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EPORT OF
HE FINANCE COMMISSION

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REPORT

OF

THE FINANCE COMMISSION

1965

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CHAPTER 1

INTRODUCTION

tommission was constituted by the President in his Order i May, 1964 which is reproduced below :—

ursuance of the provisions of article 280 of the Constitution ndia and of the Finance Commission (Miscellaneous Pro- ons). Act 1951 (XXXIII of 1951), the President is pleased to visi nstitute a Finance Commission consisting of Dr. P. V. co ajamannar as the Chairman and the following four other R embers, namely:—

(1) Shri Mohan Lal Gautam, former Minister of U.P. Government.

(2) Shri D. G. Karve, until recently Deputy Governor, Reserve Bank.

(3) Prof. Bhabatosh Datta, Director of Public Instruction, West Bengal.

(4) Shri P. C. Mathew, Member-Secretary.

2. The members of the Commission shall hold office for a period fifteen months from the date on which they respectively assume office.

3. The Chairman Dr. P. V. Rajamannar shall render part-time service as Chairman of the Commission until such date as the Central Government may specify in this behalf and thereafter he shall render whole-time service as Chairman of the Commission. Of the other members, Shri D. G. Karve would serve as a part-time member, while the other three would render whoe-time service.

4. In addition to the matters on which, under the provisions of sub-clauses (a) and (b) of clause (3) of article 280 of the Constitution, the Commission is required to make recommendations, the Commission should also make recommendations in regard to—

(a) the States which are in need of assistance by way of grants-in-aid of their revenues under article 275, and the sums to be paid to those States other than the sums specified in the provisos to clause (1) of that article, having regard, among other considerations, to—

the revenue resources of those States for the five years ending with the financial year 1970-71 on the basis of

the levels of taxation likely to be reac
financial year 1965-66;

(ii) the requirements of those States to mee pkeep of
mitted expenditure on maintenance and an
Plan schemes completed during the Third pon t hose

(iii) any further expenditure likely to devolve
States for the servicing of their debt;

(iv) creation of a fund out of the excess, if an the net
limit to be specified by the Commission of
proceeds of estate duty on property other th 04—105
cultural land accruing to a State in any financi
for the repayment of the State's debt to the 7—234
Government; and

(v) the scope for economy consistent with efficiency —113
may be effected by the States in their administr
expenditure; 116

(b) the changes, if any, to be made in the principles goverr
the distribution amongst the States under article 269
the net proceeds in any financial year of estate duty
respect of property other than agricultural land;

(c) the changes, if any, to be made in the principles governin
the distribution amongst the States of the grant to be mad
available to the States in lieu of taxes on railway fares;

(d) the changes, if any, to be made in the principles governing
the distribution of the net proceeds in any financial year
of the additional excise duties levied on each of the
followig commodities, namely :—

(i) cotton fabrics,
(ii) silk fabrics,
(iii) rayon or artificial silk fabrics,
(iv) woollen fabrics,
(v) sugar, and
(vi) tobacco (including manufactured tobacco)

in replacement of the States' sales taxes formerly levie
by the State Governments.

Provided that the share accruing to each Stat
not be less than the revenue realised from
sales tax for the financial year 1956-57 in

(e) the effect of the combined incidence of a State's 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, and the adjustments, if any, to be made in the State's share of Union excise duties if there is any increase in the State's sales tax on such commodities or products over a limit to be specified by the Commission.

5. The recommendations of the Commission shall, in each of the above cases, cover the period of five years commencing from the 1st day of April, 1966."

2. The Chairman and Shri D. G. Karve served on the Commission on a part-time basis. The other Members served on a whole-time basis. The first meeting of the Commission was held in New Delhi on 18th May 1964.

3. The intention to constitute the Fourth Finance Commission had already been announced in the Finance Minister's budget speech for 1964-65. Soon afterwards, the officer selected for nomination as Member-Secretary of the Commission, was appointed as a Special Secretary in the Ministry of Finance to attend to the preliminary work connected with the constitution of the Commission and the collection of material likely to be required by the Commission. He addressed in advance the Union Ministries, the State Governments and the Accountants General for supply of relevant material. In his letter dated 12th May 1964 [Appendix III(iv)], the State Governments were requested to furnish to the Commission, forecasts of their revenue and expenditure for each year of the five-year period to be covered by the Fourth Finance Commission (1966-67 to 1970-71), their views on the existing basis of the devolution of Central taxes and duties and their suggestions, for any changes. They were also requested to supply information on certain subsidiary points which are set out in Appendix III(iv). Similarly, the Union Government was also requested to send to the Commission forecasts of revenue and expenditure for the five-year period indicating separately the divisible pool of income-tax and share in other Central taxes and duties that was likely to accrue to the States during the Fourth Plan period [Appendix III(ii)]. The Accountants General were also addressed for the supply of information relating to repayments of Central loans due from States to the Central Government during each year of the Fourth Plan period [Appendix III(iii)].

