CHAPTER 2

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.

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 Sarvashri 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.

2.3 A number of taxes, though levied by the Government of India, are collected and retained by the States (Article 268); the net proceeds of seven items of taxation, though levied and collected by the Government of India, are entirely assigned to the States and distributed among them in accordance with the principles of distribution formulated by Parliament (Article 269). In addition, a percentage of the net proceeds of income-tax is assigned to the States (Article 270). The proceeds thus assigned to the States do not form part of the Consolidated Fund of India. Union excise duties can be shared with the States if Parliament so decides (Article 272), and almost from the commencement of the Constitution, excise duties have been so shared. In 1950-51 the receipts from income-tax and excise duties formed nearly one-half of the Union tax revenues so that the divisible pool was by no means inconsiderable. Further, Article 275 recognises the necessity for grants-in-aid of revenues of States which may be in need of assistance. Different sums can be fixed for different States, so that the weaker States can be given specific assistance to meet the necessary expenditure in the proper discharge of their duties to their people. Article 282 provides for grants by the Union and the States for any public purpose.

2.4 None of the Articles 270, 272,275 and 282 however mentions what amounts are to be so given to the States, or lays down the principles according to which they are to be distributed among the States. Some eminent persons have expressed the view that it would have been better if at least the States' shares in the divisible pool of income-tax and Union excise duties were specifically laid down in the Constitution so as to obviate controversy and uncertainty. In our opinion, the case for such a change is by no means clear. All the four Finance Commissions have recommended progressive enlargement of the divisible pool of taxes to be shared as well as the States' share therein, as the following table indicates :—

Transfers from tax sharing under Finance Commissions' Awards

(Rs. crores)

Commissions	First year of the Commission's period	Devolution of taxes in the preceding year	Devolution of taxes in the first year of the Commission's period
First	1952-53	52·66	73·23
Second	1957-58	78·25	120·72
Third	1962-63	192·86	236·58
Fourth	1966-67	288·56	384·08

The priciples of distribution of income-tax and Union excise duties among States *inter se* have also been varied by the Finance Commissions from time to time. These facts constitute a strong case against rigid determination of the States' share in the Constitution itself. Grants under Article 275 must in their very nature be variable and they have to be related to the needs of particular States. But recourse to Article 275 or Article 282 may not be sufficient in itself to meet the needs of additional transfers to States. The founding fathers of our Constitution were aware of this situation and have, therefore, made the provisions relating to federal transfers sufficiently flexible to deal with changing conditions.

2.5 The Constitution, therefore, provides for a regular statutory machinery to deal with the devolution of taxes and grants from the Union to the States. The President has to constitute a Finance Commission to carry out this task at the expiration of every fifth year or at such earlier time as he considers necessary. It is the duty of the Commission to make recommendations regarding the distribution of income-tax and Union excise duties between the Union and the States and the allocation of the States' share among them, and also as to the principles which should govern grants under Article 275. The President may also refer any other matter to the Commission in the interests of sound finance. Under this last provision, questions like the distribution of additional excise duties, taxes under Article 269 and grant in lieu of the tax on railway passenger fares have been referred to the Finance Commissions. Grants under Article 282 are outside the purview of the Finance Commission. It is under this Article that the Government of India give Plan grants to promote new programmes, and other grants to meet difficulties of States arising during the interval between two Finance Commissions. In order to meet greater needs arising in their own sphere, the Government of India are also empowered under Article 271 to levy surcharges on the taxes and duties mentioned in Article 269 and on income-tax.

2.6 The constitutional arrangement under which a statutory body is charged with the duty of periodically recommending a major part of transfers of Central funds to States is a unique feature of the Indian Constitution. No such machinery for periodical readjustments has been provided for in any of the older federations. The only near parallel is the Australian Commonwealth Grants Commission, which examines annually the plea of the claimant States of Australia for Commonwealth assistance. This body, however, is not constituted under the Australian Constitution but by a Commonwealth law; it has no power to suggest changes in tax-sharing or to recommend conditional grants. Its functions are confined to recommending unconditional grants for a few States. The innovation of a periodical Finance Commission in the Indian Constitution has the advantage of making it possible to formulate periodically an appropriate combined scheme to cover most of the transfers from the Union to the States. Such transfers have to be made under different Articles and in determining them due regard has to be paid to the language of the Articles and the principles of distribution hitherto adopted. But taken together as a whole they can, and must, subserve the overall purpose of providing necessary assistance to the States on an equitable basis.

