

## CHAPTER 9

### CENTRE-STATE FINANCIAL RELATIONS AND OUR SCHEME OF TRANSFERS TO THE STATES

The Finance Commission derives its being from Article 280 of the Constitution. This Article, in Part XII of the Constitution is basic to the fabric of Centre-State financial relations. Its position in Chapter I of Part XII of the Constitution gives a clear indication of its place and functions in the overall scheme of Centre-State relations, which is particularly spelt out from Articles 268 to 281. The sequence of the matters dealt with by these Articles is significant. Article 268 refers to the duties levied by the Union but collected and appropriated by the States. Article 269 lists the taxes levied and collected by the Union but are assigned to the States. In the case of the taxes and duties referred to in these Articles the Central Government has no discretion to retain any part of the proceeds. Article 270 refers to income tax levied and collected by the Union and distributed between the Union and the States. That proportion of the proceeds of the income tax which is distributable among the States have been treated as assigned to the States and does not form part of the Consolidated Fund of India. Article 270-also specifies that the distribution of the share of the States inter se will be prescribed by the President by Order after considering the recommendations of the Finance Commission. Article 272 refers to Union duties of excise levied and collected by the Government of India, which may be shared with the States if the Parliament by law so provides. Article 275 speaks of grants-in-aid of the revenues of the States as Parliament may determine to be in need of assistance. The sums of such grants-in-aid shall be charged on the Consolidated Fund of India. The meaning of this sequence is clear, in that, firstly, the need of transfer of resources raised by the Centre to the States is recognised and made part of the Constitution; secondly in the case of the taxes which are to be divided or may be divided between the Centre and the States, it is the Finance Commission which has to make recommendations in regard to the allocation of the respective shares between the Union on the one hand and the States on the other, and also in regard to the principles for deciding the shares of the States inter se. The Commission also has to recommend the principles which should govern the grants-in-aid to the States under Article 275. These two duties are mandatory. The President can also refer other matters to the Commission in the interest of sound finance.

2. While the Commission's discretion in the matter of making recommendations on these matters is not limited in the Constitution, it also seems clear that the Commission has little discretion to make transfers beyond the scheme laid out in Chapter I of Part XII of the Constitution. We have kept this position in mind throughout our deliberations. On a careful review and after full consideration we are of the view that the framework of Centre-State Financial relations embodied in the Constitution has stood the test of time and has worked fairly and smoothly.

3. Our terms of reference are different from those of the earlier Commissions in one important respect. For the first time, the considerations set out in paragraph 5 of the Presidential Order are to be kept in mind while making recommendations in regard to sharing of taxes and also in the determination of grants-in-aid. For the earlier Commissions, similar "considerations" were applicable only when the Commissions were determining the amounts of grants-in-aid. A few of the States have brought up this point in their memoranda to us, and also in our discussions with them. In their view, the entitlement to shares of taxes should have nothing to do with the considerations

mentioned in paragraph 5 of the Presidential Order. Such a view would be difficult to sustain as we have to estimate the requirements of all the States uniformly within the Constitutional framework of Centre-State financial relations. The Commissions in the past had also in practice made their assessments of the revenue requirements of the States on uniform considerations. The change in our terms of reference compared to those of the earlier Commissions is, in a sense, a purely formal one, recognising the past practice. Further tax shares and grants-in-aid under article 275 have always been inextricably linked in the schemes of transfer of the past Commissions. Actually, grants under article 275 were determined and recommended for the purpose of making up the revenue requirements of the States to the extent that they had not been met by the tax shares.

4. Some of the States further contended that it was incorrect for the President i. e., the Government of India, to ask the Commission to keep in mind a set of stated "considerations" as in para 5 of the Presidential Order. The argument was that these were constraints on the Commission, which has to hold the balance between the Centre and the States and therefore the Central Government ought not to indicate what considerations should be kept in mind by the Commission. This view would have some validity if the considerations set out in the Order were in fact constraints, or prescribed procedures which were not already inherent in the established practice. For instance quite clearly any Commission has to keep in mind the essential demands on the Centre's resources. It is also a well-established practice by now that the Finance Commissions refrain from considering the financing of the Central and State Plans. These are the matters referred to in clauses (i) and (ii) of para 5 of the Presidential Order. The rest of the clauses of this paragraph, except clause (vi), refer specifically to a number of items covering both the receipts and the expenditure on revenue account, which any Commission necessarily has to take into account. The Commission's freedom to take into account other factors is not inhibited. The only special feature in paragraph 5 is clause (vi) which asks the Commission to take into account the requirement of backward States for upgrading standards of administration in non-developmental sectors and services. The developmental area is excluded as being in the domain of the Planning Commission. The clause is in consonance with the widely accepted thesis that regional imbalances should be mitigated and redressed to the extent possible. It is, therefore, reasonable to take the view, which in fact we have taken, that the contents of paragraph 5 of the Presidential Order were not constraints on the Commission in any way.

5. We have given attention to the principles which should govern the grants-in-aid of the revenues of the States under Article 275. A set of principles was adopted by the first Commission. These were broadly endorsed by subsequent Commissions. Some of those principles were more in the nature of guidelines for the internal work in the Commissions in the matter of the re-assessment of the revenue forecasts of the States. Some related to areas which have since then become clearly established as being within the purview of the Planning Commission. The later Finance Commissions also had serious difficulties in the application of some of these principles, for instance, measurement of the effects of economy and efficiency in expenditure, or assessment of the comparative tax efforts of the States. In the present circumstances we believe that the following should be the principles for grants-in-aid under Article 275 :-

- (a) Grants-in-aid may, in the first place, be given to States to enable them to cover fiscal gaps, if any are left after devolution of taxes and duties, so as to enable them to maintain the levels of existing services in the manner considered desirable by us and built in their revenue forecasts. In this connection consideration should

be given to the tax effort made by the individual States in relation to targets for the Plan, to economy in expenditure consistent with efficiency and to prudent management of public sector enterprises.

