

GENERAL OBSERVATIONS AND SUGGESTIONS

134. We now deal with certain questions of a general nature which are of importance in connection with the topics constituting our terms of reference and the recommendations made by us on these topics.

I. Institutional Provision for Inter-Governmental Consultation—

135. While we were considering the requests of several States in regard to the sharing of centrally levied taxes, and in particular when we discussed with them the implications of our term of reference contained in para 4(e) of the Order of the President—i.e. adjustment of a State's share of Union Excise Duties if the State's sales tax exceeds a specified limit—, we noticed that a very widespread misunderstanding about the Union Government's policy is prevalent among them. The general charge is that the Union Government has a tendency to neglect shared revenues, even shared parts of one and the same item, in favour of non-shared revenues and that there had not been adequate exploitation of the assigned taxes mentioned in article 269 of the Constitution. Each State illustrated this view with what it thought was an apt case. Some States had a feeling that as the Constitution now stands, a temptation on the part of the Union Government to neglect the State's needs is inescapable. A general review of inter-governmental financial relations to be followed by constitutional amendment, if necessary, was also urged. A more general feeling, however, favoured more frequent consultations among the State Governments, and between State Governments and the Union Government on all matters of common financial interest.

136. It was neither necessary nor possible for us to go into the merits of these opinions except in so far as they appeared to affect the prospects of a cooperative and coordinated policy in regard to complementary and alternative sources of revenue such as Union excises on the one hand and sales taxes of States on the other. Article 274 of the Constitution would appear to have been purposefully framed to forestall and to remedy misunderstandings such as these. This article provides in effect that no proposal which in any way affects existing or prospective financial interest

of a State shall be presented to Parliament except on the recommendation of the President. An explicit provision for a recommendation by the President should normally entail some mechanism other than the usual briefing and advice from the concerned Ministry at the Centre. While on several important subjects of common financial interests, consultations with individual States and groups of States have been held in the past there is no regular provision or convention about preliminary consultation with concerned States before the President makes a recommendation to Parliament.

137. Thus, though procedural requirements of article 274 have all along been observed, such observance may be capable of further improvement in such manner as would more fully carry out the purpose of this article and would convey greater reassurance to the States. Contacts among States, and between the States and the Union Government, for discussion of matters of common financial interest ought to be much more regular than they have been in the past. Zonal meetings and meetings of the National Development Council are concerned with such a large number of important questions that they cannot always be expected to give to specific financial issues the close and detailed attention which they deserve. The real intention of article 274, namely that all aspects of the impact on State governments of financial proposals to be made to Parliament should have been previously studied and approved by the President of the Union can be better served if regular meetings at policy, as well as implementation, levels are held among representatives of the Union and State Governments. The proceedings of such meetings will be helpful to all concerned, including the President, in promoting clearer understanding and firmer approval of common financial policies. Once the practice of regular consultation is established it will tend to cover a growing area of common financial interest, not confined to tax-sharing, but extending to exchange of experiences which may lead to greater and greater co-ordination in policy and procedure, the need for which appears to have been pointed out by the Taxation Enquiry Commission even a decade ago. In countries having comparable financial relationships between a Central and several State Governments the functioning of similar institutional devices of regular consultation has produced valuable results. It would appear that the time is ripe in India to make at least a beginning in this respect.

II. Establishment of an Organisation in the Ministry of Finance for continuing the Commission's work.

138. The First Finance Commission had recommended the establishment of a small organisation preferably as part of the Secretariat of the President, for making a continuous study of the finances of the State Governments, the rates of taxes in operation, the effects of the further measures of taxation undertaken by them, the working of their commercial enterprises and their effect on the State finances and cognate matters. It was intended that this organisation should also obtain direct from the State Governments periodical information in regard to the progress of various social services such as education, medical and public health and other material and data, tabulate them and make available the results of these studies in the form of papers to the successive Finance Commissions. Although this recommendation was accepted by the Government, only a small Cell was established, initially in the President's Secretariat and subsequently transferred to the Finance Ministry following the recommendations of the Taxation Enquiry Commission.

