is one other matter which is not directly covered by the terms of reference, but on which I would like to express my personal view. Representations have been made to us that with reference to a number of commodities subject to Union excise duties, additional excise duties in lieu of sales tax may be substituted. It was pointed out that this would simplify the problem of collection and make the incidence of tax burden uniform and may have the effect of stepping up production and distribution. Such a course may not find favour with the States on the ground that sales tax is their only available elastic source of revenue. This objection may, however, be met by giving the States a larger share of the receipts from the basic excise duties and any special duties of excise or surcharges on the duties. A view has been expressed that if it were possible to make a constitutional amendment, placing the yield of excise duties on the same footing as income-tax, there might be just a possibility of the States agreeing to the merger of sales taxes and excise duties.

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the widening of the range of their functions in the economic field and the rapidly growing commitments for the maintenance of the completed Plan schemes. One can, of course, anticipate a high rate of growth in the States' receipts from Sales Tax and a few other taxes of a similar nature, but it is the elasticities of the aggregate revenue receipts and expenditures that will be really important.

8. The contribution of the divisible taxes other than income tax and Union excise duties to the meeting of these requirements of the States has been very small up till now and is not likely to increase appreciably in future. What is more disturbing is that even the two major heads in the present scheme of devolution cannot be necessarily expected to expand at the rate at which the States' normal expenditures are increasing.

9. This is already patent in the way in which the role of income tax in the devolution scheme has changed. Income tax was a "divided head" before 1919, and even in the rigidly demarcated separation of heads under the Government of India Act of 1919, a marginal provision was made for returning to the provinces a small fraction of the receipts in excess of a base-year figure. The Government of India Act of 1935 gave the Provinces a statutory share of the income tax receipts. It was, however, indicated that a fifty per cent share would be sufficient and that, in the initial years, the provinces would be able to afford the retention by the Centre of a further amount out of the fifty per cent to be transferred. The linking of the total effective Central share of the income tax proceeds with the railways' contribution to the general revenues under the Niemeyer Award was the direct result of this. Income tax was taken as the major balancing factor and it was thought that a sum of five or six crores of rupees out of its proceeds would adequately balance the provinces' budgets.

10. The provision made in the Constitution of 1950 regarding the allocation of income tax was in line with the ideas that had been evolved earlier. It was still regarded as the major balancing factor. The provision regarding the sharing of the Union excises was only permissive and not mandatory and the taxes specified under article 269 were clearly State taxes—not entering at all into the Consolidated Fund of India—which, in the interests of uniformity and convenience, the Centre would raise on behalf of the States.

11. It has by now become obvious that the importance of income tax proceeds as a balancing factor has declined.

the changes in the structure of this and other allied taxes and partly because of the changes in the dimensions of the problem of devolution. The change introduced in the income tax law in 1959 regarding the classification of the tax on the incomes of joint stock companies seriously affected the rate of growth of the distributable income tax receipts. There have recently been other inhibiting factors like the introduction of new imposts like Compulsory Deposits and Annuity Deposits which are directly based on the incomes of the tax-payers and which, therefore, compete with the ordinary income tax. It is not implied that these imposts are undesirable, but one has to note the present and potential effects of such imposts on the revenues from the income tax proper and, therefore, on the States' revenue receipts.

12. The relative decline in the importance of the income tax proceeds as a balancing factor, *vis-a-vis* the expanding requirements of the States compelled the successive Finance Commissions to bring the excise duties on an increasing number of commodities into the divisible group. We have recommended that all commodities on which excises are levied by the Government of India should be included in the devolution scheme and this was also the principle behind the recommendation of the Third Finance Commission. Even in the case of the Union excises, however, one can discern factors which are likely to lead to a decline in the rate of growth of receipts. The actual experience up till now has been that of a very high rate of growth, but this has been due to a combination of factors all of which cannot be expected to continue to operate equally actively in the coming years.

