FIRST A. D. SHROFF MEMORIAL LECTURE

FEDERAL FINANCIAL RELATIONS IN INDIA

K. SANTHANAM

FORUM OF FREE ENTERPRISE
SOHRAB HOUSE, 235, Dr. D. N. ROAD, BOMBAY - 1

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—Eugene Black

INTRODUCTORY PRESIDENTIAL REMARKS*

BY

MURARJI J. VAIDYA

Exactly a year ago, we lost our founder-president, Mr. A. D. Shroff. If the Forum of Free Enterprise is today a national institution, and it is recognised by all people, whether they agree with its views or not, that it is stimulating public thinking on economic problems, the entire credit is due to the vision and pioneering efforts and devotion to the cause of free enterprise of Mr. A. D. Shroff.

It is fitting that the Forum of Free Enterprise should commemorate the memory of the Founder-President by instituting an A. D. Shroff Memorial Lecture on his death anniversary every year.

A few months before he died, Mr. Shroff had expressed a desire that the Forum should organise a talk on the changing financial relations between the Union Government and the various States as he foresaw that this would have a great impact on the future of the economy and the democratic set-up of the country. Before a talk could be organised, Mr. Shroff died. It is in the fitness of things that his cherished desire be fulfilled by way of the First Memorial Lecture on "Federal Financial Relations in India".

The Union-&ate financial relations are nearly a century old in India. The first beginning of devolution of resources was introduced in 1870 during the regime of Lord Mayo. The basic principle underlying Union-State financial relations is that in regard to some of the major revenue-yielding taxes and also in the case of some other

* *The first A.D. Shroff Memorial Lecture at Bombay on October 27, 1966.*

taxes, where a country-wide uniformity of rates is desirable, the best authority for legislating and, in most cases, also of collecting, is the Union Government. Under this system, the Union Government is the agency for raising certain revenues for the benefit of both the Centre and the States and for distributing the proceeds between the Centre and the States and among the States themselves according to the principles and procedures laid down in the Constitution.

There are two bodies at present — (i) the Finance Commission, a statutory body appointed once in five years, and (ii) the Planning Commission, a non-statutory body — which make recommendations from time to time on the devolution of resources from the Centre to the States.

When the Constitution of India was adopted in 1950, there was no Five-Year Plan as at present. Though, from time to time, some State Governments have been stressing that Plan expenditure should be taken into account, this is not done and the Fourth Finance Commission had confined itself to non-Plan revenue expenditure, *vis a vis* revenue receipts anticipated in the coming five year period on the basis of taxation levels in 1965/66.

The Third Finance Commission had recommended grants under Article 275 to cover 75 per cent. of the States' revenue expenditure in the Third Plan but the Government did not accept this recommendation.

There is considerable force in the Minute of Dr. P. V. Rajamannar, Chairman of the Fourth Finance Commission, stressing the need for clearly defining the relative scope and functions of the two Commissions by amending the Constitution and making the Planning Commission a statutory body independent of Government.

The merger of sales tax with excise has often been stressed by leading Chambers of Commerce & Industry in the country. Because of opposition from the States, this has not been implemented. Dr. Rajamannar has suggested that this objection may be met by giving the States a larger

share of the receipts from the basic excise duties and any special duties of excise or surcharges on the duties. Business and industry are in favour of combining all kinds of taxation such as excise, sales tax, octroi, etc. The incidence should fall on the consumer at the last stage of purchase. There is a move for combining sales tax and octroi in Maharashtra which is no doubt very desirable. If the State Governments and local bodies co-operate like this, it should not be difficult for a similar co-operation and understanding to be arrived at between State Governments and the Central Government on a wider sphere for merger of all commodity taxes and equitable distribution of proceeds of the combined tax.

I make bold to say that there is no other person In the country more suited to give a talk on the subject than Mr. K. Santhanam. An eminent economist, he is not a mere theoretician. He has had the benefit of looking at the economy from the vantage point of a journalist and also as a minister. He was the Editor of "Indian Express" and "Hindustan Times" for a number of years. A distinguished Member of the Constituent Assembly, he was the Union Minister of State for Railways and Transport, Lieutenant-Governor of Vindhya Pradesh, and Chairman of the Second Finance Commission. Among his numerous contributions to the public life of the country, one must mention the excellent report which was brought out by the committee presided over by him, known as the Anti-Corruption Inquiry Committee.

Although he has retired from active politics today, he gives the benefit of his mature views to the public through articles in leading newspapers in the country. He is one of the few independent and fair-minded commentators on the Indian political and economic scene today.