- (b) Grants-in-aid may be made as correctives intended to narrow, as far as possible, disparities in the availability of various administrative and social services between the developed and the less developed States, the object being that every citizen, irrespective of the State boundaries within which he lives, is provided with certain basic national minimum standards of such services. While the long term objective may be to provide to each citizen these services at the levels obtaining in the most advanced States, due regard should be had to the feasibility of upgrading these standards in the shorter term.
- (c) Grants-in-aid may also be given to individual States to enable them to meet special burdens on their finances because of their peculiar circumstances or matters of national concern.

6. In the course of our work we have taken into account the tax effort of the States and the returns which prudent management of public enterprises should fetch to the State Governments. We have also projected expenditure requirements on the revenue account in such a manner as to induce States to improve efficiency and to regulate expenditure carefully. While providing for upgradation of emoluments, we have gone by objective tests and discounted larger expenditure which some of the States had proposed. In the matter of narrowing disparities in the standards of services between the less developed and the advanced States, we have decided that the required amounts should be provided by way of specific grants-in-aid. We have taken prohibition as a national policy, and are recommending grants from the Centre to states to cover losses of excise revenue. We have also recommended that the net interest liability devolving on the States in each year for the period covered by our Report on account of their fresh borrowings and lendings should be made good by grants to be calculated and paid by the Central Government.

7. At this stage we might deal with the point often made about the erosion in the importance of the Finance Commission, which is a body under the Constitution, in the total picture of Central Government transfers to the States. The criticism generally is that the transfers effected by the Finance Commissions have amounted only to about one-third of the total fiscal transfers from the Centre to the States. Appendix IV. 1(i) to (iv) show respectively the total transfers from the Centre to the States from 1951-52 to 1978-79, the transfers during the same period on the recommendations of the Finance Commissions, the transfers under the Plans by way of assistance for State Plans as well as in pursuance of Central and Centrally sponsored Plan schemes and other Central transfers. The Central Government's investments in its own projects in different States are not included in these figures. The point usually made is that the "other transfers" from the Centre to the States, which are discretionary, are unduly large and in fairness to all the States their magnitude should be reduced. The suggestion is that the Finance Commission should deal with more of the transfers now being effected by the Centre at its discretion. Some of the States have stressed this point as being particularly important in the present situation where the governments at the Centre and in the States are of differing political complexions.

8. These transfers include ways and means advances to the States and short-term loans for agricultural inputs which in the period 1974-79 account for Rs. 1288 crores out of the total transfers of Rs. 3761 crores. These temporary advances should properly be excluded for the purpose of counting the Centre's discretionary transfers, as they are normally recovered in the same year or the next. Small savings loans account for Rs. 441

crores in the same period. There are other items of Central transfers which are also made in accordance with uniform policies and procedures applicable to all States. However, there have been significant transfers from the Centre in the years 1969-74 and in 1974-79 which have been made to particular States in order to improve their resource position. In many cases the deterioration in the resource position of these States has probably resulted from their own decisions and actions. The loans in the first period to clear overdrafts, and again in 1978-79 to restore a degree of balance in the accounts of the States with the Reserve Bank, are of this nature. One might hold the view that these transfers to some States, in a sense, discriminate against States which manage their affairs well on their own and reward relatively weaker fiscal management of some other States. These transfers also supplement Finance Commission and Planning Commission transfers, in a manner not envisaged in the Report of the Finance Commission or by the N.D.C. However, one should also note that in part at least the deterioration of the financial position of some of the States which were given such special loans could have been due to unforeseen deviation from the assessment of the requirements of these States by the Finance Commissions.

9. Turning now to the transfers under the auspices of the Planning Commission, the Central Assistance for the State Plans is in accordance with a formula settled in the National Development Council in which all the States participate. The Centrally-sponsored Plan schemes are generally in the fields of responsibility assigned to the States or in the Concurrent List. In recent years there has been, as we understand, some blurring of the lines between the Central sector and the Centrally-sponsored Plan schemes. The scope of these schemes is currently being reviewed by the National Development Council.

10. Whatever may have been the position in the past in the matter of the size of discretionary Central transfers, the freedom of a Finance Commission to evolve its own scheme of transfer for the period covered by its Report is in no way limited. The only constraints on it are firstly, that it has to operate within the four corners of the constitutional provisions and secondly, that it should leave the area of Plan investments and Central assistance for State Plans to the Planning Commission. The latter is not in any real sense a constraint on the Finance Commission. The Central assistance for State Plans is not decided independently of the situation of the State resulting from the Finance Commission awards, for, to the extent that the States' resources are improved vis-a-vis their requirements for their Plans, the proportion of Central assistance for the Plan in the total transfer can be smaller.

11. In any discussion of Centre-State financial relations, it is necessary to bear in mind that there is not only the question of the manner and the amounts of the transfer of financial resources from the Centre to the States, but also what the efforts of the States themselves are to raise resources. Taking the States as a whole, their total tax revenue amounted to Rs. 445 crores in 1960-61, Rs. 1528 crores in 1970-71 and Rs. 2305 crores in 1973-74. The corresponding figures for 1977-78 R. E. and 1978-79 B. E. are Rs. 4316 crores and Rs. 4601 crores. The following table shows the percentage of the States' own tax revenues to the total tax revenue of the Centre and the States together from 1968-69 onwards:

Years	Total Tax Revenue (Centre & States)	(Amounts Rs. Crores)			
		Centre's tax Revenue		States' tax Revenue	
		Amount	% to total	Amount	% to total
1968-69	3735.98	2509.84	67.18	1226.14	32.82
1969-70	4185.30	2823.07	67.45	1362.23	32.55

(Amounts Rs. Crores)

Years	Total Tax Revenue (Centre & States)	Centre's tax Revenue		States' tax Revenue	
		Amount	% to total	Amount	% to total
1970-71	4734.55	3206.80	67.73	1527.85	32.27
1971-72	5567.72	3872.44	69.55	1695.28	30.45
1972-73	6438.18	4509.70	70.05	1928.48	29.95
1973-74	7378.75	5073.38	68.76	2305.37	31.24
1974-75	9202.32	6321.75	68.70	2880.57	31.30
1975-76	11164.51	7608.78	68.15	3555.73	31.85
1976-77	12313.49	8270.84	67.17	4042.65	32.83
1977-78 (R.E.)	13221.67	8906.04	67.36	4315.63	32.64
1978-79 (B.E.)	14654.09	10052.76	68.60	4601.33	31.40

It is interesting that the percentage of the tax revenues of the States to the total of the tax revenues of the Centre and the States has remained around 31 to 33 per cent except in 1972-73. This indicates that in the matter of additional resource mobilisation the States as a whole have not lagged behind the Central Government and the performance of the States has been on the whole creditable.