4. The State Governments were requested to send the material so as to reach the Commission by the middle of July 1964. It had been originally planned that on receipt of the material from the State Governments its scrutiny would be completed by the end of August 1964 and that the Commission would visit all the States from September onwards. This time schedule could not be adhered to on account of the delay in the receipt of the material from the State Governments. Material from some States was received as late as January 1965.

5. On account of the delay in the receipt of the forecasts, the Commission had to abandon the initial proposal to visit the capital of every State for discussions with the respective State Governments. In order to enable the Commission to submit its report by the prescribed date, the Commission decided to hold discussions with the State Governments at four selected centres, *viz.*, Bombay, Calcutta, Delhi and Madras. The States were given the option to choose any of the Centres according to their convenience. The discussions started in January 1965 and were completed by the end of May 1965. Appendix IV gives the dates of the discussions with the different States. The procedure generally adopted by the Commission was that the initial discussions were held with the Chief Ministers, Finance Ministers and other Ministers of the State Governments, on matters of policy and on general principles that should regulate and determine the devolution of resources. The detailed estimates and the States' forecasts were thereafter discussed with the officials of the State Governments. Important policy issues emerging from the discussions with the officials were again taken up with the Ministers at the concluding meetings. By arrangement with the Comptroller and Auditor General of India, the Accountants General of the respective States were present throughout the discussions. After the conclusion of the discussions with the representatives of every State Government, separate discussions were also held with the Accountant General of the State concerned.

6. In the course of our work, we also held discussions with senior officials of the Union Ministries of Finance and Home Affairs. The Ministers of Commerce and Prof. V. K. R. V. Rao, Member, Planning Commission, met us and pressed on us certain points including the necessity of affording relief to States by way of compensation for losses

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On account of a change in the Government and the introduction President's rule in Kerala, the representatives of Kerala were invited meet the Commission at Bangalore towards the end of May, 1965.

in revenue that might arise if the Tea Finance Committee's recommendations are implemented. We had an opportunity of exchanging views with the Deputy Chairman, Members and senior officials of the Planning Commission. Towards the end of our discussions, we had a meeting with the Comptroller and Auditor General of India.

7. A press note was issued on May 19, 1964 inviting views from persons and institutions interested in the subjects covered by the terms of reference of the Commission. We received a number of Memoranda from Chambers of Commerce and Industry, Members of Parliament and State Legislatures, Universities, Economists and others (list given in Appendix V). Some of them also requested for interviews with the Commission; during the Commisson's sittings at Bombay, Madras, Calcutta, Bangalore and Delhi, discussions were held with such individuals and representatives of non-official organizations (list given in Appendix VI) in the respective zones.

CHAPTER 2

UNION-STATE FINANCIAL RELATIONS— OUR BASIC APPROACH

8. The history of the financial relations between the Central Government of India and the Governments of the constituent units is a long one; in fact, the final year of the period to be covered by the present Finance Commission will see the completion of a century since the first beginning of devolution under the scheme introduced by Lord Mayo in 1870. It is not necessary to recount the story here—there is a good historical account in the Report of the First Finance Commission—but it is worth noting that all the experiments that have up till now been made in this field proceeded from the experience of increasing gaps between the financial requirements of the functions allocated to the Provinces or States and the finances that these units could raise under their own authority. Except for the short interlude of 'Provincial contributions' under the Meston Settlement of the nineteen-twenties, there has always been the need for substantial transfers of funds from the Government at the Centre to the constituent units.

9. The trend of administrative evolution of the country has been towards the transfer of a widening range of functions—in the field of social services and, more lately, also in the field of economic development—to the Provinces or the States. There has thus been the need for maintaining the financial viability of these units at expanding levels of expenditure. One alternative method for meeting the requirements would be to divide all revenue heads into two watertight compartments—one for the Centre and the other for the units—in the expectation that the finances and functions would match in every case. Another alternative would be to give concurrent taxing powers to both levels of Government. The first of these alternatives was tried in India under the Government of India Act of 1919, while the second has generally been recognised as economically unsound.

10. The failure of the system of a rigid division between the Central and Provincial heads of revenue introduced by the Government of India Act of 1919 could not be prevented by the Meston award and the ultimate result was unsatisfactory both to the Centre and to the

units. The experience of the nineteen-twenties led, however, to the emergence of the idea that the authority most suited for discharging a particular governmental function need not necessarily be the authority most suited to raise the financial resources required to discharge the function. The taxes on income had already been recognised before 1919 as a balancing factor and it continued to be recognised as such after 1935. But it also came to be recognised that other taxes could appropriately be levied and collected by the Central Government and distributed, wholly or partly, to the Provinces or States. The Government of India Act of 1935 recognised this principle and the Constitution adopted in 1950 made clear provision for (i) the assignment of the taxes raised by the Union Government under article 269 wholly to the States, (ii) for the obligatory division of the income-tax proceeds between the Union and the States, and (iii) for the division, with the approval of Parliament, of the proceeds of the Union excise duties.