FEDERAL FINANCIAL RELATIONS IN INDIA

BY

K. SANTHANAM

I consider it a great honour to be invited to deliver this first lecture instituted in memory of late Mr. A. D. Shroff. In my view, he was the ablest exponent of applied economics, i.e., economic theory applied to practical problems or, if you prefer it, practical economic problems treated in the light of fundamental laws and principles of economics. In 1949, when Mr. Gopalaswamy Ayyangar was the Cabinet Minister and myself the Minister of State in charge of the Ministry of Railways and Transport, one of the urgent problems we had to deal with was the rather chaotic situation relating to railway stores. There was no co-ordination between the purchase and utilisation of stores in the various Railways with the result that some Railways ordered for stores which were lying surplus in other Railways. Crores of rupees were thus unnecessarily locked up. As Mr. Ayyangar wanted to deal with the matter expeditiously, he decided to appoint a one-man committee and Mr. A. D. Shroff was the only person he could think of for the purpose. Fortunately, Mr. Shroff was able to undertake the work and he presented his report in a few months. His recommendations were so reasonable and practical that they were implemented fully and promptly. Since then, I always had a high regard for him and followed his speeches and writings carefully

I crave your indulgence for making a few observations regarding the work of the Forum of Free Enterprise under the auspices of which this lecture is being'delivered. A few weeks ago I reviewed a volume published recently containing the speeches and writings of Mr. Shroff during

the last ten years ("On Planning and Finance in India"). In many of them, he made it clear that the Forum of Free Enterprise was not advocating the uncontrolled capitalism of the nineteenth century based on the principles of *laissez faire*. He declared that such capitalism was dead as a dodo. In a modern society, every economic activity has to be regulated to some extent in public interest. According to his view, it is the new state capitalism masquerading in the name of socialism and public enterprise that was committing the mistakes of *laissez faire* capitalism. I wish only to point out that there is one fleld and only one in which there can be absolutely free enterprise which is the enterprise of free thought. I am glad to say that the Forum of Free Enterprise is trying to bring all persons who think freely and objectively on the same platform irrespective of their differences on particular economic or political issues.

The financial relations between the Centre and the Units are among the most difficult problems in a federation. In the older federations like the U.S.A., jurisdictions of the Centre and the Units were demarcated in all other aspects, but taxation was left as a concurrent subject. It was felt by the Constitution makers that it was difficult, if not impossible to foresee the requirements of either the Centre or the Units or the prospective yields of any particular source of taxation. Section 8 of Article 1 of the Constitution of United States says the Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare of the United States, but all duties, imposts and excises shall be uniform throughout the United States. By Section 10, the States are prohibited from imposing import or export duties. In all other respects, federal and State Governments have got full and concurrent powers of taxation and borrowing. The position in India is entirely different. In the Indian Constitution there is a long list of concurrent subjects, but it does not include any single source of taxation.

This vital distinction between the Indian and other federal systems is due to historical reasons. A summary of developments from a highly centralised system to the federal system embodied in the Government of India Act, 1935, is given in Chapter II of the Report of the first Finance Commission. From the point of view of political science, it is not easy to say that either system is superior to the other. For instance, in all federations where the income-tax is a concurrent subject, the complications introduced by simultaneous levy of income-tax on the same persons by the Centre as well as one or more units has been a source of great confusion and complexity. Elaborate and ingenious steps have to be taken to induce the States to put limits to their demand from this source. For instance, in U S A the taxes on property are generally left to the States, while the latter's receipts from income-tax are only a small proportion of the receipts of the federation. Complete separation of taxation powers appears to be more logical, but, as we shall see later on, it has given rise to a new set of difficult problems relating to transfer of funds from the Centre to the States. The major principles are three. The Centre as well as the States should be autonomous and neither should be unduly dependent on the other for its finances. Both should be able to obtain enough funds for their legitimate expenses. The receipts should grow with the need for expenditure. The reconciliation of these principles are never easy but at times, it may become very difficult.

Articles 268 to 281 deal with the distribution of revenue between the Union and the States. In the Seventh Schedule items 82 to 92(a) in the Union list and items 45 to 63 in the State list refer to sources of taxation. These articles as well as these items in the two lists correspond mostly to the parallel provisions and items in the Government of India Act of 1935 except in one major and a few minor respects. The major departure is in respect of the appointment of a Finance Commission once in five years. Estate duty, taxes on transactions in stock exchanges and future markets, taxes on sale or purchase of newspapers and

advertisements, and interstate sales taxes are additions in the Union list of the present Constitution. Taxes on consumption and sale of electricity, estate duty on agricultural land and taxes on vehicles are similar additions to the State list.

One of the most curious features of the Indian Constitution of 1950 is the extent of its borrowing from the Government of India Act of 1935. It is not only in respect of the financial provisions, but most of the articles of the Constitution were taken with some exceptions. The new provisions were those which were consequential to the change of status of India from that of a controlled Dominion of the British Commonwealth to an independent Republic, like the election of the President and the parts relating to Fundamental Rights, Directive Principles of State Policy, Elections and Amendment of the Constitution. This extraordinary fact of Indian leaders, who had fought strenuously against the British Government, adopting almost slavishly the Constitution which was intended to perpetuate the British rule in India is not easy to explain. In my view, this was due mainly to three reasons. The Government of India Act of 1935 was from the point of view of legal drafting a masterpiece. For nearly five years, the best legal draftsmen of Great Britain were engaged in drafting its provisions. Secondly, many of the leaders of thought in the Constituent Assembly of India like Dr. B. R. Ambedkar, Sir B. N. Rau, Mr. N. Gopalaswamy Ayyangar and Dr. K. M. Munshi were acquainted with the Government of India Act in all its details and were admirers of its precision, complexity and subtlety. Thirdly, from the concept of a minimal Centre, which was first put forward by the Cabinet Mission, political opinion had veered to the other extreme of overwhelming and dominant Centre as a result of partition and the integration of Indian States. But as a large number of Ministers and others interested in the autonomy of the States were members of the Constituent Assembly, all ideas of unitary government were rejected summarily. It was then found that the Government of India Act of 1935 provided for a strong centre with reasonable autonomy for the provinces and It was found that the best way of avoiding sharp conflicts on this vital issue was to accept the provisions of the Government of India Act except when they were inconsistent with the new basis of the Constitution. It may also be added that the decision to accept the system of responsible government of the Cabinet type in preference to the presidential system of executive made it a wise course to accept the provisions of the Government of India Act with their implications of British conventions relating to this type of executive.