12. The performance of the individual States in this regard, however, has not been uniform. The table below sets out index numbers for each State, taking the tax revenues in 1976-77:

<u>States</u>	<u>Indexed with base 1960-61 as 100</u>
1. Andhra Pradesh	853
2. Assam	515
3. Bihar	667
4. Gujarat	1415
5. Haryana	398(1968-69 = 100)
6. Himachal Pradesh	227(1971-72 = 100)
7. Jammu and Kashmir	899
8. Karnataka	1103
9. Kerala	925
10. Madhya Pradesh	916
11. Maharashtra	1058
12. Manipur	266(1970-71 = 100)
13. Meghalaya	2480 (- do -)
14. Nagaland	1421(1965-66 = 100)
15. Orissa	946
16. Punjab	787
17. Rajasthan	837
18. Tamil Nadu	870
19. Tripura	961
20. Uttar Pradesh	791
21. West Bengal	615

The uneven nature of the resource efforts of the different States can be clearly seen. These figures, however, do not necessarily reflect upon the adequacy or otherwise

would in part be due to varying rates of growth of incomes and prices in different States. Partly, it would arise from varying efforts at mobilising additional resources, tax concessions and withdrawals, and the efficiency in collecting taxes.

13. Appendix IV.2(i) shows the tax revenues of the States from 1960-61 onwards. Appendix IV.2(ii) shows the changes in the pattern of taxation in the States in terms of the percentage share of major taxes in the total tax revenue.

14. In the analysis made above we have not taken into account the revenues of local bodies and their efforts to raise their own resources. Properly speaking, it would be necessary to take into account the efforts of local bodies in each State to raise their own resources, while making comparisons of the tax efforts of the States. We have given in Appendix IV.3 for illustrative purposes, the per capita tax of the State Governments and their urban local bodies taken together for 1975-76, using the figures obtained in the exercise done by the Town and Country Planning Organisation referred to later. It is evident that there are wide divergences between the States in the matter of the resource efforts of the local bodies.

15. We had requested the States to furnish information to us on the local bodies' own resources and transfers made to them by the States, as well as their expenditure on selected services. The information we have received is shown in Appendices IV.4(i) and (ii). At our request the Town and Country Planning Organisation of the Ministry of Works and Housing of the Central Government had also collected and analysed the receipts and expenditure of urban local bodies in all the States. The results of this exercise together with a note of the Town and Country Planning Organisation may be seen in Appendices IV.5(i) and (ii). There are discrepancies between the information from the State Governments and that collected by the Town and Country Planning Organisation, which we are unable to reconcile.

16. It is a matter of disappointment to us that in many States the arrangements for a continuous study and review of the finances and expenditure of local bodies are apparently inadequate. The Sixth Commission had drawn attention to this matter and had hoped that State Governments would take remedial steps. We would like to repeat this suggestion. We had hoped to be able to make a study of local body revenues and expenditure in depth, but this has not been possible for want of complete and comparable information from all the States. We trust that the State Governments as well as research institutions would pay increasing attention to the subject of local body finances.

17. The general concern over the widening disparities in the levels of development among the States is reflected in the criticism of the existing arrangements for ordering of Centre-State financial relations. The Finance Commission and the Planning Commission together determine bulk of the transfers from the Centre to the States, and also have the largest influence on the fiscal capacity of the State to build up and maintain an adequate administrative infrastructure and to invest in development. It could be argued that since the spheres of responsibilities of the two Commissions are different, the Finance Commission could be neutral to the philosophy and requirements of development Plans. It may also be argued that if anyone is to be blamed at the national level for the widening economic disparities between the States, it should be the Planning Commission. Such a view would be untenable as it ignores the intimate relationship between the results of what each Commission does. The developmental process guided and supported by the Planning Commission should result in reduction of economic disparities between the States, and in the poorer States building up their resource potential which the Finance

Commission would take into account at the end of a Plan period. On the other hand, the Finance Commission's transfers should provide the financial wherewithal for the States to maintain and develop an adequate administrative infra-structure, which is responsive to the increasing demands that a developing economy generates. Also, there is no denying that the implementation of development Plans would itself suffer in the absence of such an infrastructure. Further, a Finance Commission's scheme of transfers which leaves a few States with substantial surpluses on revenue account which can be ploughed back into fresh investments, and the rest of the States with a zero surplus, could contribute to widening of the economic disparities.

18. Our focus should therefore be specifically on how to place the financially weaker States in a position from where, with the guidance of the Planning Commission, they could get a better start than has been the case in the past, in absolute terms as well as relative to the advanced States. There is no other way of achieving this objective than to ensure that our fiscal transfer scheme leaves as many of the poorer States as possible with surpluses on the revenue account, which could be ploughed back for fresh development. In our view the role of a Finance Commission should not be negative, of filling in the revenue gaps only, but positive in that its scheme of devolution gives a better start for developmental outlay.

19. The States have stressed the point that the fiscal transfer should be effected mainly, if not wholly, through devolution of taxes. Even the poorer States have urged, as they had before the earlier Commission, that the transfer should be made by way of tax shares rather than grants-in-aid. This would obviously help them a little more than if the grants constituted the bulk of the transfer to them, since they would then be able to share the benefits of buoyancy in the tax receipts of the Centre and of additional taxes raised by it. We are clearly of the view that the grants-in-aid element in the transfer scheme should as far as possible be a residual item and the attempt should be to make the bulk of the transfers through tax shares.