11. The principle behind all these provisions is that in regard to some of the major revenue-yielding taxes and also in the case of some other taxes, where a country-wide uniformity of rates is desirable, the best authority for legislating and in most cases also of collecting, is the Union Government. The requirements of the Centre as well as those of the component States could be met in the most equitable and efficient manner, by distributing the proceeds after these have been collected by the Central Government, rather than by dividing powers of tax collection between the Centre and the States as has been done in some federations—which would not only mean high costs of decentralised collection and large scope for evasion, but also varying rates of taxation in different areas and rigidity of distribution in the face of changing requirements. Under this system, the Union Government is the agency for raising certain revenues for the benefit of both the Centre and the States and for distributing the proceeds between the Centre and the States and among the States themselves according to the principles and procedures set out in the Constitution.

12. This makes the problem of determining what part of the divisible revenues should go to the States and what should be the distribution among the States *inter se* very important. Whatever principles are laid down with regard to these two issues have, however, to be based upon the economic realities of the country and formulated within the framework of the provisions of the Constitution. It is not possible to derive much direct help from the experiences of other Federal Countries, though the course of evolution by which

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

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

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

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

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

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

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

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

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

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

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

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

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

CHAPTER 3

ESTATE DUTY

23. Paragraph 4(b) of the Order of the President constituting the Fourth Finance Commission requires us to make recommendations in regard to the changes, if any, to be made in the principles governing the distribution among the States under article 269 of the Constitution, of the net proceeds in any financial year of estate duty in respect of property other than agricultural land. We are also required under that article to determine the proceeds attributable to Union territories.

24. A number of suggestions were made by the States in regard to the principles of distribution. The different suggestions were: (i) distribution of estate duty wholly on the basis of population, (ii) distribution partly on the basis of collection and partly on the basis of location, (iii) distribution on the basis of population with weightage to Scheduled Castes and Scheduled Tribes, (iv) distribution on the basis of 80 per cent population and 20 per cent location, and (v) continuance of the existing scheme of distribution. We are in agreement with the principles laid down by the earlier Commissions and recommend the continuance of the following principles. We recommend, however, that the share of Union territories may be raised to two per cent, taking into account population and the value of immovable property assessed in these territories in recent years.

(i) Out of the net proceeds of the duty in each financial year a sum equal to two per cent be retained by the Union as proceeds attributable to Union territories;

(ii) The balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year;

(iii) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State; and

(iv) The sum apportioned to property other than immovable property be distributed among the States in proportion to their population.

25. On the basis of the 1961 Census figures, the percentage will be as follows:

States	*Percentage*
Andhra Pradesh	8·34
Assam	2·75
Bihar	10·76
Gujarat	4·78
Jammu & Kashmir	0·83
Kerala	3·92
Madhya Pradesh	7·50
Madras	7·80
Maharashtra	9·16
Mysore	5·46
Nagaland	0·09
Orissa	4·07
Punjab	4·70
Rajasthan	4·67
Uttar Pradesh	17·08
West Bengal	8·09
Total	100·00

26. One of the considerations which the Commission is required to take into account in determining the sums to be paid to the States in need of assistance by way of grants-in-aid of their revenues under article 275 is the creation of a fund out of excesses, if any, over a limit to be specified by the Commission, of the net proceeds of estate duty on property other than agricultural land accruing to a State in any financial year, earmarked for the repayment of the State's debt to the Central Government. As the total annual net proceeds of estate duty assignable to the States are only about Rs. 7 crores at the current levels of taxation, it would not be of any practical value to create a fund by contributing a part of these proceeds. The whole question of making provision for amortisation of the debts owed by all the States both to the public and to the Central Government has been dealt with elsewhere in this report.

CHAPTER 4

GRANT IN LIEU OF TAXES ON RAILWAY FARES

27. According to paragraph 4(c) of the Order of the President, the Commission has to make recommendations in regard to the changes, if any, to be made in the principles governing the distribution among the States of the grant to be made available to the States in lieu of taxes on railway fares".

28. The tax on railway passenger fares was imposed under the Railway Passenger Fare Act, 1957 and the Second Finance Commission was, for the first time, requested to make recommendations as to the principles which should govern the distribution under article 269 of the Constitution of the net proceeds in any financial year of the tax. The Second Finance Commission decided that the proceeds of the tax should be distributed among the States in the ratio of passenger earnings which may be determined with reasonable accuracy by allocating passenger earnings among States on the basis of railway route mileage within each State with due allowance for variation in density of traffic between the various railway zones and as between the various gauges in each zone. Thus the earnings from passenger traffic of each zonal railway (excluding earnings from suburban services) were allocated by route mileage located in each State separately for each gauge. The Second Commission recommended that the proceeds of the tax be distributed in the ratio of Statewise earnings so worked out and indicated each State's share as a fixed percentage applicable for five years from 1957-58.