Let me now summarise briefly the actual provisions of the Indian Constitution dealing with the financial relations between the Union and the States. With respect to all items of taxation included in State List, the State Government has the sole jurisdiction to levy them and the entire proceeds are credited to the Consolidated Fund of the State and utilised for State purposes. There are 19 items of which the most important are land revenue, duties of excise on alcoholic liquors and narcotic drugs, general sales tax and sales tax on motor spirit, stamps and registration, taxes on motor vehicles, entertainment taxes and electricity duties. It is surprising how the anomalies in the Government of India Act of 1935 have been religiously re-introduced in the Constitution, e.g., taxes on agricultural income have been included in the State list as also estate duty in respect of agricultural land. Taxes on lands and buildings, taxes on entry of goods into a local area for consumption, use or sale therein, tolls, taxes on animals and **boats,** taxes on professions, trades, callings and employment are included in the State list, but in most ***States*** they have been assigned to the local bodies, i.e., municipalities and ***ganchayati raj*** institutions.

The taxes included in the Union list fall into four categories. Duties of customs including export duties, corporation taxes, tax on the capital value of the assets exclusive of agricultural land of individuals and companies accrue wholly to the Central Government and no part of the proceeds is to be assigned to the States. **Taxes** on

income other than agricultural income and duties of excise on tobacco and other goods manufactured in India except alcoholic liquors and narcotic drugs are to be levied and collected by the Union, but they are to be shared between the Union and the States. There is also a minor difference between them. The proceeds of income tax shall be shared, but those of excise duties may be shared. Article 269 lists seven taxes which are to be levied and collected by the Government of India, but shall be assigned to the States in the manner provided by clause 2 of that article. These are estate and succession duties in respect of property other than agricultural land, terminal tax, tax on railway fares and freights, tax on transactions in stock exchanges and future markets, tax on sale or purchase of newspapers and on advertisements published therein and lastly, tax on sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-State trade or commerce. The fourth category consists of stamp duties and duties of excise on medicinal and toilet preparations which are to be levied by the Union, but collected and appropriated by the State concerned, the proceeds in the Union territories accruing to the Union.

It is with respect to the obligatory sharing of income-tax, the optional sharing of Excise Duties and grants that the provision for a Finance Commission has been made in article 280. It may be useful to quote the entire article in order to appreciate the manner in which the four Finance Commissions which have been set up under the Constitution have functioned.

> 280 (1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.
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> (2) Parliament may by law determine the qualifications which shall be requisite for appointment as mem-

bers of the Commission and the manner in which they shall be selected.

(3) It shall be the duty of the Commission to make recommendations to the President as to—

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be. or may be, divided between them under this Chapter and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;

(c) any other matter referred to the Commission by the President in the interests of sound finance

(4) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

281. The President shall cause every recommendation made by the Finance Commission under the provisions of this Constitution together with an explanatory memorandum as to the action taken thereon to be laid before each House of Parliament.

The superiority of drafting of the Government of India Act of 1935 comes out sharply when compared with the clumsiness of article 280. The Finance Commission's obligatory duties have been declared to be two: (1) the distribution between the Union and the States of the net proceeds of taxes which are to be or may be shared and the principles which should govern the grants-in-aid of the revenues of the States from the Consolidated Fund of India. The income-tax is the only tax to be compulsorily shared while the excise duties may be shared. The value of the recommendations of the Commission with reference to these two taxes is different. The sharing of income tax is to be by the order of the President after considering the

recommendations of the Fiance Commission. A convention has been established that the Government of India will accept the recommendations both as regards the percentage to be assigned to the States and the manner in which this percentage will be distributed among the States. The share of the States does not form part of the Consolidated Fund of the Union and goes straight to the Consolidated Funds of the States. On the other hand, article 272 does not refer to the Finance Commission at all and only says "if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the States to which the law imposing the duty extends sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among those States in accordance with such principles of distribution as may be formulated by such law". Apparently, it is open to the Union Government to ignore the recommendations of the Finance Cammission in respect of the excise duties and if it wants to assign any part of the excise duties may propose such law as it pleases. Fortunately, the obvious mistakes in drafting have been overlooked and the recommendations of the Finance Commission in respect of excise duties have been taken by the Union Government as the basis of the law to be placed before the Parliament. In its turn, the Parliament has been wise enough to give effect to such recommendations without any change.