139. The Second Finance Commission also recommended that a nucleus staff with experience of the work of the Finance Commission should be retained within the Finance Ministry and made available to future Commissions. It also suggested that arrangements may be made by the Finance Ministry for the necessary statistical and other research work likely to be of assistance to the future Commissions. The Third Finance Commission also stressed the importance and necessity of arranging for the compilation of reliable statistics relevant for the determination of the needs of the states, their taxable capacity and the efficiency of their administration.

140. The Cell maintained in the Finance Ministry, however, consists of only some ministerial staff. No data except the *Conspectus of Central and State Budgets* has been made available to us by the Cell. The work of the Finance Commissions could be facilitated, if adequate arrangements are made to make a continuous study of State revenues and expenditure. For instance the result of such studies would probably have enabled us to deal more satisfactorily with our terms of reference relating to an examination of the scope for economy in administrative expenditure and a study of the combined incidence of States' sales tax and Union excise duties on production, consumption or exports than we have been able to do.

We, therefore, suggest that the present Cell maintained in the Finance Ministry may be re-organised and strengthened by the addition of personnel with suitable research experience who would be able to continue to collect and analyse the relevant material.

III. Natural Calamities

141. The Government of India has a scheme for assistance to States to meet expenditure on natural calamities in excess of the provision made by the Second and Third Finance Commissions in their schemes of devolution on the basis of the past average annual expenditure. In the course of their discussions with us, many States have urged that the conditions governing the grant of assistance under the scheme were too stringent and that the scheme should be liberalised so as to meet more adequately the needs of the States. The complaints related in particular to certain items of relief expenditure which were held to be ineligible for assistance under the scheme, the provision necessitating local inspection by officers of the Government of India, and the manner in which the excess of expenditure over the fixed amounts provided by the Finance Commission was shared between the Centre and the States. We have refixed the amounts included in the expenditure forecast on the basis of actual expenditure for eight years. We suggest that the working of the existing scheme may be reviewed and modifications made wherever required in consultation with the States.

IV. Transfer to Local Bodies

142. The forecasts of State expenditure accepted by us include large amounts by way of transfer of resources and grants to local bodies. These involve a large step-up over current levels of transfers. Although the amounts admitted by us are what are payable according to commitments incurred by the State Governments on the basis of existing laws or orders, most States were unable to supply us statements showing the break-up of the amounts among different heads of expenditure. We have admitted the amounts on the basis that the expenditure will have to be incurred exclusively on items which are ineligible for inclusion in the Plan, but it should be easy to take this reservation into account while finalising plan arrangements with each State.

V. Borrowing

143. The subject of borrowings by State Governments has come before the Commission in two contexts. By its terms of reference

the Commission has been asked to pay regard among other things, to any further expenditure for the servicing of their debt likely to devolve upon States, which are in need of assistance by way of grant-in-aid of their revenues under article 275, and to the creation by them of a fund out of the excesses, if any, over a limit to be specified by the Commission, of the net proceeds of estate duty on property other than agricultural land accruing to a State in any financial year, for the repayment of the States' debt to the Central Government. Even the total net proceeds of estate duty on property other than agricultural land accruing to States are so small in relation to the existing and prospective burden of borrowing by States from the Government of India, that unless the approach underlying this part of the Commission's terms of reference is carried substantially forward a satisfactory solution to the problem will not be found. On their side the State Governments have as a rule expressed grave concern at the mounting burden of their debts, and they have in effect requested the Commission either to provide them with enough resources for the service and amortization of their debts or to find some other way out of what many of them feel is an impasse.

