CHAPTER 1

INTRODUCTION

The Commission was constituted by the President in his Order dated 5th May, 1964 which is reproduced below :—

"In pursuance of the provisions of article 280 of the Constitution of India and of the Finance Commission (Miscellaneous Provisions) Act 1951 (XXXIII of 1951), the President is pleased to constitute a Finance Commission consisting of Dr. P. V. Rajamannar as the Chairman and the following four other members, namely: —

(1) Shri Mohan Lal Gautam, former Minister of U.P. Government.

(2) Shri D. G. Karve, until recently Deputy Governor, Reserve Bank.

(3) Prof. Bhabatosh Datta, Director of Public Instruction, West Bengal.

(4) Shri P. C. Mathew, Member-Secretary.

2. The members of the Commission shall hold office for a period of fifteen months from the date on which they respectively assume office.

3. The Chairman Dr. P. V. Rajamannar shall render part-time service as Chairman of the Commission until such date as the Central Government may specify in this behalf and thereafter he shall render whole-time service as Chairman of the Commission. Of the other members, Shri D. G. Karve would serve as a part-time member, while the other three would render whoe-time service.

4. In addition to the matters on which, under the provisions of sub-clauses (a) and (b) of clause (3) of article 280 of the Constitution, the Commission is required to make recommendations, the Commission should also make recommendations in regard to—

(a) the States which are in need of assistance by way of grants-in-aid of their revenues under article 275, and the sums to be paid to those States other than the sums specified in the provisos to clause (1) of that article, having regard, among other considerations, to—

(i) the revenue resources of those States for the five years ending with the financial year 1970-71 on the basis of the levels of taxation likely to be reached in the financial year 1965-66;

(ii) the requirements of those States to meet the committed expenditure on maintenance and upkeep of Plan schemes completed during the Third Plan;

(iii) any further expenditure likely to devolve upon those States for the servicing of their debt;

(iv) creation of a fund out of the excess, 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 State's debt to the Central Government; and

(v) the scope for economy consistent with efficiency, which may be effected by the States in their administrative expenditure;

(b) the changes, if any, to be made in the principles governing the distribution amongst the States under article 269 of the net proceeds in any financial year of estate duty in respect of property other than agricultural land;

(c) the changes, if any, to be made in the principles governing the distribution amongst the States of the grant to be made available to the States in lieu of taxes on railway fares;

(d) the changes, if any, to be made in the principles governing the distribution of the net proceeds in any financial year of the additional excise duties levied on each of the followig commodities, namely :—

(i) cotton fabrics,
(ii) silk fabrics,
(iii) rayon or artificial silk fabrics,
(iv) woollen fabrics,
(v) sugar, and
(vi) tobacco (including manufactured tobacco)

in replacement of the States' sales taxes formerly levied by the State Governments.

Provided that the share accruing to each State shall not be less than the revenue realised from the levy of the sales tax for the financial year 1956-57 in that State;

(e) the effect of the combined incidence of a State's 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, and the adjustments, if any, to be made in the State's share of Union excise duties if there is any increase in the State's sales tax on such commodities or products over a limit to be specified by the Commission.

5. The recommendations of the Commission shall, in each of the above cases, cover the period of five years commencing from the 1st day of April, 1966."

2. The Chairman and Shri D. G. Karve served on the Commission on a part-time basis. The other Members served on a whole-time basis. The first meeting of the Commission was held in New Delhi on 18th May 1964.

3. The intention to constitute the Fourth Finance Commission had already been announced in the Finance Minister's budget speech for 1964-65. Soon afterwards, the officer selected for nomination as Member-Secretary of the Commission, was appointed as a Special Secretary in the Ministry of Finance to attend to the preliminary work connected with the constitution of the Commission and the collection of material likely to be required by the Commission. He addressed in advance the Union Ministries, the State Governments and the Accountants General for supply of relevant material. In his letter dated 12th May 1964 [Appendix III(iv)], the State Governments were requested to furnish to the Commission, forecasts of their revenue and expenditure for each year of the five-year period to be covered by the Fourth Finance Commission (1966-67 to 1970-71), their views on the existing basis of the devolution of Central taxes and duties and their suggestions, for any changes. They were also requested to supply information on certain subsidiary points which are set out in Appendix III(iv). Similarly, the Union Government was also requested to send to the Commission forecasts of revenue and expenditure for the five-year period indicating separately the divisible pool of income-tax and share in other Central taxes and duties that was likely to accrue to the States during the Fourth Plan period [Appendix III(ii)]. The Accountants General were also addressed for the supply of information relating to repayments of Central loans due from States to the Central Government during each year of the Fourth Plan period [Appendix III(iii)].

4. The State Governments were requested to send the material so as to reach the Commission by the middle of July 1964. It had been originally planned that on receipt of the material from the State Governments its scrutiny would be completed by the end of August 1964 and that the Commission would visit all the States from September onwards. This time schedule could not be adhered to on account of the delay in the receipt of the material from the State Governments. Material from some States was received as late as January 1965.