The same confusion is to be found in relation to grants. Article 275(1) leaves it to Parliament to determine by law the grants to be paid to such States as may be in need of assistance . There are two provisos to that article enabling the Government of India to make grants for promoting the welfare of the scheduled tribes and raising the administration of scheduled areas in any State and grants to the State of Assam to meet extra expenditure in respect of the administration of tribal areas of that State and to meet the costs of schemes of development in those areas. Clause 2 of that article states that until Parliament provides grants by law this power of making grants shall be exercisable by the President by order and the President shall make such an order only after considering the recommendations of the Finance Commission. The constitutional position therefore, is; (1) Finance Commission is to make recommendations only of the principles which should govern grants-in-aid; (2) the Parliament may by law prescribe specific grants for the States in need of assistance; and (3) till Parliament makes such law, the President may by order make grants of specific sums after considering the recommendations of the Finance Commission. Actually. all this confusion has been resolved in practice by the Finance Commissions, after making some meaningless attempts to formulate principles, recommending specific sums and the President making by order grants of these sums. The Union Government has not so far thought fit to ask the Parliament to make any law under article 275(1) nor has any attempt been made by any section of Parliament to induce it to exercise this power.

Article 280 enables the President to refer to the Finance Commission any other matter which he may consider to be in the interests of sound finance. One would have thought that the Union Government would have been anxious to utilise this power to investigate important aspects of State finances. As may be seen later, only a limited use has been made of it in the case of the second and fourth Finance Commissions. It may be useful to refer to two other points before I proceed to review the work of the Finance Commissions of 1951, 1956, 1960 and 1964.

Article 282 empowers the Union or a State to make any grants for any public purpose even though that purpose may not be within the legislative jurisdiction of the Parliament or the State Legislature. Obviously, this article was intended to give powers to the Union and the States to make grants for special bodies and purposes like the United Nations and other international bodies and to any State in case of serious natural calamities like famine, flood, or earthquake. But this article has been used extensivey for making plan grants to the States without referring to the Finance Commission or enacting any law of Parliament.

Article 292, clause 1, empowers a State to borrow within the territory of India upon the security of its Consolidated Fund within such limits, if any, as may from time to time be fixed by the legislature of the State and to the giving of guarantees within such limits as may be fixed. Clause 2 enables the Government of India to make loans to or give guarantees in respect of any loans raised by any State subject to such limits as may be laid down by law of Parliament. The general scheme of the Constitution is that ordinarily the Union and the States should provide for their capital needs by public borrowing within limits laid down by law of Parliament or the State legislature as the case may be. The Parliament is, however, empowered to come to the assistance of any State which, for any special reason, is unable to raise loans for an essential Purpose. The spirit of the Constitution has been completely set aside and the Union and the State Governments have not thought At to have any limits placed for their borrowing and the Central Government has become the main creditor of all the States.

In accordance with the Constitution, the Finance Commission Miscellaneous Provisions Act was passed in 1951 determining the composition of the Finance Commission. It is to consist of a Chairman and four other members. The Chairman is to be selected from among persons who have had experience in public affairs. Of the other members, one should be qualified to be appointed as a Judge of a High Court, the second should have special knowledge in the finances and accounts of the Government, the third should have had wide experience in financial matters and administration and the fourth should have special knowledge of economics. It has become customary to appoint an ex-Finance Minister of a State and one of the high officials of the Finance Ministry of the Central Government for the second and third members. The Commission shall have all the powers of a civil court under the Code of Civil Procedure 1908 for summoning and enforcing the attendance of witnesses, requiring the production of any document and requisitioning any public paper from any court or office. These powers have not had to be exercised by any of the Commissions.

For all the Commissions, the first term of reference has been the distribution between the Union and the States of the net proceeds of taxes which are to be or may be divided between them. As has already been pointed out, they are the income taxes and excise duties At the time when the first Commission was appointed 50% of the income-tax was assigned to the States and this was distributed according to the Niemeyar Award modified by that of Chintaman Deshmukh after partition of India. It was stated that the percentages fixed were partly on residence and partly on population, but the exact formula was not given by either. Before the Neogi Commission as well as the other Commissions, Bombay and Bengal have been pleading that this distribution should be on the basis of collection, while most of the other States argued that as income-tax is a central revenue and the place of collection does not represent the actual origin of Incomes, the distribution should be wholly on the basis of population After an elaborate examination of these contentions the Neogi Commission recommended that 20% of the States' share of the divisible pool should be distributed among the States on the basis of the relative collection of the States and 80% on the basis of their populations according to the census of 1951. Instead of allowing the Government of India to calculate the percentages accruing to each State every year, the Commission recommended certain fixed percentages based on the actual figures of collections for the three years ending 1950-51 which were to hold good for the entire period of five years from 1952-53 to 1956-57. According to Article 270. out of the total net proceeds the part attributable to Union territories and taxes payable in respect of Union emoluments has to be deducted. It is for the Auditor-General to calculate the latter and declare the net proceeds. The Neogi Commission

prescribed 22% of the net proceeds as attributable to Part C States. Out of the balance, it recommended that States should get 55% instead of 50% that was then obtaining. At the time the Second Finance Commission reported the B and C States had disappeared and it recommended 1% as net proceeds attributable to Union territories and out of the balance 60% to be assigned to the States.