20. We have dealt with the determination of the shares of the States in all items of Central taxes excepting income tax and Union excise duties, and now turn to the principles for the distribution of the shares of the States in the proceeds of these taxes. The sharing of income tax with the States is mandatory under Article 270 of the Constitution. The sharing of Union excise duties with the States is permissible under Article 272. Over the years the revenue from the latter has come to dominate not only the Central revenues but also the statutory transfers to the States. It is, therefore, not possible to conceive of a scheme of fiscal transfer from the Centre to the States which does not provide for sharing of Union Excise Duties.

21. Since the Constitution distinguishes between the two taxes, we have to determine separately the shares of the States in income tax and in excise duties and the principles of distribution thereof among the States. Also not many States have proposed or countenanced the theory that there need be no distinction in this matter between income tax and Union excise duties or that identical principles of distribution could be adopted for both.

22. Most States have pressed for the size of the divisible pool of income tax being raised from the level of 80 per cent determined by the Sixth Commission. In support, they have referred to the fact that the Central Government has recently raised the Union Surcharge to 15 per cent from the earlier level of 10 per cent simply as a revenue measure rather than for meeting any specific Union purposes. In the view of the States, as also of some others, this step in effect deprives the States of a share in the increased

revenue from income tax and surcharge taken together. It has also been pointed out that the basic tax and the surcharge are substitutable. We feel that though Article 271 does not in express terms lay down that the Union surcharge should be for meeting the burdens of the Centre arising from any emergent requirements, there is an underlying assumption that a surcharge should only be levied for meeting the requirements of some unexpected events and should only be for the period during which it lasts. In this view a surcharge continued indefinitely could well be called an additional income tax, shareable with the rest of the proceeds of income tax. We have, however, refrained from suggesting such a course in view of the express provision in the Constitution. We feel, though, that it would be necessary and proper to give weight to the strong feelings of the States on this subject by increasing the size of the divisible pool. Accordingly we recommend that in the period covered by our report, 85 per cent of the net proceeds of income tax, excepting in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, shall be assigned to the States excluding Sikkim, where the tax is not leviable at present. This would mean in effect that out of the total net collections of income-tax excluding the Union surcharge, 20.22 per cent, or about Rs.1214 crores in the five year period, would remain with the Centre.

23. Traditionally, in the distribution of income tax shares among the States inter se, a weight has been given to the contribution to income tax revenues from each State. One of the earlier Commissions had observed, and this is valid even today, that after the amendment of the Income Tax law in 1959 which had the effect of shifting a large part of income tax on companies to the category of corporation tax, what may be termed incomes of local origin in each State contribute significantly towards the income tax revenues from that State. It would also be probably true to say that the income tax on emoluments of State employees would be in the same category. In view of such considerations, we have decided that ten per cent of the divisible pool of income tax should be distributed among States in the same proportion of their contribution to the income tax revenue. A smaller proportion is likely to be unacceptable to the States which contribute significantly to income tax revenue. A larger proportion would set a trend in the wrong direction, considering the fact that the larger collections of the revenue come from the advanced States, and the effect of a larger weightage to contribution would tend against the objective proposed for our fiscal transfer scheme. For the purpose of determining the proportions of the contribution of the States to the income tax revenue, we have decided to adopt, like the last two Commissions, the State-wise proportions of net assessments, taking the years 1972-73 to 1976-77. We have obtained information from the Union Ministry of Finance for this purpose, which is shown in Appendix IV.6.

24. For the rest of the divisible pool of income tax, the tradition has been to distribute it in the population ratio of States. This is based on the theory that population is what the first Commission called a broad measure of the needs of the States. In the context of the relations between the Centre and the States, it is difficult in our view, to discount the population factor. When population is used as a factor in the determination of the tax shares, it is a recognition of an element in the relations between the Centre and the States and between the States inter se, which is difficult to replace. Traditionally, this has been accepted as a factor in the determination of the shares of the States in the proceeds of income tax, and to discount the weight given to this factor so far may well be taken as a derogation of the importance of some at least of the States in the Union. Any substitution of the population factor by others, in our present context, would mean the introduction of criteria like levels of development which, in any case, have now come to be accepted as part of schemes for distribution of the proceeds of excise duties. A weight to factors such as levels of development in the case of income tax is unlikely to be acceptable to the developed States. We have accordingly decided that 90 per cent of the net proceeds of income tax shareable with the States should be distributed among them in the population ratio.

Dr. C. H. Hanumantha Rao also feels that the principles for the distribution of the divisible pool of income tax among the States should be the same as in the case of excise duties. However, in view of the decision of the Commission to give a significant weight-age to factors in favour of the less developed States in the distribution of the much enlarged divisible pool of excise duties he concurs with the overall recommendations in this Chapter.

25. Though at the moment income tax is not leviable in Sikkim, we have to provide for distribution of a share to Sikkim in case the levy is extended to that State in the period covered by our Report. We have accordingly worked out the shares of the States in the net proceeds of income tax, including Sikkim and excluding it. For this purpose, we are obviously not in a position to make an estimate of its share in the portion of the net proceeds of the tax distributed in proportion to contribution.

26. We have determined the proceeds attributable to Union territories on the same principles as we have adopted for the States, as 2.19 per cent.

27. We accordingly recommend, in respect of distribution of the net proceeds of income tax in each of the years 1979-80 to 1983-84 that -

- (a) Out of the net proceeds in each financial year, a sum equal to 2.19 per cent thereof shall be deemed to represent the proceeds attributable to Union territories,
- (b) The percentage of the net proceeds, except the portion representing the proceeds attributable to Union territories, to be assigned to the States, should be 85, and
- (c) The distribution among the States inter se of the share assigned to the States in respect of each financial year should be on the basis of the following percentages:-