144. The Commission must, therefore, squarely face the whole problem of the budgetary implications of borrowings by State Governments. In one specific respect, namely the service and amortization of the market borrowings of State Governments, the Commission is definitely of opinion that both these must form part of the revenue liabilities of State Governments. While interest liability has in the past been readily accepted as a revenue liability, amortization provision has been allowed as a legitimate charge on revenue only in the case of States which are not in need of grants in support of their revenues under article 275. The acceptance of the item of amortization as a legitimate part of revenue expenditure is, in our opinion, unaffected by the source from which the revenues are derived—revenues levied and collected by States, revenues accruing to States under the scheme of devolution, and grants out of the Consolidated Fund of India made in support of revenues of States as recommended by the Finance Commission. While almost all States have urged a claim for adequate strengthening of their revenues to enable them to make a suitable provision for amortization of their market borrowings, only a few among them have made any substantial provision for the same in their budget.

145. It is likely that this lack of adequacy and of uniformity of budget provision has been at least partly due to the view taken so

far that provision for amortization of market borrowings is admissible only to the extent to which a State's revenue resources, other than grants to which they are entitled under article 275, can bear the financial burden. We have accepted as legitimate items of revenue expenditure the provision already included in the budgets of State Governments on account of amortization of their market borrowings. We recommend that an early inquiry through a representative and expert body should be undertaken to decide the principles of a scheme of amortization of public borrowings by the States. The recommendations of this body should form the basis on which all State Governments should be given an opportunity to recast their expenditure forecasts of the next five years. As the programme of public borrowings by State Governments is normally formulated in consultation with the Government of India there should be no difficulty in ascertaining the factual position of each State in regard to its amortization needs under an approved scheme. As the several guarantees given by a State Government to third parties constitute a contingent liability which it owes to the public the soundness of the practices currently followed in this respect should also be examined by the body to be set up to consider the question of public indebtedness of State Governments.

146. By far the more important in regard to amounts involved, and more complicated in regard to underlying policies is the problem of borrowings by States from the Government of India. The Central Government as a creditor of State Governments is in a peculiar position. Cases in which a State Government approaches the Centre with a request for a loan for a purpose which it decides by its unaided judgment as being in need of such finance are becoming very few. As a rule most of the objects of expenditure and investment by State Governments are determined by joint consultation either directly or through the Planning Commission. At least in some cases the Centre is keen on offering an inducement to a State Government to undertake a fresh responsibility. While the ultimate judgment of the State Government is in no way fettered, over a growing area of public expenditure, the relations between the two authorities are developing into an unlimited partnership. Whatever may be the position in law the Government of India cannot appraise the credit of a State Government, and certainly not of a number of State Governments, differently from its own credit. A survey of the soundness of the present system of inter-governmental borrowing is necessary as much in the interests of the States, as that of the Government of India.

147. It is necessary to be clear about the purpose and nature of a loan before its service and amortization can be put on a sound basis. When borrowing was largely confined to meeting either distress expenditure or the provision of a public amenity no serious doubt existed as to the burden both of interest and repayment being borne by revenues over an appropriate number of years. The mere fact that certain items of expenditure resulted in the creation of durable assets did not alter the fact that the expenditure had to be finally met out of revenue. Only items of expenditure which created a productive asset, bringing in a net revenue which would pay for interest and repayment, could be classified as investments and kept out of the revenue budget. A number of items fell between the two clearly defined classes, as being partly a revenue amenity and partly a capital investment. The extent to which each such item constituted a burden on general revenues had to be determined by the extent of its being an amenity and not an investment. This in substance was the prevailing practice of State and Central Governments till the developmental functions of both the State and Central Governments became increasingly important.