The Commission had again to discuss the claims of collection and population. It was the opinion of this Commission that the industrially developed States like Bengal and Bombay were better placed financially than the other agricultural States owing to the growth of revenue from sales tax, motor vehicle tax, electricity duties and entertainment taxes. Therefore, it came to the conclusion that collection should be completely abandoned in favour of population as the basis of distribution. However, in order to make the transition smooth, it recommended that 10% might be distributed on the basis of collection and 90% on the basis of population and expressed the hope that collection would be altogether dispensed with by the following Commission. The actual distribution was expressed as before, as fixed percentages to hold good for five years from 1957-58 to 1961-62. The Finance Act of 1959 classified the income-tax paid by companies as corporation tax and it ceased to be part of the divisible pool. As this constituted a considerable reduction of the divisible pool, the Government of India made up the shortfall by a special compensation grant till the report of the next Finance Commission.

The Third Finance Commission was appointed in 1960 and as suggested by the Second Finance Commission, its recommendations were to be applicable only for four years from 1st April 1962 so that this period might coincide with the end of the Third Five-Year Plan. It felt that the exclusion of income-tax from companies which was essentially of all-India origin from the divisible pool had strengthened the case for collection. It increased the percentage attributable to the Union territories to 2.5 and recommended that 663% of the net proceeds of income tax should be assigned to the States and distributed among them on the basis of 20% on collection and 80% on population. The fourth Finance Commission appointed in 1964 increased this percentage to 75 and endorsed the basis of distribution recommended by its predecessor.

Though the sharing of excise duties was provided in section 140(1) of the Government of India Act of 1935 it was not acted upon because the federal part did not come into existence and the Second World War intervened. It was, therefore, left to the first Finance Commission to apply this provision.

As has already been pointed out, there is some ambiguity in the Constitution regarding excise duties, as Article 272 leaves the matter wholly to Parliament, while Article 280 enjoined upon the Finance Commission to consider the distribution of taxes which may be shared. That Commission came to the conclusion that it was within its competence to recommend to the President the division of Union excise although such recommendations had to be implemented through a law of Parliament. As the Commission was breaking new ground, it was anxious not to disturb the Central budget too much. It decided to restrict the distribution to a few selected excises. It recommended that 40% of the net proceeds of the duties on tobacco (including cigarettes, cigars etc.), matches and vegetable products should be allocated to the States. Here again. there was considerable conflict of opinion regarding the basis of distribution. As there was no reliable data regarding consumption of each of these commodities in the various States, distribution on the basis of population was recommended and it took the form of specified percentages to be valid for the 5-year period. The second Finance Commission considered the demand of many States that all excise duties should be shared. But it came to the conclusion that it was neither necessary nor expedient to make such a sweeping change. It, therefore, widened the range by adding sugar, tea, coffee, paper and vegetable non-essential oils to the three duties which were already divided. It found that it was necessary to reduce the share

percentage of net proceeds of these duties to 25% in order to maintain the financial equilibrium between the Union and the States. Some data of consumption had been prepared for this Commission, but it felt that they should not be relied upon. So, it decided that 90% of the States' share of the Union excise duties should be distributed on the basis of population, the balance of 10% being used for adjustments. As usual, this was reduced to specific percentages for the various States which for the first time included Jammu and Kashmir also. The second Commission did not think it necessary to allocate any percentage for the Union territory, as such allocation was not enjoined by Article 272 as it was by Article 270 in respect of income-tax. But the third Commission thought it desirable to allocate 1% for the purpose. It found it difficult to resist the claim of the States for a share in the entire proceeds of excise duties. As the expenditure of the States was increasing fast, it expressed the view that "the viability of the States may best be secured by larger devolution of the Union excise duties and this should be effected by providing for the participation of States by convention in the proceeds for Union excise duties". It recommended 20% of the net proceeds of excise duties comprised in a Schedule consisting of 35 items should be assigned to the States. This Schedule contained most of the then existing excise duties but it excluded the duty on motor spirit, as this was to be utilised for maintenance and improvement of communications and distributed as a special purpose grant. It did not specify the exact basis of distribution of this 20% among the States, but merely gave percentages and stated that they were arrived at mainly on a population basis, but the relative financial weaknesses of the States, the disparity in the levels of development, the percentage of scheduled castes and tribes and backward classes were also taken into account.

The Fourth Finance Commission finally extended the sharing to the proceeds of the excise duties on all articles levied and collected in any year and fixed the States' share at the same 20%. It pointed out that as the number of articles on which excise duties were levied and the rate of excise duties had greatly increased during the period, their actual recommendation would amount to about 30% of thg 35 commodities on which excise duties were levied on the basis of the Report of the Third Finance Commission.

The third common item of reference to all the Finance Commissions is that relating to the principles of grants-in-aid under Article 275(1). The First Commission suggested budgetary needs, tax effort, standard of social services, special obligations and broad purposes of national importance as guiding principles. While generally endorsing these principles, the Second Finance Commission pointed out that "in a Union in which the Centre and the States co-operate for planned development grants-in-aid should serve this end. Priorities and provisions in the plan itself should determine the fiscal needs for development for the period of the plan." It was also of the view that the gap between the ordinary revenue of the State and its normal inescapable expenditure should as far as possible be met by sharing of taxes. Therefore, grants-in-aid should be largely a residuary form of assistance given in the form of general and unconditional grants. While grants for special purposes may be given under the article there was no scope for such grants when all such purposes were provided in a comprehensive plan. The Third Finance Commission merely discussed how far the grants recommended should cover the needs of the plan. It made recommendations covering not only the revenue gap of the States, but also 75% of the revenue component of the Third Plan. This was not accepted by the Government. The Fourth Commission did not recommend the inclusion of plan grants or special purposes grants. It is not possible for any Finance Commission during the time at its disposal to go into the taxation policies of the States or sit in judgment on the legitimacy of its expenditure in any respect. The States have to be presumed to know their business and assume that if any State could not

balance its revenue budget, it is in need and the Finance Commission should try to help it as far as possible.