29. The Railway Passenger Fares Act, 1957 was repealed by Act VIII of 1961 and the tax was merged in the basic fares. The Union Government, however, decided to make an *ad hoc* grant of Rs. 12.50 crores per annum to the States in lieu of the tax for a period of five years from 1961-62 to 1965-66. The Third Finance Commission which was asked to recommend the principles on which the *ad hoc* grant should be distributed, recommended that the distribution should be on the principle of compensation to place the States broadly on the same footing as before and accordingly worked out the distribution of the sum of Rs. 12·50 crores per year.

30. We agree that the distribution of this grant should be on the basis of compensation and that the percentage share of each State in which the tax is leviable should be worked out on the principles enunciated by the Second Finance Commission. In our term of reference on the subject, while we have been asked to make recommendations regarding changes, if any, to be made in the principles governing distribution among States of the grant to be made available to the States in lieu of taxes on railway passenger fares, the actual amount of grant to be distributed has not been indicated. Therefore, instead of recommending the sums payable to each State, we consider it desirable to express the States' shares in percentages. In determining the percentage share as stated below, we have utilized the latest available statistics of railway route length in each State under each gauge and the average annual earnings from passenger traffic (excluding earnings from suburban traffic) for three years ending 1964 for which actuals were available:

Percentage share of each State in grant in lieu of tax on railway passenger fares

States	*Percentage share*
Andhra Pradesh	9·05
Assam	2·79
Bihar	9·99
Gujarat	7·11
Jammu & Kashmir	—
Kerala	1·85
Madhya Pradesh	9·85
Madras	5·81
Maharashtra	8·98
Mysore	3·98
Nagaland	0·01
Orissa	2·12
Punjab	7·43
Rajasthan	6·40
Uttar Pradesh	18·23
West Bengal	6·40
Total	100·00

31. In view of the fact that the tenure of the present *ad hoc* grant of Rs. 12·50 crores per year expires at the end of 1965-66 and the recommendation of the Railway Convention Committee about the future quantum of grant would be available only by the end of this year, we have adopted the only practical course of recommending each State's share in terms of percentages. However, for calculating the residuary revenue deficit of the States to be covered by grants-in-aid under article 275 of the Constitution, some assumption had to be made about the likely amount of grant to be made available to the States in lieu of taxes on railway fares. In this regard, we considered that the best course would be to adopt the present level of annual grant *viz.*, Rs. 12·50 crores. If, as a result of any increase in the grant the States were to receive larger amounts, such amounts would be available to the States as surplus.

32. While the determination of the quantum of the grant does not lie within our jurisdiction, we feel that it is desirable to place on record the views of the States on this subject. The States have almost unanimously represented to us that fixation of the grant at a particular level has deprived them of a potentially elastic source of revenue and have urged that the level of grant should be raised in the proportion in which the railway passenger earnings have increased since the merger.

CHAPTER 5

INCOME TAX

33. Article 280(3) (a) read with article 270(1) of the Constitution provides that it shall be the duty of the Commission to make recommendations to the President as to the allocation between the Union and the States and the distribution among the States themselves of the "net proceeds" of taxes on income other than agricultural income levied and collected by the Government of India. Corporation tax, the proceeds attributable to Union territories and taxes payable in respect of Union emoluments are excluded from the divisible pool. Accordingly, we have to make recommendations in regard to three matters namely:—

(a) the percentage of the "net proceeds" of income-tax to be assigned to the States;

(b) the manner of distribution among the States of their share; and

(c) the percentage of the "net proceeds" which shall be deemed to represent proceeds attributable to Union territories.

34. Before we deal with them, we give below a brief account of the claims advanced before us by the State Governments on the aforesaid matters affecting them. Practically all the States have urged for an increase in the share to be assigned to them and have pointed out that as a result of the change in the classification of the income-tax paid by companies brought about by the Finance Act, 1959, the rate of growth of the divisible pool has been adversely affected. It was further argued that what the framers of the Constitution had intended to be a flexible and expanding source of revenue to the States had ceased to have the significance that was once contemplated. While the collections from corporation tax have increased by well over 600 per cent in the course of the last 12 years, the corresponding growth in the divisible pool of income tax was less than 50 per cent. Some of the States have reiterated the views placed by them before the previous Commissions that though the Government of India was competent to levy any surcharge, wholly for the purposes of the Union under article 271, such a levy in the very nature of things, was intended to be a temporary measure to

serve a particular situation. It was, therefore, urged that during normal times there should be no need for any surcharge exclusively for the Union. However, if at all such a surcharge was levied, it should as a matter of course be merged with the basic rates after a period of three years.

