

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

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

CHAPTER 2 UNION-STATE FINANCIAL RELATIONS— OUR BASIC APPROACH

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 Commission'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.

each federation has sought to adapt its system of financial relations to changing political and economic conditions is very instructive.

13. A special feature of importance in India is the introduction of Five-Year Plans and the consequent distinction that has evolved between plan and non-plan expenditure. Many States urged upon the Commission to include expenditure on the Fourth Plan in the estimates for the coming five years. Some States supplied detailed expenditure forecasts on new projects and also on the likely revenue components of their Fourth Plan outlays. The Commission has, however, felt it desirable to leave all such expenditure out of its consideration. This decision is based not on grounds of any Constitutional limitation of the powers of the Finance Commission but on practical considerations consequent on institutional arrangements relating to the Five-Year Plans.

14. When the provisions regarding the Union-State financial relations were incorporated into the Constitution, it was not possible for any one to anticipate the importance and magnitude of our successive Five-Year Plans. There was no reference to Plan expenditure as such in the terms of reference of the First Finance Commission (November 1951—December 1952) and that body did not find it necessary to draw a line of distinction between plan and non-plan expenditure. In fact, it emphasised the need for taking into account development expenditure of various types in determining the transfer of resources from the Centre to the States. The Second Finance Commission (June 1956—September 1957) was, however, specifically asked to take into account both the requirements of the Second Five-Year Plan and the efforts made by States to raise additional revenues. The dimensions of Plan expenditure, however increased rapidly and it became the normal practice to make grants for plan expenditure under the discretionary provisions of article 282 instead of making statutory grants under article 275, on the basis of the pre-determined plan allocations as phased and modified by the annual plan discussions. The Third Finance Commission (December 1960—December 1961) recommended grants under article 275 to cover 75 per cent of the States' revenue expenditure on the Third Plan, but the Government of India did not accept this recommendation.

15. The terms of reference of the Fourth Finance Commission do not expressly mention plan expenditure. The fact that the Commission is to make its recommendations in the light of its estimates of revenue receipts of the States in the coming five years on the basis of taxation levels likely to be reached in 1965-66, takes additional

taxation outside its scope. And the fact that the Commission is specifically asked to take into account the committed expenditure on the maintenance and upkeep of the completed Third Plan schemes may be taken to imply that new outlays on Fourth Plan schemes are not expected to enter into its estimates.

16. The Constitution does not make any distinction between plan and non-plan expenditure, and it is not unconstitutional for the Finance Commission to go into the whole question of the total revenue expenditure of the States. It has been pointed out to us that the reference to "Capital and recurring sums" in the first proviso to article 275(1) of the Constitution suggests that even capital expenditure need not necessarily be outside the scope of the Finance Commission. It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure.

17. The present Finance Commission has, therefore, confined itself to non-plan revenue expenditure *vis-a-vis* the revenue receipts anticipated in the coming five-year period on the basis of taxation levels in 1965-66. We have not, however, taken the view that the function of the Finance Commission is simply to recommend such devolution and grants-in-aid as would merely fill up the non-plan revenue deficit as reported by the States because such an approach will be extremely mechanical. We have reassessed the States' estimates in the manner detailed in a subsequent Chapter. We have not taken budgetary deficits as a criterion for distribution in the case of divisible taxes and duties.

18. In regard to income-tax, the Constitution does not say that it should be distributed on the basis of budgetary needs. In fact, however great the budgetary needs, a State will not get a share, if, for some reason or other, the tax is not leviable in that State. And, even when there is no budgetary need in a particular case, a State cannot be denied some share in the income-tax proceeds if the tax happens to be levied within that State. In the case of the Union excises also, the provisions are almost similar, though the Union Government has in this case the option of not distributing any share among the States.

22. An attempt has been made in the above paragraphs to state briefly the basic principles adopted in deciding the scheme of sharing of taxes and grants. Further discussion of the issues involved will be found in the subsequent Chapters.

The estate duty on non-agricultural property is in effect a State tax collected by the Centre—the receipts do not enter the Consolidated Fund of India—and here also the budgetary needs do not come in as a criterion for distribution. The additional excise duties in lieu of sales tax are again States' taxes in substance and the distribution should logically be based on the principle of compensation for loss of revenue.

19. The only article in the Constitution which refers to the need for financial assistance is article 275. The grants-in-aid under this article are to be made only to "such States" as are in the opinion of Parliament "in need of assistance". The obvious implication of this provision is that if any State is in need of assistance, after the taxes to be compulsorily or optionally shared with the States have been distributed on the basis of the principles uniformly applicable to all States, such assistance is to be granted under article 275. Corrective action for residuary deficits can be taken only under the authority of this article.

20. The Third Finance Commission took "the relative financial weaknesses of the States" as one of the criteria for determining the shares of the States in the divisible pool of the Union excises. We have departed from this approach on the ground that if any State is in need of specific financial assistance because of large deficits that cannot be covered by uniformly applied principles of tax-sharing, such assistance should appear explicitly as grant, rather than being disguised as shares of taxes. If in the case of some States, our recommendations appear to involve large grants under article 275, the reason is that the required financial assistance to meet the residual deficit has in each case been shown explicitly as grants. The size of these grants could have been made smaller by devising the sharing of the Union excise receipts in such a way as to incorporate a grant element based on anticipated budget deficits into the shares going to some States. This would not have affected the total transfers from the Centre to the deficit States and it would have reduced somewhat the total amount of transfers from the Centre to the States. It would, however, have had the effect of concealing the fact of their financial deficits.

21. The States for which we have not recommended article 275 grants should have surpluses in their non-plan revenue budgets and in a few cases the surpluses are substantial. The Planning Commission will, we expect, take these surpluses into account when determining the pattern of Central assistance.