5. On account of the delay in the receipt of the forecasts, the Commission had to abandon the initial proposal to visit the capital of every State for discussions with the respective State Governments. In order to enable the Commission to submit its report by the prescribed date, the Commission decided to hold discussions with the State Governments at four selected centres, *viz*., Bombay, Calcutta, Delhi and Madras. The States were given the option to choose any of the Centres according to their convenience. The discussions started in January 1965 and were completed by the end of May 1965.* Appendix IV gives the dates of the discussions with the different States. The procedure generally adopted by the Commission was that the initial discussions were held with the Chief Ministers, Finance Ministers and other Ministers of the State Governments, on matters of policy and on general principles that should regulate and determine the devolution of resources. The detailed estimates and the States' forecasts were thereafter discussed with the officials of the State Governments. Important policy issues emerging from the discussions with the officials were again taken up with the Ministers at the concluding meetings. By arrangement with the Comptroller and Auditor General of India, the Accountants General of the respective States were present throughout the discussions. After the conclusion of the discussions with the representatives of every State Government, separate discussions were also held with the Accountant General of the State concerned.

6. In the course of our work, we also held discussions with senior officials of the Union Ministries of Finance and Home Affairs. The Ministers of Commerce and Prof. V. K. R. V. Rao, Member, Planning Commission, met us and pressed on us certain points including the necessity of affording relief to States by way of compensation for losses

*On account of a change in the Government and the introduction of President's rule in Kerala, the representatives of Kerala were invited to meet the Commission at Bangalore towards the end of May, 1965.

in revenue that might arise if the Tea Finance Committee's recommendations are implemented. We had an opportunity of exchanging views with the Deputy Chairman, Members and senior officials of the Planning Commission. Towards the end of our discussions, we had a meeting with the Comptroller and Auditor General of India.

7. A press note was issued on May 19, 1964 inviting views from persons and institutions interested in the subjects covered by the terms of reference of the Commission. We received a number of Memoranda from Chambers of Commerce and Industry, Members of Parliament and State Legislatures, Universities, Economists and others (list given in Appendix V). Some of them also requested for interviews with the Commission; during the Commisson's sittings at Bombay, Madras, Calcutta, Bangalore and Delhi, discussions were held with such individuals and representatives of non-official organizations (list given in Appendix VI) in the respective zones.

CHAPTER 2

UNION-STATE FINANCIAL RELATIONS—OUR BASIC APPROACH

8. The history of the financial relations between the Central Government of India and the Governments of the constituent units is a long one; in fact, the final year of the period to be covered by the present Finance Commission will see the completion of a century since the first beginning of devolution under the scheme introduced by Lord Mayo in 1870. It is not necessary to recount the story here—there is a good historical account in the Report of the First Finance Commission—but it is worth noting that all the experiments that have up till now been made in this field proceeded from the experience of increasing gaps between the financial requirements of the functions allocated to the Provinces or States and the finances that these units could raise under their own authority. Except for the short interlude of 'Provincial contributions' under the Meston Settlement of the nineteen-twenties, there has always been the need for substantial transfers of funds from the Government at the Centre to the constituent units.

9. The trend of administrative evolution of the country has been towards the transfer of a widening range of functions—in the field of social services and, more lately, also in the field of economic development—to the Provinces or the States. There has thus been the need for maintaining the financial viability of these units at expanding levels of expenditure. One alternative method for meeting the requirements would be to divide all revenue heads into two water-tight compartments—one for the Centre and the other for the units—in the expectation that the finances and functions would match in every case. Another alternative would be to give concurrent taxing powers to both levels of Government. The first of these alternatives was tried in India under the Government of India Act of 1919, while the second has generally been recognised as economically unsound.

10. The failure of the system of a rigid division between the Central and Provincial heads of revenue introduced by the Government of India Act of 1919 could not be prevented by the Meston award and the ultimate result was unsatisfactory both to the Centre and to the

units. The experience of the nineteen-twenties led, however, to the emergence of the idea that the authority most suited for discharging a particular governmental function need not necessarily be the authority most suited to raise the financial resources required to discharge the function. The taxes on income had already been recognised before 1919 as a balancing factor and it continued to be recognised as such after 1935. But it also came to be recognised that other taxes could appropriately be levied and collected by the Central Government and distributed, wholly or partly, to the Provinces or States. The Government of India Act of 1935 recognised this principle and the Constitution adopted in 1950 made clear provision for (i) the assignment of the taxes raised by the Union Government under article 269 wholly to the States, (ii) for the obligatory division of the income-tax proceeds between the Union and the States, and (iii) for the division, with the approval of Parliament, of the proceeds of the Union excise duties.

11. The principle behind all these provisions is that in regard to some of the major revenue-yielding taxes and also in the case of some other taxes, where a country-wide uniformity of rates is desirable, the best authority for legislating and in most cases also of collecting, is the Union Government. The requirements of the Centre as well as those of the component States could be met in the most equitable and efficient manner, by distributing the proceeds after these have been collected by the Central Government, rather than by dividing powers of tax collection between the Centre and the States as has been done in some federations—which would not only mean high costs of decentralised collection and large scope for evasion, but also varying rates of taxation in different areas and rigidity of distribution in the face of changing requirements. Under this system, the Union Government is the agency for raising certain revenues for the benefit of both the Centre and the States and for distributing the proceeds between the Centre and the States and among the States themselves according to the principles and procedures set out in the Constitution.

12. This makes the problem of determining what part of the divisible revenues should go to the States and what should be the distribution among the States *inter se* very important. Whatever principles are laid down with regard to these two issues have, however, to be based upon the economic realities of the country and formulated within the framework of the provisions of the Constitution. It is not possible to derive much direct help from the experiences of other Federal Countries, though the course of evolution by which