35. On the question of the percentage of the States' share, while some States did not suggest any change in the existing percentage, some others suggested that the entire net proceeds be assigned to the States. The suggestions by other States fell between these two views. One State proposed that 50 per cent of the proceeds of both income-tax and corporation tax should be assigned to the States. Another view was that the permanent solution to the shrinkage in the divisible pool was suitably to amend the Constitution so as to provide for inclusion of the proceeds from corporation tax in the divisible pool; alternatively, the Centre should make good to the States by way of grants the loss on account of non-inclusion of corporation tax in the divisible pool.

36. We have considered the claims put forward by the States. We are in general agreement with the observation of the Third Finance Commission that in the case of a divisible tax in which there was obligatory participation between the Union and the States, a sound maxim to observe would be that all participating Governments, more particularly the one responsible for levy and collection, should have a significant interest in the yield of that tax. Due note should also be taken of the States' representation about the need for abating in some measure the loss sustained by them, consequent upon the reclassification of income tax paid by companies.

37. The fixation of the States' share should take into account the present level of yield of this source of revenue and its likely future rate of growth; on these points we have accepted the forecasts as supplied to us by the Ministry of Finance. Considering the various facts placed before us, we are of the view that some further increase in the States' share is justified. We accordingly recommend that 75 per cent of the divisible pool of income-tax should be allocated to the States for distribution among them.

38. As regards the priniciples of distribution of the States' share *inter se*, the views expressed by the States were widely divergent. While some States wanted the share to be distributed entirely on the basis of population, another view was that the distribution should be solely on the basis of collection. The other suggestions made were

that the distribution should be made on the basis of (i) 80 per cent. on population and 20 per cent on area; (ii) 75 per cent on population, 15 per cent on area and 10 per cent on colltction; (iii) 70 per cent on total population, 20 per cent on collection and 10 per cent on urban population; (iv) population with proper weightage to Scheduled Castes and Tribes, by counting twice over, the Tribal population; (v) population, relative financial weakness and economic backwardness; (vi) 50 per cent on population and 50 per cent on inverse ratio of *per capita* income; and (vii) 50 per cent on population and 50 per cent on collection. Some States were in favour of the continuance of the existing principle, namely, 80 per cent on the basis of population and 20 per cent on the basis of collection.

39. We have no hesitation in rejecting some of the factors, put forward by the States, like area, backwardness and financial weakness and proportion of Scheduled Castes and Tribes in the population as proper bases for a scheme of distribution of the proceeds of income tax among the States. There remain only two factors which we were convinced are relevant, namely, population and contribution. Though contribution is not synonymous with collection, in the absence of data necessary for a correct determination of the contribution of each State, collection must be taken as the only available indicator of contribution. Taking these two factors of population and collection, there can be divergence of opinion as to the relative proportion to be assigned to these two factors. Though we discussed various proportions, we were eventually impressed by the fact that a sense of certainty and stability as regards the principles to be adopted in the distribution of income-tax should prevail. It is not desirable that every time a new Finance Commission is appointed, there should be reopening of the basis of distribution. We have therefore decided that the principle of distribution to individual States of their share in the divisible pool of income-tax proceeds should be the same as recommended by the First Finance Commission and by the Third Finance Commission, that is to say, 80 per cent on the basis of population and 20 per cent on the basis of collection.

40. A regards the actual manner of distribution of the States' share in each year, we feel that it will be convenient both to the States and to the Union if the shares are expressed as fixed percentages. Taking, therefore, the average of the collections of the three years ending with 1963-64, and the population figures according to the 1961 Census, the percentage share of each State in the distributable amount would work out as given in the table below. We accord-

ingly recommend that 75 per cent of the net proceeds in any financial year of taxes on income other than agricultural income, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, be assigned to the States and distributed among them in the following manner :—

States	*Percentage*
Andhra Pradesh	7·37
Assam	2·44
Bihar	9·04
Gujarat	5·29
Jammu & Kashmir	0·73
Kerala	3·59
Madhya Pradesh	6·47
Madras	8·34
Maharashtra	14·28
Mysore	5·14
Nagaland	0·07
Orissa	3·40
Punjab	4·36
Rajasthan	3·97
Uttar Pradesh	14·60
West Bengal	10·91
Total	100·00

41. As regards the percentage to be fixed under clause (3) of article 270 which shall be deemed to represent proceeds attributable to Union territories, we recommend that this should be prescribed as two and a half per cent of the net proceeds of the tax. We have arrived at this figure by allocating to the Union territories taken together, the share which would have accrued to them collectively, had they been entitled to a share of income-tax, on the same basis, namely, 80 per cent population and 20 per cent collection, as that recommended by us in respect of the States.

CHAPTER 6

UNION EXCISE DUTIES

42. Under sub-clause (a) of clause (3) of article 280 of the Constitution, the Finance Commission is required to make recommendations to the President as to the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be divided between them under the provisions of Chapter I of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds. Union excise duties, which are referred to in the Constitution in article 272 and entry No. 84 in List I (Union List) of the Seventh Schedule, fall in the category of taxes which 'may be' distributed between the Centre and the States and hence the entire subject of their division between the Centre and the States on the one hand and as between different States on the other, comes within the purview of the Commission.