<u>States</u>	<u>Percentage with Sikkim</u>	<u>Percentage without Sikkim</u>
1. Andhra Pradesh	8.021	8.023
2. Assam	2.521	2.522
3. Bihar	9.536	9.540
4. Gujarat	5.957	5.959
5. Haryana	1.819	1.819
6. Himachal Pradesh	0.595	0.595
7. Jammu and Kashmir	0.818	0.818
8. Karnataka	5.440	5.442
9. Kerala	3.948	3.950
10. Madhya Pradesh	7.354	7.356
11. Maharashtra	10.949	10.953
12. Manipur	0.188	0.188
13. Meghalaya	0.178	0.178
14. Nagaland	0.085	0.085
15. Orissa	3.738	3.739
16. Punjab	2.713	2.714
17. Rajasthan	4.362	4.364
18. Sikkim	0.035	..
19. Tamil Nadu	8.048	8.050
20. Tripura	0.258	0.258
21. Uttar Pradesh	15.422	15.429
22. West Bengal	8.015	8.018
All States	<u>100.00</u>	<u>100.00</u>

28. We have already spelt out our objective of ensuring that the results of our fiscal transfer scheme should place as many of the less affluent States as possible in surplus on the revenue account. We are doing so by a combination of two related aspects of the sharing of proceeds of excise duties with the States, namely, the size of the divisible pool and the principles for its distribution. At this stage we may refer to a demand made by two States, namely, West Bengal and Tripura, that 75 per cent of the Central revenues should be shared with the States. From the memoranda of these States we are not able to make out how this percentage has been arrived at and how it has been estimated by them that the balance of the Central revenues would be adequate for meeting the inescapable expenditure of the Central Government. The West Bengal memorandum does not spell out the views of the State Government on the principles of the distribution of proceeds of income tax and excise among the States. Therefore, it does not appear that the State's demand for 75 per cent of the Central revenue for the States is based on any estimation of the needs of the States vis-a-vis the needs of the Centre. Nor can we appreciate how such a demand is in consonance with the provisions of the Constitution. We are unable to agree with their approach.

29. We have a special feature of the Union excise duties to deal with. In its last Budget, the Central Government has levied an excise duty on generation of electricity. The State Governments had been pressing for the withdrawal of the levy or, in the alternative, for the transfer to them of the entire net proceeds. They had not only moved the Central Government on these lines, but many of them had also made similar representations to us in the course of our discussions with them. We have now been informed by the Union Ministry of Finance that the Central Government has decided that the entire non-shareable portion of the net proceeds of the excise duty on generation of electricity would be transferred to the States, with effect from 1st April 1979, subject to the levy continuing to be in force beyond that date. The Union Ministry of Finance has also furnished its estimates of the revenue expected to be collected in each State in each of the years covered by our Report. Their communications may be seen in Appendix IV. 7.

30. We are wholly in agreement with the approach of the Central Government that the net proceeds of the revenue from this duty should be given back to the States in which they are realised. We have decided accordingly to recommend that the entire collections of revenue from this duty attributable to each State, net of cost of collection, in each year of the period covered by our Report, should be transferred to that State. We have taken note of the manner of attributing to States the net proceeds in certain cases, as indicated by the Union Ministry of Finance in their communications cited above. In case the Central Government gives up the levy of this excise duty, from that year onwards the States should be in a position to obtain resources, equivalent to their shares of the proceeds of the excise duty, through adjustments in their electricity duties or in the electricity tariffs.

31. Considering their size, the Union excise revenues must have a predominant role in the transfer of financial resources to the States. We have also decided, as mentioned earlier, that the bulk of the fiscal transfers to the States should be by way of tax shares, reducing the element of grants-in-aid under Article 275 to a residual position on the one hand and leaving surpluses on revenue account with as large a number of States as possible on the other. In regard to the Centre, we have to ensure that after the fiscal transfers we propose, it is left in a sufficiently comfortable position to meet all the demands on its resources. In this connection we have taken note of the existing methods of financing the Plan, which include not only transfers to the States by way of Central assistance for their Plans, but also the possible requirements for budget support to the Centre's own Plans

and the Plans of the Union Territories. Keeping these considerations in mind we recommend that the divisible pool of Union excise duties should be 40 per cent of the net proceeds of excise duties, as clarified hereafter, collected on all commodities in any year, excluding the net proceeds of the duty on generation of electricity. The net proceeds should include the proceeds from all Union excise duties excluding additional duties of excise in lieu of sales tax which we have separately dealt with and cesses levied under special Acts and earmarked for special purposes, but including other excise duties whether they are designated special or regulatory or by any other name. We do not also take into account the proceeds of the Additional Duties of Excise on certain textiles and textile articles levied under Ordinance No. 4 of 1978 promulgated by the President. Section 4(2) of the Ordinance lays down that the proceeds shall not be distributed among the States.

32. A large number of States have urged us to recommend that the revenues of the Central Government from the corporation tax should also be shareable with the States in the same manner as income tax. They have pointed out that the amendment in the Income Tax Law carried out by the Central Government in 1959 had the effect of transferring to the category of corporation tax a sizeable part of the revenue which was part of income tax till then. We are not commenting on this issue, as different views may well be held on it. The States have also pointed out that thereafter the revenues from the corporation tax have increased enormously, and much faster than income tax. Further, some States have made out that they have to incur large expenditures in order to provide the infrastructure and other services which sustain the businesses paying corporation tax. The States have also pointed out that if the corporation tax were made shareable with the States, the interest of the Centre need not be adversely affected, for the share of the States in the income tax could be suitably reduced. Their anxiety generally is that they should have the scope for sharing in an item of revenue which is much more buoyant than income tax and is bound to grow in future as it has in the past. Even if we sympathise with the point of view of the States, we are unable to make any specific recommendation on this matter since the Constitution is categorical that the corporation tax revenues are not shareable with the States. We can only suggest, in view of the strong representations made by the States to us as well as to the earlier Commission, that the Central Government may consider holding consultations with the States in order to settle the point finally.

