

CHAPTER 1

INTRODUCTORY

This Finance Commission, the fifth Commission to be set up under Article 280 of the Constitution, was constituted by an Order of the President dated the 29th February, 1968, 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 (33 of 1951), the President is pleased to constitute with effect from the 15th March, 1968, a Finance Commission consisting of Shri Mahavir Tyagi, former Union Minister of Rehabilitation, as the Chairman and the following four other members, namely:

- * (1) Shri P. C. Bhattacharyya, former Governor, Reserve Bank of India.
- (2) Shri M. Seshachalapathy, retired Judge, Andhra Pradesh High Court.
- (3) Dr. D. T. Lakdawala, Professor, Department of Economics, Bombay University.
- (4) Shri V. L. Gidwani, former Chief Secretary, Government of Gujarat, Member-Secretary.

2. The members of the Commission shall hold office until the 31st day of July, 1969.
3. Shri Mahavir Tyagi 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 P. C. Bhattacharyya shall render part-time service as member of the Commission until such date as the Central Government may specify in this behalf and thereafter, he shall render whole-time service as member of the Commission. The other three members will render whole-time service.
4. The Commission shall make recommendations as to the following matters:—
 - (a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter 1 of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds:

- (b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 for purposes other than those specified in the provisos to clause (1) of that article and other than the requirements of the Five Year Plan, having regard, among other considerations, to—
- (i) the revenue resources of those States for the five years ending with the financial year 1973-74 on the basis of the levels of taxation likely to be reached at the end of the financial year 1968-69;
 - (ii) the requirements on revenue account of those States to meet the expenditure on administration, interest charges in respect of their debt, maintenance and upkeep of Plan schemes completed by the end of 1968-69, transfer of funds to local bodies and aided institutions and other committed expenditure;
 - (iii) the scope for better fiscal management as also for economy consistent with efficiency which may be effected by the States in their administrative, maintenance, developmental and other expenditure;
- (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 the repealed tax on railway passenger fares;
- (d) 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;
- (e) the desirability or otherwise of maintaining the existing arrangements under the Additional Duties of Excise (Goods of Special Importance) Act, 1957, in regard to the levy of additional duties of excise on sugar, textiles and tobacco in lieu of the States' sales taxes thereon, with or without any modifications and the scope for extending such arrangements to other items or commodities;
- (f) irrespective of the recommendation made under item (e) above, 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 leviable under the 1957 Act aforesaid on each of the following commodities, namely,
- (i) cotton fabrics,
 - (ii) silk fabrics,

- (iii) woollen fabrics,
 - (iv) rayon or artificial silk 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;

- (g) the principles which should govern the distribution of the net proceeds of such additional items or commodities as may be recommended under item (e) above for levy of additional excise duties in lieu of the States' sales taxes thereon;
 - (h) the scope for raising revenue from the taxes and duties mentioned in article 269 of the Constitution but not levied at present;
 - (i) the scope for raising additional revenue by the various State Governments from the sources of revenue available to them; and
 - (j) the problem of unauthorised overdrafts of certain States with the Reserve Bank and the procedure to be observed for avoiding such overdrafts.
5. The Commission in making its recommendations on the various matters aforesaid shall have regard to the resources of the Central Government and the demands thereon on account of the expenditure on civil administration, defence and border security, debt servicing and other committed expenditures or liabilities.
6. The Commission shall make an interim Report by the 30th September, 1968 covering as many of the matters mentioned in para 4 above as possible and in particular, in respect of the financial year 1969-70; and make the final Report by the 31st July, 1969 on each of the said matters and covering a period of five years commencing from the 1st day of April, 1969, indicating in its Reports the basis on which it has arrived at its findings and making available the relevant documents."

The date for submission of the interim Report was extended to 31st October, 1968, by the President's subsequent Order dated 24th September, 1968.