43. The first question we had to consider was whether the States should at all be given a share out of Union excises. We note that under the Constitution the distribution of proceeds of Union excise duties between the Centre and the States is merely permissive and does not stand on the same footing as the compulsory assignment to the States of proceeds of taxes enumerated under article 269 of the Constitution or compulsory distribution between the Centre and the States of the proceeds of income tax under article 270 of the Constitution. The States thus do not have a constitutional right to claim a share out of the proceeds of Union excises. It is for Parliament to decide if the States should at all be given a share. In taking a decision however, Parliament is required to take into account the recommendations of the Finance Commission on this subject made available to it under sub-clause (a) of clause (3) of article 280 of the Constitution. The factual position is that ever since 1952-53, the States have been getting a share out of Union excise proceeds. The first three Finance Commissions had taken the view that having regard to the growing requirements of funds by the States for developmental and other essential services, recourse to permissive sharing contemplated under article 272 of the Constitution was not only justified but even necessary. We endorse this view.

44. The next question that we had to consider was: Which of the excisable commodities should be selected for the distribution of proceeds between the Centre and the States and what percentage of the total proceeds on those commodities should be made over to the States? Before giving our recommendations on this aspect, we would state the legal and constitutional position in regard to the excise levy. Articles 246 and 272 of the Constitution empower the Union Government to levy and collect excise duties on all goods manufactured or produced in India, excepting alcoholic liquors for human consumption and opium, Indian hemp, and other narcotic drugs and narcotics. This power is exercised by the Union Government through certain enactments, the most important of them being the Central Excises and Salt Act, 1944. The Union excise levies which are currently in operation could be grouped under the following categories:

(i) Basic excise duties on a large number of items levied under the Central Excises and Salt Act 1944 as amended from time to time by the Finance Acts of each year;

(ii) Cesses or excise duties levied on certain goods under special Acts , the proceeds of the duty being earmarked for specified uses, for example, excise duty or cess on the production of copra, oil extracted from oilseeds, salt, coal, iron ore, rubber, mill-made cloth, etc.

(iii) Additional duties of excise in lieu of sales taxes on sugar, tobacco and textiles under the Additional Duties of Excise (Goods of Special Importance) Act, 1957;

(iv) Additional duties of excise on motor spirit, kerosene, refined diesel oils and vaporising oil, diesel oil not otherwise specified and furnace oil under the Mineral Oils (Additional Duties of Excise and Customs) Act, 1958;

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*Some of the special Acts are listed below:

(1) The Indian Coconut Committee Act, 1944.
(2) The Indian Oilseeds Committee Act, 1946.
(3) The Coal Mines Labour Welfare Fund Act, 1947.
(4) The Coal Mines (Conservation and Safety) Act, 1952.
(5) The Rubber Act, 1947.
(6) The Rubber (Amendment) Act, 1960.
(7) The Iron Ore Mines Labour Welfare Cess Act, 1961.
(8) Khadi and other Handloom Industries Development (Additional Excise Duties on Cloth) Act, 1953.
(9) Dhoties (Additional Excise) Act, 1953.
(10) Cotton Fabrics (Additional Excise Duty) Act, 1957.

(v) Special duties of excise on certain goods levied for the first time in March 1963 in the form of surcharges on basic duties on certain items under the Finance Act of 1963 and later amended by subsequent Finance Acts; and

(vi) Regulatory duties of excise levied under the Finance Acts, the purpose of the provision being to give to the Executive, powers to vary rates of duties on any item within certain limits.

All the above levies are imposed in exercise of the legislative power given to the Union Government under article 246 of the Constitution, read with item 84 in List I of the Seventh Schedule and therefore fall within the scope of article 272.

45. The additional duties of excise in lieu of sales taxes on sugar, tobacco and textiles levied under the Additional Duties of Excise (Goods of Special Importance) Act, 1957 fall in a distinct category as the net proceeds of these levies are wholly paid to the States after retaining a small portion representing the share attributable to Union territories. We discuss the issues connected with these duties in a separate chapter.

46. The special duties of excise levied under the Finance Acts are of recent origin. These were introduced in 1963 in the context of the National Emergency and the present position is that the proceeds of these duties are earmarked exclusively for Union purposes and are not sharable with the States. It has been contended that the proceeds of special duties of excise should also be made sharable with the States. We take the view that it is open to us to suggest that proceeds of special excises should also be shared with the States. This would not at all be repugnant to the constitutional position as the Constitution nowhere lays down, as indeed it does in article 271 for taxes falling under articles 269 and 270, that surcharges on excises would be exclusively for the use of the Union. So far as the legal ban under the Finance Acts is concerned, that is something that can always be reviewed by Parliament, particularly in the light of such recommendations as the Finance Commission may make. On practical considerations, however, we think that it would be desirable to keep the proceeds of special duties of excise outside the sharing scheme. These duties are renewed on a year to year basis and are not on the same footing as the basic duties of excise under the Central Excises and Salt Act, 1944. Further, if the object of including these duties in the sharing scheme is to enable the States to have larger resources, this

can equally well be achieved by suggesting a larger share to the States out of the basic duties.