2.7 A purposive scheme of federal finance should be designed to serve the following two broad purposes. It should, firstly, augment the States' own limited resources so as to help them meet their expanding need for expenditure as far as that can be done from surpluses of the Union. It must be remembered that the Government of India are not in the happy situation of certain other Federal Governments, whose surpluses are sometimes so large as to create a deflationary influence on the economy. A large transfer to the States means a greater dent in the funds of the Government of India, who have to provide for the compulsive requirements of national defence, situations of national emergency, and the equally imperative overall needs of planning. The pre-emptive character of the financial needs of the Union constitutes a limiting factor in formulating the scheme of transfers to States. Yet the States should have fairly adequate funds, including their own revenues and transfers from the Union, to maintain and improve their services to a reasonable extent. It is essential to provide for investment in human resources, maintenance of welfare services, and building up of necessary infrastructure, which are largely within the State sphere, and the States can justly claim that they should be enabled to carry out these functions upto a reasonable standard and should not be left helpless in the vicious circle of stagnation and low development due to inadequate finance. It is the task of the Finance Commission to strike a dynamic balance between the competing claims of the two layers of Government and to allocate the available resources between them so as to serve the needs of the country's welfare and development as a whole. In the case of both, the existing levels of taxation and of expenditure are not adequately indicative of their potential resources and reasonable requirements. It is these factors that the Commission has to take into account in making its recommendations.

2.8 Secondly, it is desirable to see that the transfer of funds is so designed as to assist adequately the States with comparatively less capacity to raise resources. The distribution of Union transfers among the States has to be made after taking into account the resources of individual States so as to avoid large disparities. Of the 17 States in India, the richest has a *per capita* income of Rs. 619 and the poorest of 292; the largest State has a population of 9 crores and the smallest one of 4 lakhs. The progress of the nation depends, in a real sense, on the development of the weaker States and there is a danger that large and persistent disparities in the basic service levels in different States would weaken national unity and strength. Substantial amounts distributed among States on the basis of population have the result, to some extent, of reducing disparities between their resources. But the need for equalisation demands a more positive redistributive policy. Such purposive distribution of funds has to distinguish between more advanced and less developed States. Where the general level of economic development of the country is not high, the degree to which backward States can be assisted to come up to the average level of services is a matter for detailed assessment, but there can be no doubt that Article 275 of the Constitution is designed to help the States which are less developed and have less capacity to raise resources of their own. How far such transfers can be made available to enable States with low *per capita* income to improve their level of services, and the stages

by which that should be done, are matters to be decided not merely on fiscal considerations, but with due regard also to the promotion of a sense of national unity.