Besides these three common terms of reference, each Commission was given some special terms. The First Commission was asked to recommend about the continuance or modification of the terms of any agreement entered into by the Government of India with the Governments of Part B States. As the revenue systems of the Indian States were different from those of British India, transitional arrangements were required to enable the B States to fall in line with the former British India provinces. In accordance with the recommendations of the Committee set up in 1948 under the chairmanship of Mr. V. T. Krishnamachari, the Centre agreed to make good to such States as were in deficit on account of integration for a transitional period the difference between the revenue loss to them from Union subjects and the expenditure saved to them on Union subjects and services as a result of financial integration. These were called revenue gap grants. These States were entitled to the benefits accruing from the proposals of the Finance Commission, if thereby they would get a larger amount than the revenue gap grants. The First Commission found it was necessary to continue revenue gap grants only to Mysore, Baurashtra and Travancore-Cochin and all other States were brought completely in line with the A States.

The Second Finance Commission was asked to recommend the principles governing the distribution under Article 269 of the net proceeds in any financial year of estate duty in respect of property other than agricultural land; (2) the modifications, if any, in the rates of interest and the terms of repayment of the loans made to the various States by the Government of India between the 15th day of August 1947 and the31st day of March 1956; (3) the distribution of additional duty of excise on mill-made textiles, sugar and tobacco in replacement of sales tax levied by the State Government and (4) the principles governing the distribution of net proceeds of the tax on railway fares which was proposed to be levied in 1957. Of these, the tax on railway fares under article 269 was abolished in 1961, but the Government of India continued to pay Rs. 12.5 crores a year as compensation. Regarding estate, duty, the Commission recommended the retention of 1% for the Union territories and the balance to be divided into two parts attributable to immovable and movable properties. The proceeds from duty on immovable property should be divided in the ratio of the gross value of all such properties brought into assessment in that year, while the proceeds from movable property was to be divided in proportion to population. It was the reference regarding Union loans to States that was particularly significant. The Commission recommended that the outstanding balances on 31st March 1957 of all loans by the Government of India to State Governments made between 15th August 1947 and 31st March 1956 excluding rehabilitation and interest-free loans should be cosolidated as follows: The balances of all loans carrying interest at 3% or more per annum and repayable on or before 1st April 1977 be consolidated into one single loan at 3% repayable on 31st March 1987; (2) the balances of all loans carrying interest at 3% or more per annum and repayable on or before 31st March 1977 be consolidated into one single loan at 3% per annum repayable on 31st March 1972; (3) the balances of all loans carrying interests at less than 3% and repayable on or after 1st April 1977 be consolidated into one single loan at 2½% repayable on 31st March 1987 and (4) the balances of all loans carrying interest at less than 3% per annum and repayable on or before 31st March 1977 be consolidated into one single loan at 2½% per annum, repayable on 31st March 1972. The Regort said, "as a result of this consolidation besides rehabilitation and interest-free loans there will be only four loans due from each State to the Union in respect of the loans taken during the period 15th August 1947 to 31st March 1956. We feel that the implementation of the scheme will bring about a great deal of order and simplicity in this field." The Commission also suggested that future loans for each State should consist of only one medium-term and one , long-term loan at a rate of

interest approximating to the net cost of all union borrowings in that year. To appreciate the value of these proposals it may be pointed out that during the period of First Five-Year Plan the number of outstanding loans to the Sates rose by 2750 between 1951 and 1956. Unfortunately, the Government of India did not see its way to accept these recommendations though they were wholeheartedly supported by all the States, with the result that innumerable small and big loans maturing on various dates continue to be issued to the States.

The Third Finance Commission was not given any new term of reference. But it was asked to recommend whether any changes should be made in the principles governing the distribution of the estate duty, the additional excise duties and the tax on Railway fares. It did not recommend any material change in any of them. The Fourth Finance Commission was instructed that in making their recommendations regarding grants to States, the Commission should have regard to the following considerations - the revenue resources of the States for the five years ending with financial year 1970-71; in the levels of taxation likely to be reached in 1965-66; the requirements of the States to meet the committed expenditure resulting from the Third Plan; the servicing of the debt; setting apart a portion of the estate duty for repayment of States' debt to the Central Government and the scope for economy consistent with efficiency which may be effected in the administrative expenditure. It was further asked to report on the effect of the combined incidence of States sales tax and Union duties of excise on the production, consumption or export of commodities or products, the duties on which are shareable with the States. With respect, to the latter term of reference, the Commission came to the conclusion that adequate data for determining the combined incidence of the two taxes and their economic effects were not available and, therefore, the question of fixing a ceiling except by persuasion could not arise.