148. In 1955 the Government of India advised the State Governments that all expenditure on capital assets, that is durable or fixed though not necessarily productive or self-liquidating assets, should be held eligible for being serviced out of loans, and that the amortization of such loans need not be treated as a charge on revenue except to the extent that the State Governments were bound to provide in accordance with any law or with any specific undertaking given in the case of any loan [Appendix III (xi)]. In its initial stages this practice, which ran counter to the more discriminating policy of the earlier period of keeping out of the revenue budget only productive and self-liquidating items of capital expenditure, did not produce serious results, though it appears that some at least among the State Governments had repeatedly urged the claims of the more orthodox policy. The diversion of large items of unproductive or inadequately productive capital expenditure from the revenue to capital budgets made it possible to show a balanced revenue budget and to go on balancing the capital budgets also by fresh borrowings. As the sources and purposes of borrowings were numerous and ever on the increase, no serious question about the soundness of the new system projected itself for some time on the attention of Governments. But as the burden of Central loans began to pile up and as the unproductive i.e. non-revenue earning

nature of a large part of it e.g. education, health, protective irrigation, etc. became clear, the States felt that any further continuance of this policy by the Government of India could only mean that the Centre would ultimately take care not only of the interest, but also of the repayment liability of the whole debt, at least of that part of it which was not clearly productive of a net return equal to these obligations. As we have noted above more than one State has urged us to take this view of their indebtedness to the Centre.

149. As recently as March of this year the classification of expenditure as between capital and revenue accounts has received attention from the Finance Ministry of the Government of India. [Appendix III (x)]. While it is recognized that only clearly productive items of capital expenditure can be kept out of the revenue budget no definite provision has yet been made to ensure the observance of this salutary principle. Even when the general principle is accepted its application, or rather its reapplication in a developmental pattern of expenditure, is bound to raise a number of difficult procedural and financial issues. Apart from the current and prospective application of a more rational principle, the scrutiny, classification and treatment of accumulated indebtedness would need an elaborate, expert and representative deliberation. We are convinced, however, that in the interest of financial soundness such an inquiry ought not to be delayed any further. In regard to periods, rates of interest and other terms of each loan made by the Government of India to a State Government a much more specific and discriminating approach, than it has been possible to adopt in recent years, appears to be called for. It is only in the light of a thoroughgoing investigation of past commitments and of future borrowings that the exact impact of Central loans on State budgets can be measured, and incorporated into the scheme of devolution and grants which it is the function of the Finance Commission to recommend.

150. The overshadowing of current budgets by plan budgets, and generally of maintenance by developmental objectives has naturally created a ready acceptance of higher expenditure targets and of continued borrowing. A few State Governments readily admitted that their budgeting was optimistic in regard to revenue, that is they had budgeted for higher figures of revenue than they hoped to receive. This unusual attitude was sought to be defended partly as a target for achievement and partly as an apparent justification for higher expenditure budgets than were justified. Somehow this

was thought to be consistent with a welfare State. Even with this leavening of optimism budgets were not balanced in every case. Such situations, it was claimed would be met by ways and means overdraft. While as yet such attitudes and occurrences are rare, the very fact that they are beginning to come to the surface indicates that a thorough revision of the policy underlying borrowing by States, especially from the Centre, is urgently called for. In their turn borrowers from State Governments are developing attitudes which reflect similar ideas of optimism and complaisance. A sounder and more rational arrangement between the purposes and the terms of loans must be reinstated to secure and enhance the strength of the fiscal system.

VI. Statistical data required by the Commissions.

151. The earlier Finance Commissions had emphasised the need for collecting reliable Statistical data on a continuous basis and making them available to Finance Commissions at the very commencement of their work. We have mentioned elsewhere that very little information had already been collected and compiled. We had to make our own arrangements for collection and analysis of the statistical data required by us. We issued a questionnaire to the State Governments requesting them to furnish information on 30 subsidiary points which were relevant to the work of the Commission. The questionnaire will be found in Appendix III(iv).