2.9 The transfer of funds recommended by the Finance Commission can only partially fulfil the objective of equalisation in view of the division of functions which now exists between the Planning Commission and the Finance Commission, whereby the former looks after developmental needs and gives Plan grants for this purpose. As the language of Article 275 stands, there is nothing to exclude from its purview grants for meeting revenue expenditure on Plan schemes, nor is there any explicit bar against grants for capital purposes. In the terms of reference of the First Finance Commission there was no mention regarding Plan expenditure, and that Commission dealt with the revenue expenditure requirements of the States as a whole. The Second Finance Commission was asked to take into account the requirements of the Second Five Year Plan as well as the efforts made by the States to raise additional revenue from the sources available to them. Its recommendations for grants under Article 275 were such that the States may thereby be able to meet their total revenue expenditure on Plan and non-Plan account along with the Plan grants and revenues from additional tax measures. The Third Finance Commission had similar terms of reference and it recommended, by a majority, grants under Article 275 to the States of such amounts as would enable them, along with any surplus out of tax devolutions, to cover 75 per cent of the revenue portion of their Plan outlay after taking into account the additional tax revenues expected of them. This recommendation was, however, not accepted by the Government of India. The Fourth Finance Commission was not specifically asked to take into consideration the requirements of the Fourth Plan. While it did not consider itself precluded from recommending Plan grants, it did not do so, because it considered it desirable that the Planning Commission, having been specifically constituted for this purpose, should have unhampered authority in this domain. The present Commission is by its terms of reference specifically asked not to take into consideration requirements of the Plan for the purpose of recommending sums to be given as grants under Article 275. The principles evolved for allocation of Central assistance for the Plan among the States provide for a portion of the assistance being distributed only among States with *per capita* income below the all-India average. It has been argued before us that while our terms of reference exclude the requirements of Plan schemes, they do not contain an embargo on our considering increased expenditure so as to improve the levels of specific social services outside the Plan and that it was open to us to recommend grants for meeting such increases in expenditure. We are not, however, able to agree with this view as it would blur the entire division of functions between this Commission and the Planning Commission.

2.10 It may be observed that there is no similar limitation on the process of tax devolution. The Articles in the Constitution which provide for devolution of taxes have, on the other hand, their own requirements. One State has in its memoranda submitted to us suggested that the proceeds of all taxes and duties, whether they are

assigned to States or shared with them compulsorily or voluntarily, should be distributed among them in accordance with an integrated scheme of devolution, so that the proceeds of each such tax or duty are treated alike as feeder sources of a common divisible pool; and that their distribution among the States *inter se* should be made on the basis of uniform priciples serving the sole purpose of meeting the fiscal needs of each State. We have carefully considered this suggestion which applies generally to the whole scheme of tax devolution. In our view the Constitution has made a clear distinction between taxes and duties wholly assigned to the States (Article 269), taxes compulsorily shared between the Union and the States (Article 270) and duties which may be divided between the Union and the States optionally if so provided by Parliament by law (Article 272). There is separate provision in Article 275 for grants-in-aid to States in need of assistance. In the case of taxes on income other than agricultural income, the proceeds of which are compulsorily shared between the Union and the States, the allocation of a part of such proceeds on the basis of contribution has been hitherto adopted, and it can, in a sense, be considered to be the counterpart of the tax on agricultural income which can be levied by the States themselves. Different considerations might arise in the distribution of excise duties where sharing is not obligatory, while the needs of States for assistance as grant-in-aid of their revenues can be dealt with separately by grants under Article 275. We have not therefore thought it necessary or desirable to depart from the practice established by the previous Finance Commissions in formulating separate schemes for distribution of different taxes and duties like estate duty, income tax, Union excise duties, etc.

2.11 All the Finance Commissions have taken the view that taxes under Article 269 are levied by the Government of India largely for the sake of uniformity and convenience and they are therefore distributable among the States on the basis of their origin. Regarding income-tax which is compulsorily shareable under Article 270 and the Union excise duties which may be shared under the permissive provisions of Article 272, distribution has to be made among all the States in which they are leviable, in conformity with suitable principles formulated in a Presidential Order or Parliamentary Enactment after considering the recommendations of the Finance Commission. As these taxes are leviable in all States, no State can be excluded from a share in the distribution nor can the particular requirments of individual States be taken into consideration. Within these limitations, the scheme of transfers has to be so devised that, on the whole, the States with low *per capita* income may be enabled to provide services reasonably near the all-India level. It cannot however be expected that, as a result of the Finance Commissions' recommendations, all the States would be put in a position of equality. States with higher *per capita* incomes, higher rates of taxation or greater assets in relation to their debt liabilities, will, to some extent, remain in a better financial position. They would, therefore, be able to spend more on non-Plan revenue account, or have a surplus available for Plan and capital purposes. On the other hand, weaker States with *per capita* expenditure higher than the average, lower tax levels or more unproductive debt and unremunerative

commercial departments or enterprises, would, apart from the devolution accruing to them, have to make further efforts to improve their position.