I shall now proceed to give a brief summary of the financial results of the recommendations of these four

Commissions. The share of the States in income-tax during the First Five-Year Plan amounted to Rs. 277.9 crores, during the second Rs. 377.2 crores, and during the Third Rs. 554.6 crores. The respective figures for Union excises were Rs. 64.6 crores, Rs. 280.9 crores and Rs. 613.7 crores. Grants-in-aid under article 275(1) of the Constitution were Rs. 27.03 crores, Rs. 152.99 crores and Rs. 291.72 crores.

So far I have been dealing with the financial relations flowing directly from the Constitution. The inauguration of the Five-Year Plans in 1951-52 and the setting up of the Planning Commission brought about a new development in federal financial relations which were not regulated by any financial rules and became, therefore, a source of great uncertainty in such relations. At pages 103-106 of the Explanatory Memorandum on the Budget of the Central Government, under the item "other grants" are to be found details of grants issued to the various States, most of them being plan grants. They are given under the heads, Scientific Departments, Irrigation, Medical, Public Health, Agriculture, Rural Development, Animal Husbandry, Co-operation, Industries and Supply, Broadcasting, Labour and Employment, Miscellaneous social and developmental organisations, Community Development, National Extension Service and Local Development Works, Public works maintenance of border roads, Aviation, Forest and Miscellaneous. Under each of these heads are to be found four or five minor heads. For instance, under Public Health, we find the sub-heads of educational and training schemes, schemes for control of diseases, primary health units and family planning, malaria eradication and other grants including material and equipment. Under the miscellaneous head there are no less than 13 sub-heads. Most of the grants are matching grants. That is to say, the States have to And a share of the expenses before they become entitled to the Central share. During the First Plan, these grants amounted to Rs. 133 crores. They increased to Rs. 461 crores during the Second Plan and rose to Rs. 821 crores in the Third Plan.

It will thus be found that the discretionary grants made under the recommendations of the Planning Commission have been much greater than the grants given under article 275(1). As the settlement of the amounts of these grants and later their actual issue depended upon detailed discussions between the State Governments, the Planning Commission and the Central departments concerned, the financial autonomy of the State was being steadily encroached. Another feature of these grants .is they are available only for the Plan period at the end of which they become committed expenditure for which the States are exclusively responsible. Naturally, they approach the Finance Commission and try to get a greater share of revenue and larger grants. This constitutes a vicious circle.

This process was greatly intensified by the loans issued by the Centre. On 15th August 1947 the total debt of the provincial governments to the Centre was only Rs. 44 crores. By 31st March 1951, it had gone up to Rs. 195 crores, mostly on account of loans issued for rehabilitation of refugees from Pakistan. During the First Mve-Year Plan, loans to the amount of Rs. 799 crores were issued to the States. This went up to Rs. 1,411 crores during the Second Plan and during the Third Plan it reached the astounding figure of Rs. 3,100 crores. If there were reliable evidence that all these loans were being productively invested by the States, especially if the interest and instalments due on these loans could be met from the income and recovery of the investments, they may not be open to much objection. But as a matter of fact; a considerable portion of these loans has been spent for purposes which do not yield any income, like hospitals and colleges. Another portion has been spent on roads, minor irrigation and other works, which though strengthening the infrastructure of the State economy their burden of interest and repayment fall on the State revenues. Another significant portion is accounted in the States' budgets as loans to agriculturists for various purposes. There have been large arrears in many States in the recovery of these loans and it is likely that a considerable amount may have to be written off in the end. For the year 1965-66, the States had to pay to the Centre nearly Rs. 170 crores as interest and Rs. 282 crores as capital repayment for the loans. These amounts are usually adjusted but a considerable part of either is paid by many States from the new loans of the Government of India.

From this, it will be clear that as a result of planning the federal financial relations have become seriously distorted. This has been referred to in the reports of the various Finance Commissions. The Second Finance Commission said: "Some anomalies inevitably arise where the functions of the two Commissions, the Finance Commission and the Planning Commission, overlap. The former is a statutory body with limited functions, while the latter has to deal comprehensively with the fiinances of the Union and the States in the widest sense of the term. So long as both these Commissions have to function, there appears to be a real need for effectively co-ordinating their work." The Third Finance Commission was even more explicit. It stated: "A general weakness of federal-State financial relations, more particularly in the field of devolution, is that federal assistance tends to be discretionary in character, not necessarily on principles of uniform application. To safeguard the position of the States, our Constitution provides, therefore, that the assessment of the needs of the States as well as the measure of assistance to be afforded and the form in which this should be given, are determined by an independent Commission to be constituted at intervals of not more than five years. But this role and function of the Finance Commission, as provided in the Constitution, can no longer be realised fully due to the emergence of the Planning Commission as an apparatus for national planning." Though the main report of the Fourth Finance Commission did not refer to this point, its distinguished Chairman, Dr. P. V. Rajamannar, appended a minute specially dealing with this issue. He points out that the setting up of the Planning Commission has In practice restricted the scope and functions of the

Finance Commission. He says, further, "as the entire plan both as regards policy and programme come within the purview of the Planning Commission and the assitance to be given for plan projects either by way of grants or loans is practically dependent on the recommendation of the Planning Commission it is obvious that a body like the Finance Commission cannot operate in the same field. The main function of the Finance Commission now consists in determining the revenue gap of each State and providing for filling up the gap by a scheme of devolution, partly by a distribution of taxes and duties and partly by grants-in-aid."