1.2 During the earlier stages of our work a question arose as regards advance tax collections being included in the net proceeds of income tax divisible between the Union and the States. We took up this matter with the Comptroller and Auditor-General of India and

the Government of India. Subsequently on the 1st May, 1969 we received a supplementary reference from the President which is reproduced below:

“Whereas since the commencement of the Constitution, Advance Tax collections made under the Income-tax Act have been taken into account in determining the net proceeds of taxes on income for purposes of article 270 (2) of the Constitution only on completion of regular assessment;

And whereas successive Finance Commissions have recommended the distribution between the Union and the States of the net proceeds of taxes on income under article 280 (3) (a) of the Constitution on the said basis;

And whereas the Comptroller and Auditor-General of India has also certified the net proceeds of taxes on income under article 279 (1) of the Constitution in each of the financial years until and including 1966-67 on the said basis;

And whereas it is now considered that the Advance Tax collections made in a financial year should be taken into account in determining the net proceeds of taxes on income in that year and not be left over for such determination in subsequent years on completion of regular assessment as hitherto;

Now, therefore, in pursuance of sub-clause (a) and (c) of clause (3) of article 280 of the Constitution of India, the President is pleased to refer the following further matters to the Finance Commission, constituted by S.O. No. 812, dated the 29th February, 1968, namely:—

- (a) the distribution of the Advance Tax already collected and not included in the net proceeds of taxes on income in the financial years until and including 1966-67 as certified by the Comptroller and Auditor-General of India;
- (b) the changes, if any, in the distribution between the Union and the States of the net proceeds of taxes on income as prescribed in the Constitution (Distribution of Revenue) Order, 1965, in so far as the taxes on income collected in the financial years 1967-68 and 1968-69 are concerned, in the event of the net proceeds thereof being certified by the Comptroller and Auditor-General of India after taking into account the Advance Tax collected in the respective years; and
- (c) the distribution of the net proceeds of taxes on income in each of the financial years 1969-70 to 1973-74 as determined on the revised basis.

2. The Commission shall take into account the effect of the recommendations made by them on the matters specified in paragraph 1 above in making their recommendations

under S.O. 812 aforesaid, as to the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds under sub-clause (a) of clause (3) of article 280 of the Constitution and also as to the determination of the sums to be paid as grants-in-aid of the revenues of the States in need of assistance under clause (1) of article 275 of the Constitution."

1.3 We assumed office on the 15th March, 1968. The Chairman served on the Commission on a part-time basis upto 31st July, 1968 and thereafter rendered whole-time service. Of the other Members, Shri P. C. Bhattacharyya rendered part-time service till the date of his sudden demise on the 13th February, 1969. His untimely death has been a great loss to the Commission, and we place on record our appreciation and gratitude for the valuable contribution made by him in the Commission's deliberations with his keen intellect, profound learning and wide experience.

1.4 In place of the late Shri P. C. Bhattacharyya, the President by his Order dated the 19th February, 1969, appointed Shri G. Swaminathan, former Additional Deputy Comptroller and Auditor-General of India, as a part-time Member of the Commission. Shri Swaminathan assumed office as Member on the 21st February, 1969.

1.5 We held our first meeting on the 16th March, 1968 and adopted rules of procedure similar to those framed by the Fourth Finance Commission. A Press Note was issued on the same day indicating the terms of reference of the Commission and inviting written memoranda setting out views and specific suggestions from those interested in the matter.

1.6 Before the actual appointment of the Commission our Member-Secretary was appointed as Officer on Special Duty to attend to the preliminary work in the Union Finance Ministry. He addressed the State Governments and the Accountants General in advance for supply of material required in connection with the work of the Commission. The State Governments were requested to supply the forecast of revenue receipts and non-Plan revenue expenditure for the 5 years 1969-70 to 1973-74 and information on various subsidiary points by the 5th April, 1968. The Union Finance Ministry was also requested to send its forecast and other information by the 15th April, 1968. These dates were later extended. The State Governments were asked to submit the information in so far as it was relevant for the interim Report by the end of May, 1968 and their forecasts and Memoranda for the final Report by the end of September, 1968. However, due to certain Constitutional changes and mid-term elections in certain States we received the required material from some of them as late as in March, 1969.