13. The very high rate of growth in the Union excise receipts in the last fifteen years has been due to, first, increases in the number of commodities taxed; secondly, increases in rates; thirdly, rise in prices; and fourthly, increases in the outputs of the taxable commodities. The growth of excise revenues on account of increase in the number of commodities taxed cannot continue at a rapid rate, when practically all the commodities likely to yield large revenues have already been brought under the scope of this levy. There are, in fact, certain excise duties yielding very small revenues, and it may become desirable to eliminate some of them from the excise schedule.

14. To the extent that the growth of revenues results from changes in the rates of taxation, one notes that the rates on most of the commodities are already fairly high and it is doubtful whether

any substantial increase in these rates will be practicable in the future. One also notes that one of the items in our terms of reference indicates that the Union Government is disturbed over the combined incidence of the Central excise duties and the States' sales taxes on production, consumption and export. We have stated in the Report that we do not find it possible to apportion the effects of these two categories of taxes on production, consumption or export and we accordingly do not recommend the linking-up of the States' shares of the Union excise proceeds with the levels of their sales taxes. But if the Centre wants at all to persuade the States to keep their sales tax rates at a moderate level, it will have to be cautious about increasing the Union excise duties.

15. Increase in the Union excise revenues resulting from rise in prices will be naturally small, because most of the duties are, and have to be, specific, rather than *ad valorem*.

16. The only dependable growth factor in the future Union excise revenues is the prospective increase in the outputs of the excisable commodities. While it should be expected that the outputs will increase—presumably at higher rates than in the past—it would appear that the growth of excise revenues on account of this factor alone cannot continue to be as great as the past growth rates which were brought about by a combination of this factor with certain other very active factors which are not likely to continue with equal effectiveness in the future.

17. The conclusion that emerges is that the total receipts from income tax and the Union excises are not likely to increase at a rate fast enough to match the rate of increase of the States' normal essential expenditures. It may be argued that the percentage shares allocated to the States out of these two sources may be increased further in the future years. It should however be realised that in the case of income tax, if the States' share in the divisible pool is raised to 75 per cent as recommended by us, the scope for further increase in the share will be very limited under the present provisions of the Constitution defining the divisible pool. In the case of the Union excises, there would theoretically be a large scope to increasing the share of the States above the 20 per cent recommended by us, but any set of uniform principles adopted for all the States will mean that the additional amounts to be shared will go largely not to those States which will require financial assistance, but to those which even otherwise will have large surpluses.

18. All this emphasizes the suggestion made earlier that it is now time to re-examine the provisions of the Constitution with a view to ensuring a more flexible devolution scheme than is possible now. In this connection one might also refer to the existing provisions in article 269 regarding certain specified taxes which are to be levied and collected by the Union Government, but the proceeds of which are to be wholly assigned to the States. At present, the only tax in this category that is being levied and collected by the Union is the estate duty on property other than agricultural land (The Central Sales Tax also comes under article 269, but it belongs in effect to a different category). The total receipts from the estate duty are still small, but the potentialities are large, though not large enough to compensate for the relative decline in the importance of income-tax proceeds. A railway fare tax introduced in 1957 was merged with the fares four years later, with the result that the States ceased to have a statutory claim on the receipts. As things stand now, a mere terminological change can prevent the division of the receipts from a particular source between the Centre and the States, or can make a purely Central revenue a divisible one. A ten per cent increase in the amounts payable by railway passengers for their tickets will create divisible resources, if designated as a "tax on fares", and will create resources for the Centre only, if designated as an "increase in fares". The distinction between a tax on the output of a Government enterprise and an increase in its price is extremely tenuous, and it is desirable that in such cases action should be taken on the lines which are consistent with the spirit of the Constitution, unless the constitutional provision itself is changed. This is particularly important because article 269 has been very inadequately exploited up till now and because if it has to be exploited at all to produce significant revenues for the States, the only two items that have a good potentiality are the terminal taxes on goods and passengers and the taxes on railway fares and freight.

19. It is necessary to emphasize here that the suggestions made above need not necessarily mean a larger total of transfers to the States than under the present arrangements. But, in view of the expanding requirements of the States, it is desirable to be prepared for larger transfers. The justification for the widening of the base of devolution arises from this as well as from the need for a system which would make the distribution scheme more flexible and would make it possible for the future Finance Commissions to devise their