33. We now turn to the principles of distribution of the shares of the States in the net proceeds of excise. It is now well established that the distribution of the net proceeds of excise duties among the States is used by the Finance Commissions to make their contribution to the reduction of imbalances among the States. We have already referred to the growing concern in the country over the widening economic disparities between the States. It is true that the reasons are not only to be found in the financial strength of weakness of the States, but also in cultural and institutional factors which could facilitate or retard economic growth. Some of these important factors are susceptible to being changed by Government action if there is a will to do so. Notwithstanding such considerations, there is no doubt that financial strength would be a decisive influence in favour of growth. It is axiomatic that the potential for mobilising financial resources is not the same in States which have different levels of development and domestic product. This also means that the people in the poorer States do not have the same opportunities for advancement and the same access to public services as those in the advanced States. Annexure VII.3 shows the average per capita SDP at current prices of each State for the 3 years 1960-61 to 1962-63 compared with the 3-year averages for 1973-74 to 1975-76. There has hardly been any change in

the relative ranks of the States in the two periods. In fact, the position of Bihar, Andhra Pradesh, Assam, Madhya Pradesh and Uttar Pradesh has worsened. Appendix IV. 8 shows the variations in the total of Plan and non-Plan expenditure in the different States, taking the average annual expenditure for the years 1961-64 and 1974-77. In the first period the difference between the highest and the lowest per capita expenditure was Rs. 77. 07, while in the later period the difference had widened to Rs. 183. 16.

34. The Finance Commissions in the past have distributed some part of the proceeds of excise duties on the basis of relative backwardness of States. Each Commission had evolved its own method of assessing their relative backwardness. Since the proportion of the net proceeds of excise distributed on this principle was not large, the contribution which the past Commissions made towards reduction of inter-State imbalance was modest. We have already indicated that our aim is to do more in this direction. We propose to do so by a combination of different measures. Population, as a determinant of the shares of States in divisible taxes is merely a scale factor. Therefore, appropriate factors other than this factor have to be built into the scheme of distribution of the proceeds of excise to realise the basic objective of our scheme of fiscal transfer.

35. As regards the indicators of levels of development of States, we think that, for our purposes, it would be desirable to adopt the overall indicators of backwardness such as per capita income and the proportion of people below the poverty line, instead of partial indicators such as the level of schooling, health services, road mileage, etc. Partial indicators reflect very much the particular pattern of allocation of resources by different States. It is possible that a State which has the necessary resource potential may neglect certain sectors, whereas even a less developed State lacking in resources may show more than average performance in respect of certain services. Besides, construction of an overall index of backwardness or level of development on the basis of individual or partial indicators is beset with the problem of relative weights to be assigned to these indicators. Any set of such weights decided a priori or on the basis of factor analysis is bound to be highly arbitrary.

While it is true that as between States with the same per capita income level, the proportion of people below the poverty line may differ depending on the way the resources have been allocated and on policies followed for the reduction of poverty by different States, it should be recognised that the poverty problem of some States is partly the result of special factors on which the governments concerned have little control. We have, therefore, decided to give some weight to this factor with a view to take account of such special factors.

36. Another factor which we have taken into account is directly related to the primary concern of a Finance Commission with the fiscal needs of States and their potential to raise their own resources. We have noted earlier that the revenue-raising potential is not the same in all the States.

37. In the light of these considerations, we have decided that the shares of the States in the divisible pool of excise should be determined giving equal weight to the population factor, the inverse of the per capita State Domestic Product, the percentage of the poor in each State measures by a method which Prof. Raj Krishna has evolved for us, and a formula of revenue equalisation which we have worked out. Each of these principles should be given equal weight of 25% to determine the shares of the States in the divisible pool. On full consideration we have come to the conclusion that by adopting such multiple criteria for the distribution of the pool of excise revenue among States,

instead of on the basis of any single criterion of backwardness, we would be reducing the chance of the formula becoming either unduly favourable to certain States or working harshly against some others.

38. We have used the per capita State Domestic Product in a comparable series at State current prices which has been worked out for us by the Central Statistical Organisation. We have adopted the annual average for the triennial 1973-76. The poverty percentage in each State is the proportion of people below an augmented poverty line in the State to the aggregate poor population in all the States. The augmented poverty line is the minimum per capita consumption expenditure level for 1970-71 on the well-known Dandekar-Rath criterion plus the State budget expenditure per capita in that year on selected public services directed towards the welfare and security of the citizens. A note setting out the methodology and the poverty percentages of each State may be seen at Appendix IV. 9. We are conscious that the estimates of 1970-71 are somewhat outdated but we believe that this should not make any material difference for our purpose in the light of general experience that the incidence and distribution of poverty have not changed significantly in recent years.

39. The revenue equalisation principle we have adopted is a recognition of the fact that States which are less favourably placed in regard to their resource potential should be specially helped in order to place them in a position where they can also take steps more readily for the betterment of the people living in those States. We have computed the per capita revenue potential of each State with reference to the average per capita SDP for the triennium 1973-76. The per capita average of each State's own tax and non-tax revenue for 1975-76 and 1976-77, obtained from the Accounts, were regressed on the average per capita income, excluding the five atypical States of Manipur, Meghalaya, Nagaland, Sikkim and Tripura. We thus derived the estimated values of per capita revenue of each State. The distance of the per capita revenue thus estimated for each State from the maximum estimated per capita revenue among all the States - that of Punjab - has been multiplied by the estimated population of the State as on 1st March 1976 obtained from the Registrar General. For the atypical States their own average per capita revenue for the years 1975-76 and 1976-77 has been adopted. The percentage of the product of the distance of the per capita revenue so estimated from that of Punjab and the population for each State in the total of these products for all the States gives us the share of each State in the 25 per cent component of the divisible pool of excise. In the process described, it will be noted that if a State has been lacking in effort to raise resources compatible with its resource potential, it will not be rewarded. Nor is any State penalised which has raised resources in excess of the estimated revenue consistent with its resource potential.

40. We have worked out the relative shares of all the States in terms of percentages in accordance with the principles we have adopted. At present Union duties of excise are not leviable in Sikkim and that State is therefore not entitled to a share in the net proceeds of these duties. We should, however, provide for a share for that State in case the duties become leviable in it within the period covered by our Report. We have accordingly worked out, on the same principles as for the other States, the percentage shares for Sikkim as well as the other States. These should become operative if and when Union duties of excise are levied in Sikkim.