47. The regulatory duties of excise which were for the first time introduced in 1961 have not yet become important; no collections were made upto 1964-65. The imposition of these duties is essentially a regulatory measure and we do not think that it is necessary to bring the proceeds of these duties into the sharing scheme.

48. The cesses, or the additional excise duties on items like copra, salt, iron ore, coal, oilseeds, mill-made cloth, fabrics, dhoties, etc. referred to as item (ii) in paragraph 44 above have special objects in view and the proceeds are utilized for only earmarked purposes enumerated in the relevant legislations pertaining to each of these levies. In view of this, the sharing of the proceeds of these levies between the Centre and the States would not be desirable.

49. Under the Mineral Oils (Additional Duties of Excise and Customs) Act, 1958, additional duties are levied on certain mineral oil products. These duties are levied to give effect to the price reductions enforced on the oil distributing companies from time to time and to adjust the benefits accruing to these companies as a result of fluctuations in the "posted prices" of bulk refined products in the Persian Gulf and variations in freights therefrom the Indian ports—ceiling selling prices in the country being built up on the basis of import parity linked with the Persian Gulf. These price reductions and cost and freight accumulations are mopped up and credited to the Government exchequer through the mechanism of these additional duties. The duties are recovered from the oil companies and the benefit of the reduction in cost is not passed on to the consumers. These levies are basically in the nature of excise duties under the Central Excises and Salt Act, 1944. We suggest that for the purpose of distribution of the proceeds between the Centre and the States the yield of the two levies, *viz.*, the basic and the additional may be taken together and the total made sharable in the same manner as the proceeds of the basic excise duties.

50. The first two Finance Commissions confined the sharing scheme to a few selected items: the First Finance Commission to three, *viz.*, tobacco, matches and vegetable products and the Second to eight, *viz.*, tobacco, matches, vegetable products, sugar, tea, coffee, paper and vegetable non-essential oils. The Third Finance Commission's approach to the question of selection of items for sharing was different from that of the earlier Commissions. It accepted in principle

the reasonableness of the demand of the States for participation in the proceeds of all Union excises; for purposes of distribution, however, it included only the commodities on which duties collected in 1960-61 amounted to Rs. 50 lakhs or more. The duty on motor spirit was excluded from the sharing scheme as that Commission had recommended a separate special purpose grant of a corresponding amount for the development of communications. In their representations to us, the States have almost unanimously argued that whatever reservations the last Finance Commission's distribution scheme had should now go and that they should be entitled to a share out of the proceeds of excise duties on all commodities, including the commodities which might be taken up for the levy in the coming quinquennium.

51. The arguments advanced by the States in favour of extending the sharing scheme to all commodities run on the following lines:

(i) If a coordination between the excise policy of the Union Government and the sales tax policies pursued in the States is at all to be achieved, it would be necessary to put the States in a position in which they have and continue to have a substantial interest in the collection and levy of Union excises. One method of achieving this object would be to make Union excise duties on all commodities sharable with the States;

(ii) The larger the number of commodities brought within the divisible pool, the greater would be the evenness in the flow of resources to the States, as fluctuations in the yield on certain items would be neutralised by fluctuations in the yield of some other items. The States' requirements are growing and, therefore, an elastic source of revenue like a share in excises on all commodities would go to strengthen their position;

(iii) As the commodities covered by the Union excise duties are of country-wide consumption, there is no justification for selecting only a few of the commodities for sharing;

(iv) The system of sharing only selected commodities suffers from the defect that if, for one reason or another, the excise duty on a shared commodity is reduced or abolished and substituted in part or whole by a levy on a related product not included in the sharable list, the States stand to lose. For example, the excise duty on steel ingots was one of the sharable items listed by the Third Finance Commission. For various reasons, the Union Government later

substituted the duty on steel ingots by a levy on iron and steel products, but the States did not get any share out of the new levy although it was in replacement of a levy, proceeds of which were sharable; and

(v) In any economy where industry is getting diversified, new lines of production will emerge continuously and any formula for the sharing of excise duties should therefore cover such new products.

We find considerable force in the above arguments and therefore, recommend that all Union excise duties currently levied as also those that might be levied in the coming five years should be shared between the Centre and the States.

52. As to the question of sharing special excises, our attitude, as already explained, is that no sharing need be provided. We, however, suggest that in future the resort by the Union Government to special excises should not be the rule but the exception. Any departure from the normal levy of basic excises should be on the basis of provisions expressly inserted by Parliament in the Acts levying the special excises.