II.—Recent development in State finances

2.12 In performing its task, the Finance Commission has first to address itself to the question of determining the size of devolutions on a broad consideration of the needs of the States and the available surplus funds with the Union. It may be useful in this connection to review the major developments in the field of State finances since the implementation of the recommendations of the Fourth Finance Commission. These recommendations were expected to leave ten States with no deficit on non-Plan revenue account and six States with surpluses on such account. However, in a brief interval of less than three years, a large number of States showed substantial revenue and capital deficits and several States ran into unauthorised overdrafts. The Fourth Finance Commission did not entirely adopt the mechanical approach of covering all the non-Plan revenue deficits estimated by the States, but they reassessed them to some extent. The major modifications made in the States' forecasts were that the Electricity Boards and other Public Corporations were assumed to pay the entire interest due on loans given to them by the States, and departmentally managed enterprises (including electricity schemes) were not to show any working losses. But even if the States had achieved these goals, their deficits would have substantially continued. It will be worthwhile to analyse the causes which underlie this rapid worsening of the financial position of the States.

2.13 The years 1965-66 and 1966-67 were characterised by a combination of difficult circumstances. The hostilities with Pakistan, sudden cessation of American aid, devaluation of the rupee and serious failures of the monsoon made for an extremely uncertain and gloomy situation resulting in the postponement of the Fourth Five Year Plan. Food prices rose sharply, growth of industrial production slowed down, and real incomes fell. As a result of large increases in the All India Working Class Consumer Price Index number, there was agitation by State Government employees for increases in dearness allowance. During the period from April, 1966 to March, 1969, the Government of India enhanced dearness allowance of their employees with effect from six different dates. With varying time lags, the State Governments had to follow suit. In many States, no margin was left for meeting any increase in other expenditure resulting from increased prices, much less for Plan expendtiure. The serious failure of the monsoon in 1966 and 1967 also had the effect of increasing the States' expenditure on famine relief, which amounted to Rs. 73·49 crores and Rs. 78·89 crores in 1966-67 and 1967-68, respectively as against the provision of Rs. 15·69 crores per annum which the Fourth Commission had taken into account. The States' finances were also adversely affected due to remissions and suspensions of land revenue and lower recovery of interest and loan instalments due for repayment. The Government of India's scheme for famine assistance by way of grants and loans took care

of a substantial part of the approved famine expenditure; but the uncovered portion of the approved expenditure, as well as the unapproved items and expenditure by way of loans and advances, cast an additional burden on States' revenues. Owing to the pressing needs of the law and order situation, non-developmental expenditure (excluding interest and famine relief) increased at a rate faster than that of non-Plan developmental expenditure. On the receipts side, the States obtained a sizeable benefit by way of larger devolution of taxes to the extent of Rs. 87 crores in 1968-69 due to additional taxation measures taken by the Government of India. Even then, many States had to reduce their revenue Plan expenditure, and some of them relied solely on Central assistance for financing their Plan expenditure. The pattern of Plan assistance complicated the picture by covering a part of the revenue expenditure on Plan account by loans from the Centre. The States also ran into serious difficulties on the capital side, as they got less loan assistance from the Centre and had to make larger repayments. The net transfers from the Centre to the States on capital account decreased from Rs. 560 crores in 1965-66 to Rs. 514 crores in 1967-68 and Rs. 431 crores in 1968-69 (B.E.). The States tried to meet a part of the reduction in loan receipts by reducing their loans and advances to others, but even then there remained a considerable strain on their finances. In addition, in several States other non-Plan expenditure (excluding dearness allowance, famine relief and interest charges over which they had no control) has shown a steep increase. It was not possible for us to examine in detail the reasons for this increase.