41. We thus recommend that during each of years 1979-80 to 1983-84 -

(a) the entire net proceeds of the Union excise duty on generation of electricity

should be paid out of the Consolidated Fund of India to each State in an amount equal to the collection in or attributable to that State; and

- (b) out of the balance of the net proceeds of the Union excise duties levied and collected on all other articles excluding cesses levied under special Acts and earmarked for special purposes, forty per cent should be paid out of the Consolidated Fund of India to the States and distributed among the States on the basis of the following percentages:-

State	Percentages	
	Excluding Sikkim	Including Sikkim
1. Andhra Pradesh	7.698	7.691
2. Assam	2.793	2.793
3. Bihar	13.025	13.021
4. Gujarat	4.103	4.101
5. Haryana	1.177	1.177
6. Himachal Pradesh	0.521	0.521
7. Jammu & Kashmir	0.839	0.839
8. Karnataka	4.877	4.876
9. Kerala	4.036	4.035
10. Madhya Pradesh	8.727	8.725
11. Maharashtra	6.633	6.632
12. Manipur	0.218	0.218
13. Meghalaya	0.200	0.200
14. Nagaland	0.097	0.097
15. Orissa	4.682	4.682
16. Punjab	1.226	1.226
17. Rajasthan	4.813	4.813
18. Sikkim	-	0.028
19. Tamil Nadu	7.641	7.637
20. Tripura	0.373	0.373
21. Uttar Pradesh	18.293	18.290
22. West Bengal	8.028	8.025

42. The net surplus or deficit situation of each State on revenue account as re-assessed by us, and the position emerging as a result of our scheme of fiscal transfers are shown in the following Table:-

STATES	Non Plan Revenue Surplus (+) Deficit (-) Without Devolution	Revenue Deficit after Devolution of revenues	Revenue Surplus after Devolution of revenues
1. Andhra Pradesh	(-) 579.79	..	923.18
2. Assam	(-) 410.12	..	86.82
3. Bihar	(-) 1057.53	..	1092.32
4. Gujarat	(+) 164.12	..	1127.99
5. Haryana	(+) 370.06	..	678.63
6. Himachal Pradesh	(-) 317.33	207.07	...
7. Jammu & Kashmir	(-) 358.61	199.56	..

STATES	Non Plan Revenue	Revenue	Revenue
	Surplus (+) Deficit (-) Without Devolution	Deficit after Devolution of revenues	Surplus after Devolution of revenues
8. Karnataka	(+) 1.15	..	1006.15
9. Kerala	(-) 531.11	..	235.05
10. Madhya Pradesh	(-) 422.63	..	1111.25
11. Maharashtra	(+)1290.70	..	3004.75
12. Manipur	(-) 184.08	146.32	..
13. Meghalaya	(-) 129.29	92.61	..
14. Nagaland	(-) 236.26	218.35	..
15. Orissa	(-) 952.19	136.92	..
16. Punjab	(+) 389.97	..	809.50
17. Rajasthan	(-) 663.24	..	220.28
18. Sikkim	(-) 36.20	35.72	..
19. Tamil Nadu	(-) 849.00	..	627.39
20. Tripura	(-) 196.23	136.57	..
21. Uttar Pradesh	(-)1258.86	..	1943.86
22. West Bengal	(-) 857.33	..	715.27
<u>TOTAL</u>	(-)9039.80	<u>1173.12</u>	<u>13582.37</u>
	(+)2216.00		
<u>Net</u>	(-)6823.80		

1. Net surplus and deficits are shown without taking account of provisions recommended by us separately for upgradation of standards of administration.
2. Devolution of taxes and duties refers to Income tax, Union duties of excise, Additional duties of excise and grant in lieu of tax on railway passenger fares.

43. Eight States have gaps left on the revenue account. We recommend that grants-in-aid of the revenues of each of these States equivalent to the amount of the deficit on the revenue account should be charged on the Consolidated Fund of India and paid in each year of the period covered by our Report, as shown in the following table:-

STATES	Total amount to be paid in the five years.	(Rs. crores)				
		Grants-in-aid to be paid in				
		1979-80	1980-81	1981-82	1982-83	1983-84
1. Himachal Pradesh	207.07	37.60	40.54	41.63	43.00	44.30
2. Jammu & Kashmir	199.56	41.06	40.82	39.20	39.40	39.08
3. Manipur	146.32	26.19	28.00	29.27	30.76	32.10
4. Meghalaya	92.61	16.97	17.67	18.44	19.48	20.05
5. Nagaland	218.35	38.29	41.34	43.65	46.48	48.59
6. Orissa	136.92	41.55	37.74	29.03	19.16	9.44
7. Sikkim	35.72	6.32	6.70	7.11	7.54	8.05
8. Tripura	136.57	24.36	25.75	27.29	28.85	30.32
<u>TOTAL</u>	<u>1173.12</u>	<u>232.34</u>	<u>238.56</u>	<u>235.62</u>	<u>234.67</u>	<u>231.93</u>

44. The total transfers to all States, recommended by us as shares of taxes and grants-in-aid including grants for upgradation of standards of administration, are 55 per cent of the total divisible tax receipts of the Central Government in the period covered by our report and 26 per cent of the total revenue receipts of the Central Government.

45. Prof. Raj Krishna has different views on some of the recommendations in this Chapter, which he has set out in his Note of Dissent appended to this Report.