1.7 The Comptroller and Auditor-General of India was requested to instruct his principal civil Accounts Officers to supply such statistical material as the Commission might call for and also to meet it for discussion when the Commission visited the State headquarters.

1.8 In view of the limited time available for submission of the interim Report, we invited the State Governments to send their representatives to New Delhi for discussions in respect of all matters to be covered by the interim Report. These discussions were held during the period June to August, 1968.

1.9 Our interim Report covering items (c), (d) and (j) of paragraph 4 of the Presidential Order and making interim recommendations for devolutions and grants in respect of the financial year 1969-70 was submitted to the President on the 31st October, 1968. A copy of the interim Report is included as Annexure to this final Report.

1.10 We commenced our discussions and consultations with the State Governments for our final Report in November, 1968, and visited the headquarters of each State for this purpose. Owing mainly to the delay in receipt of forecasts and other necessary material from certain States we were able to complete our visits to all the States only in April, 1969. The dates of the discussions are indicated at Appendix II. They generally commenced with meetings with the Chief Minister, Finance Minister and other Ministers or with the Governor and his senior advisers in case of States then under the President's rule. Thereafter, we had detailed discussions with senior officials for clarification and elucidation of their forecasts and examination of the memoranda and other material furnished. A final meeting was also generally held with the Chief Minister and other Ministers or the Governor. The Chief Minister of Jammu and Kashmir, whom we were not able to meet when we visited the State, was kind enough to come to New Delhi for discussions soon after our return. The Chief Minister of Orissa also held further discussions with us at New Delhi. At the time of our visits to Bihar, Punjab, Uttar Pradesh and West Bengal, these States were under President's rule. After the formation of representative Governments in these States, the Finance Minister of Punjab and the Chief Minister and Finance Minister of Uttar Pradesh had supplementary discussions with us at New Delhi. All these discussions with the representatives of State Governments at various levels were held in private sessions, and they were frank and informative and gave us a clear picture of their various problems and difficulties as well as their policies and programmes in various matters. We wish to place on record our sincere appreciation and gratitude for the assistance, co-operation and hospitality which we received in ample measure from all the State Governments.

1.11 Both at the time of discussions with State Governments' representatives at New Delhi in connection with the interim Report and at State headquarters for the final Report, the Accountants General of the respective States were present. The Commission had also separate meeting with the Accountant General at the end of discussion with the State's representatives. Our thanks are due to these officers and to the Comptroller and Auditor-General for all the assistance which they have readily rendered to us.

1.12 In some State Capitals, on the conclusion of our discussions with the State Governments we met representatives of the Press to keep them informed of the progress of our work, though it was

obviously not possible for us to indicate to them any views or conclusions on various matters, which we had still to formulate after completion of the discussions with all State Governments as well as the Government of India. We should like to express our appreciation of the interest shown by the Press in our work.

1.13 Towards the conclusion of our work, we had discussions with the Cabinet Secretary and the Secretaries of the Finance Ministry, Government of India, and with the Chairmen of the Railway Board and the Central Board of Direct Taxes. We had also the opportunity of exchanging views with other distinguished persons including Dr. V. K. R. V. Rao, Minister of Education and Youth Services, Dr. K. L. Rao, Minister of Irrigation and Power, Shri K. Santhanam, Chairman of the Second Finance Commission, Shri A. K. Chanda, former Comptroller and Auditor-General of India and Chairman of the Third Finance Commission, Dr. D. R. Gadgil, Deputy Chairman of the Planning Commission, Shri B. Venkatappiah, Member of the Planning Commission and Shri N. Rajagopala Ayyangar, Chairman of the Press Council of India. A complete list of persons who appeared before the Commission is given in Appendix IV.