2.14 In the context of these difficulties and the heavy requirements for expenditure which they had to meet, the efforts made by State Governments for raising more revenues and effecting economy of expenditure were on an extremely inadequate scale. The additional tax measures adopted by State Governments from year to year were on a diminishing scale, being Rs. 40 crores in 1966-67, Rs. 26 crores in 1967-68 and Rs. 18 crores in 1968-69. In the last two years, some States abolished or reduced land revenue on smaller holdings. The total loss due to various tax reductions is estimated at Rs. 13 crores in 1969-70 of which Rs. 9 crores would be under land revenue.

2.15 The above aggregate picture of the States financial position does not fully reflect the magnitude of the difficulties of individual States; in the case of weaker States the stress was more acute. It may be mentioned that the position of the Government of India was also not comfortable. Owing to the inflationary pressures and industrial recession, their tax revenues increased at a rate of only 0·75 per cent, which is lower than that of State taxes. With an additional taxation of Rs. 155 crores, the Centre's revenue surplus diminished by Rs. 316 crores between the years 1965-66 and 1968-69 (R.E.).

2.16 The States have thus had to meet the requirements of increased revenue liabilities for which their own revenues along with the transfers recommended by the Fourth Finance Commission have

not been sufficient. The Government of India sanctioned further increase in dearness allowance to their own employees in 1968 when the twelve-monthly average of the cost of living index reached 215. Many of the State Governments have followed suit. Besides these increased commitments, they have placed before us fresh proposals which will add considerably to their non-Plan expenditure. Under the financial stress, the State Governments had postponed some items of necessary expenditure which now need urgent attention. Payments of grants to local bodies and schools were delayed and they will now have to be made. Maintenance of roads and buildings was greatly neglected, and it will have to be improved. The Education Commission presided over by Dr. Kothari recommended minimum pay scales for school teachers, and several States have suggested provisions for implementing them. A number of States had appointed Pay Commissions for revising the salary structures of their employees; their recommendations have now to be carried out. A few States are considering proposals for reorganisation and expansion of their police force in the light of their law and order situations. Interest charges on State borrowings are fast increasing, but returns from investments and receipts of interest on loans and advances to others have not been adequate. Some States have sought to question the norms adopted by the Fourth Finance Commission regarding recovery of interest on loans to Electricity Boards on the ground that the assumptions made by that Commission did not take into account certain facts like investment on works-in-progress, losses on rural electrification, high costs of distribution, lack of hydro-electric power, etc. The Fourth Finance Commission had allowed provision for amortisation of market loans to the extent that the State Governments were actually making such provision. Other State Governments that were left out had protested to the Government of India who agreed to compensate them by converting a part of their Plan loans into grants. Many State Governments have now proposed to extend the amortisation provision to their loans from the Government of India. On the commencement of the Fourth Five Year Plan, the revenue expenditure on maintenance of completed Plan schemes of the years 1966-67 to 1968-69 has become committed expenditure for which no Plan grant would be received.

III.—**Our approach**

2.17 In our interim Report, we recommended grants under Article 275 to cover only the expenditure requirements of the States on a cash basis for the year 1969-70. In determining such requirements, we had proceeded on the basis of the 1968-69 budget estimates of the States and allowed for some growth, and for extra expenditure on dearness allowance. We also provided for committed expenditure on an *ad hoc* basis. On that footing, we provisionally recommended grants under Article 275 to thirteen States, totalling Rs. 176·81 crores. We had postponed consideration of questions relating to norms of tax effort, expenditure and returns from commercial enterprises, provision for amortisation of debt, items of fresh expenditure, etc. We have tried to deal with these matters in this Report.

2.18 The question of assessment of the forecasts of revenue receipts and expenditure of the States is considered in detail in Chapter 6 of this Report, which deals with grants under Article 275. We propose to indicate here our broad approach to the problem. In estimating the total deficit of each State we have taken into account their revenue resources on the basis of 1968-69 levels of taxation and their requirements for expenditure on revenue account, including committed Plan expenditure and interest charges. We have adopted the States' forecasts of tax and non-tax revenues as well as normal revenue expenditure on the basis of existing policies, with some adjustments. We have assumed suitable rates of returns in respect of investments in Departmental commercial schemes and in other concerns, and recovery of interest due on loans to Electricity Boards and to other parties. These assumptions are made in the expectation that the State Governments will take effective measures to obtain adequate interest on their loans and returns on their investments and commercial undertakings which will safeguard them from loss. No interest has been allowed for *ad hoc* loans taken from the Government of India to cover unauthorised overdrafts.