152. The task of the Commission involved the assessment of revenue receipts and expenditure of the States over the Fourth Plan period. This in turn required the estimation of the past and current growth rates of a number of components of receipts and expenditure. The data available in the budget papers could not be used for trend analysis without adjustment. There were many elements which made it difficult to compare the data over time. Changes introduced from time to time in budget classifications and accounting practices, step-up in receipts on account of additional taxation measures and take-over by corporations of departmentally run industrial and commercial enterprises are some of the major causes of non-comparability in the statistics of revenue receipts and expenditure of the States. Some of the items of statistics that should be collected are the following:—

- (i) Information on additional taxation and other elements necessary for adjustments to make budget figures comparable over time;

- (ii) rates of the principal taxes, duties and fees levied and the changes made from time to time in the rates;
- (iii) details of schemes outside the plan financed partly or wholly by the Central Government or commodity committees;
- (iv) regular comparable data on arrears of taxes in different States;
- (v) loans advanced by State Governments to corporations, electricity boards etc.; rate of interest and other terms and conditions;
- (vi) debt position of the States—Central and Public Debts—interest rates, terms of repayment and provision for appropriation;
- (vii) number and pay ranges of State Government employees and employees of local bodies including Panchayat institutions and teachers in aided schools;
- (viii) data on financial and economic results of irrigation (commercial), multipurpose river schemes and departmentally run commercial and industrial enterprises; and
- (ix) details of transfer of resources to local bodies in each State and the manner of utilisation of these funds.

153. It has been stated in the Chapter on Income-tax that we have been obliged to accept collection as the only available measure of contribution for the distribution of income tax proceeds amongst the States. It may be said that a better indicator of contribution would be provided by measures of income originating in an area or accruing to the residents of an area but adequate data are not available. An early attempt should be made to collect such information in future.

154. Successive Commissions have felt the need to have reliable data on State's contribution to excise duties, on the basis of consumption. The commodities concerned fall under two categories: (i) excisable goods consumed by households, and (ii) producer and intermediate goods. There is no readily available information in respect of the second category. As regards the first category, the National Sample Survey collects information on household consumer expenditure annually, but State-wise information is not available for any round except for the 13th round (1957-58); the 13th round data were considered by the Commission.

for the purpose of distribution of excise duties. We urge that information on consumption data, both household and non-household, on excisable articles should be collected and maintained on an up-to-date basis.

155. Our terms of reference include the study of the effect of the combined incidence of States' Sales tax and Union duties of excise on the production, consumption or export of commodities or products, the duties on which are shareable with the States. We have said elsewhere that due to lack of statistics, we are not in a position to study the problem. Only one or two States have made any real attempt to collect information on commodity-wise yield of Sales tax. Even in those States, the information collected is far from satisfactory. We recommend that immediate steps should be taken to collect commodity-wise information on Sales tax and excise duties. This information would be useful to the State Governments themselves.

156. Some States urged that *per capita* income should be taken as a criterion for the distribution of excise duty and income-tax. We examined the available data on State income and found that they are not comparable from State to State and therefore not usable for the purpose. We urge that the process of building up reliable and comparable estimates of State income should be accelerated.

CHAPTER 12

SUMMARY OF RECOMMENDATIONS

157. Our recommendations to the President in regard to devolution and grants-in-aid are set out below :—

Under article 269 of the Constitution:

I. Estate Duty.—In each of the five years commencing from 1st April, 1966 :—

- (i) Out of the net proceeds of the duty in each financial year, a sum equal to two per cent be retained by the Union as proceeds attributable to Union Territories ;
- (ii) The balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year ;
- (iii) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State ; and
- (iv) The sum apportioned to property other than immovable property be distributed among the States as follows :—

State	Percentage
Andhra Pradesh	8.34
Assam	2.75
Bihar	10.76
Gujarat	4.78
Jammu and Kashmir	0.83
Kerala	3.92
Madhya Pradesh	7.50
Madras	7.80
Maharashtra	9.16
Mysore	5.46
Nagaland	0.09
Orissa	4.07
Punjab	4.70
Rajasthan	4.67
Uttar Pradesh	17.08
West Bengal	8.09
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