46. We have recommended earlier that the Central Government should pay grants-in-aid under Article 275 in order to meet the losses in excise revenue which may result from steps taken by the States to introduce prohibition. We have also set out the manner in which such grants should be calculated by the Central Government. Besides, as we have mentioned elsewhere, we have not taken into account, while re-assessing the revenue forecasts of the States, any net interest liability arising out of their fresh borrowings and lendings in the period covered by our Report, since we are not in a position now to make reasonably accurate estimates. It is necessary that any such net interest liability which arises in any of the years covered by our Report, is covered by grants-in-aid under Article 275 equivalent to the amount of net liability in the case of the 8 States mentioned in paragraph 43 above. In the case of the other States, if in the period covered by our Report, the net interest liability on account of fresh borrowings and lendings exceeds the surplus on revenue account which we have estimated, such excess should be covered by grants-in-aid under Article 275. We consider that it would be helpful to the Central Government and to the States to specify the manner in which the net interest liability and the amounts of the grants-in-aid, if any, should be calculated by the Central Government. We accordingly recommend as follows:-

- (i) For the liability on account of payment of interest, all such borrowings during a year, as are according to the normal rules of classification brought to account under the Major Heads of Account '603' and '604', except the following items, should be taken into account at the rates of interest as are actually applicable to each such borrowing:
  - (a) overdrafts on the Reserve Bank of India;
  - (b) cash credit accommodations from the State Bank of India or other commercial banks for procurement of foodgrains, edible oils, other commodities of civil supplies, etc., in as much as the State Governments should recover the interest payable on such accommodations at the time of disposal of such commodities;
- (ii) where the whole or a part of such fresh borrowings in a year is repayable within the same year (e.g. loans for agricultural inputs), or in subsequent years within the period 1979-84 (e.g. block loans, as at present, for State Plans), the liability on account of interest in a year on such fresh borrowings should be computed with reference to the amount of the borrowings outstanding from time to time;
- (iii) gross interest liability of Assam on account of fresh borrowings from the Centre during 1979-84, as computed in accordance with (i) and (ii) above, should be reduced by Rs. 22 lakhs in 1980-81, Rs. 42 lakhs in 1981-82, Rs. 62 lakhs in 1982-83 and Rs. 79 lakhs in 1983-84. These amounts have been included in the assessment of the non-plan revenue expenditure of the State Government in the respective years, as interest liability on loans assumed by the Commission as likely to be received by the State from the Centre at the level of Rs. 4 crores each year towards the construction of the new capital of the State. If the loan in any year is different, a corresponding adjustment should be made;

- (iv) For computing receipts on account of interest on fresh lendings, whether for Plan or non-Plan purposes, by the State Governments, during each of the years from 1979-80 to 1983-84, a uniform rate of interest at 6 per cent per annum on the outstandings of all such fresh loans, brought to account under all the Major Heads of Account from '677' to '767', should be taken into account, except fresh loans to Government servants (Head 766) other than house building loans;
- (v) like the liability for payment of interest on fresh borrowings, interest receipts on fresh lendings should be computed, in the manner prescribed above, from year to year, on the outstanding amounts of such fresh lendings;
- (vi) the Accountant General of each State should be requested to intimate to the Ministry of Finance, by the middle of January in each year, the figures of actual borrowings, of different categories, of the State Government, brought to account under the Major Heads of Account '603' and '604', during the first 8 months from April to November of that financial year, as also the rate of interest and the terms of borrowings applicable in each case. Likewise, the figures of actual lendings, and the terms thereof, as well as fresh investments, referred to in (v) above, during the first 8 months of the year should be obtained from the Accountants General;
- (vii) on the basis of such actuals for the first 8 months of a year and the estimates, on best judgement, of further borrowings, lendings and investments during the last 4 months of a year, computations of the net interest liability on fresh lendings and borrowings should be made in relation to each of the years from 1979-80 to 1983-84;
- (viii) the additional grant-in-aid that, on such computation, may become due to a State Government, in respect of each financial year, should be paid by Presidential Order, before the close of that year, subject to final adjustments towards payment of arrears or recovery of excess payments, if any, in the following year in the light of the actual amounts and the terms of fresh borrowings, lendings and investments in that previous year; and
- (ix) following the computations made as above, the President should be moved to increase, to the extent required, the grants recommended by us under Article 275 of the Constitution to the 8 States mentioned in paragraph 43 above. In the case of the other States, the net interest liability computed should be set off against the surplus as assessed by us, and the net deficit, if any, should be given as grants-in-aid by Presidential Order under Article 275.

47. We would suggest that the Central Government should incorporate suitably every year in the Explanatory Memorandum on the Central Budget or in the Supplementary Demands as the case may be, the computations made as above and the grants payable towards the net interest liability. The State Governments concerned should also be kept informed of such computations.

CHAPTER 10UPGRADATION OF STANDARDS OF ADMINISTRATION

In accordance with sub-paragraph (vi) of paragraph 5 of the Presidential Order, the Commission has to have regard, among other considerations to:

" the requirements of States which are backward in general administration for upgradation of standards in non-developmental sectors and services with a view to bringing them to the levels obtaining in the more advanced States over the period covered by the Report of the Commission; the manner in which such expenditure could be monitored, being also indicated by the Commission."

2. The Sixth Finance Commission had allowed provisions to enable States which were backward in standards of general administration to improve the standards. That Commission was required to deal with this matter as one of a ten-year span, of which the first five years were the period covered by its Report. The financial provisions made by it for States were calculated so as to bring them up to the all-States' average of per capita expenditure on each of the various services regarded by that Commission as falling within the purview of the phrase "general administration" used in its terms of reference. We are, however, required to confine ourselves to providing for upgradation of standards of administration in non-developmental sectors and services. The period in which this upgradation of standards is to be attained is limited to the five years covered by our Report.

3. For an assessment of the existing standards and of the gaps between the backward and the more advanced States, we have decided to confine ourselves to the sectors and services which are the more important elements in the basic administrative infrastructure of government. In our view these would be the following:—

1. Administration of taxes.
2. Treasury and Accounts administration.
3. Judicial administration.
4. General administration, consisting of revenue, district as well as tribal administration, and the Secretariat services.
5. Police.
6. Jails.

Certain States have sought provisions to upgrade the administration in certain other fields like education, welfare of Scheduled Castes and Tribes etc., which do not in our view belong to the category of non-developmental sectors and services specified in our terms of reference, but rather to the Plan.

4. There is no doubt that, judged on various indicators, there are disparities in respect of the administrative infrastructure between the States, and there is a clear need to upgrade and improve the standards of administration in several States. The capabilities and efficiency of the administration have a significant bearing not only on the quality of public services rendered and the level of satisfaction of the citizenry, but also on the developmental situation in a State. We feel that administrative efficiency is not a function of finance alone, but depends very much on the priority accorded to the performance of basic administrative tasks by the State Governments themselves, their attention to improvements in organisational structures and methods of work, the capacity of the