2.19 Having arrived at a broad assessment of the shortfall in the States' revenue resources on this basis, we had to determine how far it should be covered by devolution of taxes and how far by grants under Article 275. The general suggestion of most of the States and the view of many distinguished witnesses before us was that the States' need for additional resources should be met, as far as possible, by devolution of taxes rather than by grants. The earlier Commissions have also expressed the same view. We consider that the aim of a reasonable policy of transfer of resources should be to minimise the number of States receiving grants so that as many States as possible may have the benefit of such additional resources as they may raise.

2.20 In the light of these general principles, we considered the question of distribution of proceeds of divisible taxes. We noted that due to inclusion of advance tax collections in the same year according to the revised basis now adopted, the size of the divisible pool of income-tax will now be larger than it was hitherto. In view of the increased needs of the States, however, we considered it necessary to maintain the States' share at the existing level and also to increase the States' share of Union excise duties in the last two years of the five-year period by including the proceeds of special excise duties in the divisible pool. We have also modified the principles of distribution of the States' share among them, with a view to giving greater weightage to population and increasing the relative shares of States which have lower *per capita* income and are economically more backward.

2.21 The question of determining the quantum of grants under Article 275 raises several important considerations. The general principle followed hitherto has been to cover by such grants the non-Plan revenue deficits left after taking tax devolutions into account. From our analysis of the States' forecasts, it was clear to us that States' deficits on revenue account could not be entirely ascribed to

their low taxable capacity or their special problems. In some States the rates of taxes are much lower than the general level of rates levied by other States. Some States have adopted policies resulting in expenditure above the average all-India level. Several States urged before us that filling up the entire revenue deficits in such cases was unfair to States which paid greater regard to financial prudence and made greater efforts in raising revenues. A number of eminent witnesses who appeared before us commented adversely on the procedure of mechanically filling up budgetary deficits of States, which puts a premium on disregard of proper fiscal management. We see considerable force in this view. We have also to consider whether the Union can spare all the money needed to cover fully the States' estimated deficits which, according to their forecasts, are of the order of Rs. 7368 crores for the five-year period.

2.22 Under a federal Constitution, the States have plenary powers within their own sphere in deciding on their policies of taxation, expenditure and investment. It is difficult for a Commission or any outside authority to judge the propriety of these policies. It is not, therefore, possible to regulate the grants to States on the basis of any judgment regarding the particular policies adopted by individual States. Our terms of reference, however, require us to have regard to the scope for economy consistent with efficiency and to the scope for better fiscal management. All that can be done is to keep in view broad considerations which can be applied to all the States as regards their total tax effort, overall expenditure levels, and returns from investment. There are a few items of revenue receipts and expenditure in respect of which no suitable general consideration could be adopted. These have been taken into account on the basis of actuals.

2.23 The deficits worked out in the manner broadly explained in the preceding paragraphs have been taken as reflecting the needs of the States. In case of States where such deficits are not covered by the tax devolutions along with other transfers under Article 269 and the States' share of the grant in lieu of railway passenger fare tax and additional excise duties, the remaining portions of the deficits have been taken into account for determining grants under Article 275.

2.24 It was found that for the year 1969-70 and subsequent years the actual deficits of some of the States were likely to be substantially larger than those worked out by us in the manner described above. It is, however, desirable for maintaining the administrative and social services that such States should be given further help for a short period during which they may be expected to take suitable measures for improving their finances. It is necessary also to have regard to the fact that many of the States might have been under the impression that their whole deficit would be taken care of. Accordingly, in cases where the States were likely to incur actual deficits substantially higher than those estimated according to our assessment, we have recommended suitable larger grants in the earlier years and reduced their amounts gradually over the five-year period.