1.14 In pursuance of the Press Note issued by the Commission a number of memoranda was received from the various Chambers of Commerce and Industry, Universities, Economists, Members of Parliament and State Legislatures and others. A list of the organisations and individuals who sent memoranda is given in Appendix III. The Commission also held discussions with a number of individuals and representatives of Chambers of Commerce and other organisations at the various State headquarters and at New Delhi as indicated in Appendix IV. We are grateful to all the persons and organisations who have assisted us in our work, for sending their written memoranda and responding to our request to meet us for personal discussions at New Delhi and various State headquarters.

1.15 We wish to place on record our sense of appreciation of the very useful work done by our officers and the members of our staff. Our Joint Secretary, Shri G. C. Katoch, and Deputy Secretaries, Shri R. K. Mukherji and Dr. V. P. Kachwaha, efficiently carried out their onerous responsibilities of collecting, analysing and placing for our consideration a large mass of information from several sources and assisted us in our deliberations. Our Under Secretary, Shri G. H. Bijlani, and our team of Senior Research Officers consisting of Sarvaswari T. S. Rangamannar, R. D. Gupta, G. G. Nair, S. P. Sharma and K. V. Nambiar and the technical staff did excellent work, often at great pressure, in collecting and processing the budgetary data and other statistics and material for our use and in detailed scrutiny of the forecasts furnished by the State Governments and the Government of India. Our Superintendent, Shri P. Seshadri, and the staff under him efficiently looked after the running of the office; and our personal staff ungrudgingly carried out the duties assigned to them at all times. But for the diligence and willing co-operation of all the officers and members of our staff it would not have been possible for the Commission to complete its task satisfactorily, and we are deeply grateful to them all.

THE PROBLEMS—OUR APPROACH

I.—Union-State financial relationships

2.1 In our Constitution, India is described as a Union of States. Due to a number of provisions in it tending towards a strong Centre, eminent Constitutional writers have described the Indian Constitution as quasi-federal. The imbalance between the functional responsibilities assigned to the States and the financial resources allocated to them, which is a general feature of many full-fledged federations, also exists in India. Many economic, social and developmental services like education, medicine and public health, agriculture, cooperation, small industries, etc., require local supervision and nearness of the governing authority, and they have been naturally included in the functions of States which are in more direct contact with the people. In a developing economy these services have to grow rapidly. On the other hand, in regard to distribution of powers of taxation, the Constitution has recognised adequately the economic allegiance of taxes and has assigned each tax exclusively to one or other of the two layers of Government which is best in a position to levy and collect it, thereby attempting to avoid overlapping of tax jurisdiction. In view of the increasing trend of the economy towards integration under modern conditions, the taxes assigned to the Union have been producing increasingly larger yields. This has resulted in the Union having relatively larger resources than the States, and consequently there is need for substantial transfers to the States. The changes in the assignment of tax powers which have been adopted hitherto, for instance the amendment of the Constitution regarding tax on inter-State sales and the arrangements in respect of estate duty on agricultural land, have been in the direction of giving further tax powers to the Union. In the current discussions on the question of Union-State financial relationships, while increase in the functions and powers of States is being generally demanded, no clear suggestions have yet emerged regarding the tax powers which should be transferred to the States. On the other hand there is a large school of opinion that advocates the centralization of the tax on agricultural income. There is a chronic gap between the States' own revenues and their expenditure commitments and consequently there is persistent and growing need for larger transfers of funds to States.

2.2 A distinguishing feature of Union-State financial relationships in India is the explicit recognition in the Constitution of the varying nature of this need and the provision of a periodical review of the situation by a quasi-judicial body. Aware of the experience of other federations regarding the great disparity between the States' capacity to raise revenues and their need to effectively discharge their essential functions, our Constitution-makers made specific provisions for remedying this imbalance.