I may draw attention to one another anomaly in the present federal financial relations between the Union and the States. Article 269 lists seven taxes which are to be levied by the Union, but the entire net proceeds except the small portion that may be attributable to Union territories have to be distributed to the States in accordance with the law of Parliament. Of these taxes, only the estate duty in respect of property and inter-State sales tax have been levied. The tax on railway passenger fares was levied, but this has been discontinued. I think the spirit of the Constitution requires that in the levy of these taxes which are intended for the benefit of the States, it is the general opinion of the States that ought to prevail. The Union Government is interposed merely as an agent for ensuring uniform rates and methods of collection. But there has been no attempt by the Central Government to consult the States about these taxes. It is even more curious that the State Governments have not put forward reasonable claims for utilising these taxes for their own benefit and for their being consulted.

I may now sum up my considered views on the existing federal financial relations and make suggestions for putting them on a proper basis. There is no scope for any increase in the States' share of the income-tax. There is some scope for increasing the share of excise duty. But it does not require a Finance Commission which can after all only increase the percentage in a more or less arbitrary manner. I would suggest that 75% of the proceeds of income-lax and 50% of the proceeds of all excise duties should be distributed to the States on the basis of their population. After such distribution there should be no grant either under **275**(1) or under **282** to the States generally. But for the very poor States a fixed percentage of Central revenues, say, 5% may be set apart. The distribution of this amount as well as the desirability of levying taxes listed in article **269** as well as a genral review of the finances of the States may be entrusted to the Finance Commission if it is considered that changing the Constitution is not desirable. I would, however, prefer that article 280 should be repealed and articles **270** and **272** should be amended incorporating the percentages of income-tax and excise duties and the method of sharing them. In that case, the distribution of the grant to the Door States may be done on the recommendation of the Planning Commission at the beginning of every Five-Year Plan.

I do not also think that the Union Government should directly make any loans to the States. They should be encouraged to borrow directly from the public as much as they can. For the balance, they should borrow from the Reserve Bank subject to limits fixed by the Central Government which should stand guarantee for such loans. A special wing should be created for the purpose and the loans should be on a business basis in the same wag as World Bank. A corps of inspectors and advisers should be built up by this wing to ensure that loans are made only for productive purposes and to watch the progress of the projects. Existing loans may be transferred to that wing. It may be conducive to better relations between the Union and the States if out of the existing loans, a Dart, say, at the rate of Rs. 50 per capita for each State is written off.

In conclusion, I would like to quote the following observations at the end of my book "Union State Relations in India": "In the long run, it is not desirable that theory and practice should continue to diverge indefinitely. If the present relations between the States and the Union continue for a long time, an amendment of the Constitution,

particularly for financial unification, may become necessary and this may even lead to a completely unitary political system. But, as I have pointed out, the creation of Linguistic States makes it difficult to contemplate the disappearance of State autonomy." I think it is imperative that the federal financial relations should be restored to a definite constitutional and statutory basis.

The views expressed in this booklet are not *necessarily the* ***views*** *of the Forum* of *Free Enterprise.*

A. D. Shroff

Champion of Free Enterprise

Mr. A. D. Shroff was a champion of free enterprise and a great leader of business and industry, and an economist whose predictions have proved right over the years.

He was associated with promotion of planning in the country even before independence. When Netaji Subhas Chandra Bose was the President of the Indian National Congress, in 1938 he appointed a National Planning Committee, with Pandit Jawaharlal Nehru as the Chairman. Mr. Shroff was one of the members of the Committee.

After graduating from Sydenham College in Bombay and the London School of Economics, Mr. Shroff started as an apprentice at the Chase Bank in London. On return to India, he joined a well-known firm of sharebrokers and was also teaching advanced banking at the Sydenham College of Commerce & Economics. For over forty years, he was associated with a number of industrial and commercial enterprises, many of which owe their origin and development to him. He was a Director of leading concerns like Tatas, and his range of interests covered insurance, radio, investment, shipping, banking, and a number of other industries.

He was one of the eight authors of the well-known Bombay Plan presented to the country by private enterprise in 1944. He was also an unofficial delegate at the Bretton Woods Conference in 1944 which set up the World Bank and the International Monetary Fund.

He served on a number of committees including the well-known Shroff Committee on Finance for the Private Sector set up by the Reserve Bank of India.

In 1956, he started the Forum of Free Enterprise which has stimulated public thinking in the country on free enterprise and its close relationship with the democratic way of life. It is a tribute to Mr. Shroff's vision, courage and leadership that in spite of many adversities, the Forum of Free Enterprise has established itself as a national institution within a short time.

His important writings have been published in a book, "On Planning & Finance in India" (Pub: M/s Lalvani Publishing House, 210 Dr. D. N. Rd., Bombay-1), and is available to Forum members and student associates at a concessional price.

"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

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Published by M. R. Pai for the Forum of Free Enterprise, 235 Dr. Dadabhai Naoroji Road, Bombay-1, and Printed by Michael Andrades at the Bombay Chronicle Press, Horniman Circle, Bombay-1.

11/December/1966

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