53. On the question of the percentage of the proceeds of distributable excises, it has been suggested to us by practically all the States that in order to impart viability to States' finances and to introduce in them a measure of elasticity, a higher proportion than the one recommended by the last Finance Commission should be prescribed for distribution to the States. Some have suggested as high a proportion as 50 per cent. of the net yield from basic and special excises on all commodities. We take the view that in determining the over-all share of the States, due regard has to be given to the requirements of the States on the one hand and the needs of the Union Government on the other. Having considered the issue in this light and keeping in mind the estimates of yield from the existing excise duties in the coming quinquennium as also the requirements of the States, we have come to the conclusion that the States' share out of the distributable excises may be fixed at 20 per cent. of the net proceeds. We would like to stress that the financial significance of the figure of 20 per cent recommended by us is not comparable with that of the same figure recommended by the Third Finance Commission, in as much as we visualize the sharing of the duties on all commodities, including the commodities that might be taken up in the coming quinquennium,

whereas the last Finance Commission had confined the sharing scheme to 35 selected commodities. It appears from the data available before us that if we had confined the sharing to the 35 commodities, we would have fixed the proportion at around 30 per cent, so as to keep the transfer to the States at about the same level as visualized in our present scheme.

54. In regard to the principles for the distribution of the total of the States' share as between different States, the views placed before us are divergent. Some States have argued that the most relevant factor for determining the state-wise allocation would be not 'population' or 'needs', as measured by any other indicator or indicators, but consumption of excisable commodities in each State. Some others have advocated the use of population as the sole criterion. Then, some others have argued that the factor of economic backwardness should be brought in for determining the distribution. And finally there is a suggestion from certain States that following the principles adopted by the last Finance Commission, the factor of 'relative financial weakness should also be taken into account for determining the State-wise share.

55. The logic behind the proposal for distributing excises on the basis of consumption of excisable commodities is that such a distribution would be in accordance with the 'contribution' that each State has made to the total proceeds. Then it is also pointed out that if ever a large scale substitution of sales taxes by Union excises were to take place, the resistance from the States to this substitution would be less if the distribution of excises took into account the 'contribution' factor. It appears to us that there is no case for the adoption of contribution' as the sole criterion. One may, however, argue that consumption' or 'contribution' should be taken into account by combining this factor with other factors like population and economic and social backwardness. We wish we were in a position to give our considered judgment on this issue, but in the absence of reliable state-wise data regarding consumption of excisable commodities, we find ourselves unable to use 'consumption' or 'contribution' as a factor in the distribution scheme. Some States suggested to us that in the absence of reliable consumption data we could use such factors as the ratio of urban and rural population. We have avoided using such indirect data and we think that it would be more desirable to devise the distribution scheme on the basis of ascertainable factors than on the basis of uncertain indicators. Elsewhere in this report we have emphasized the need for a systematic collection of data bearing on

consumption, particularly consumption of commodities subject to Union excise duties.

56. The proposal for devising the distribution scheme entirely on the basis of 'population' is supported on the ground that population of a State represents the 'needs' of the State and since the sharing of excises with the States is not compulsory under the Constitution and is only permissive, the proceeds of excises should be so distributed between the States that each gets according to its needs. It may also be argued that in the case of some commodities, population is a rough index of total consumption. There is some substance in both these arguments but we do not agree with the view that population is the only index of the needs of a State. There are other factors which are equally relevant. In our view while population should be the major factor for determining the distribution, relative economic and social backwardness of States should also be taken into account.

57. Before we go to define the factors that we have taken into account for determining the relative backwardness of each State, we would like to deal with the suggestion of certain States that following the lead given by the last Finance Commission, we should also take into account the factor of relative financial weakness as measured in terms of revenue deficits. We have stated at the very beginning of our Report that we do not think that it is proper to bring in the element of grant into the distribution scheme of divisible taxes. In our view such non-plan revenue deficits as are left in certain States, after taking into account the share of central taxes on the basis of general and uniform principles applicable to all States, should be covered by explicit grants under article 275 rather than by adjustments in the formulae for distribution of taxes. Another point on which we wish to clarify our stand is that we distinguish between economic and social backwardness of a State and its financial weakness. It is possible that a State may be economically backward and poor in social services and yet it may have fairly comfortable position on revenue account. There are States of this type. In the distribution of proceeds of excise duties we have not taken financial weakness but have taken economic and social backwardness as indicated by the following factors:

(i) *Per capita* gross value of agricultural production;

(ii) *Per capita* value added by manufacture;

(iii) Percentage of workers (as defined in the Census) to the total population;

(iv) Percentage of enrolment in Classes I to V to the population in age group 6—11;

(v) Population per hospital bed;

(vi) Percentage of rural population to total population; and

(vii) Percentage of the population of Scheduled Castes and Tribes to total population.

58. We consider that it would be adequate if the factor of relative economic backwardness is given weight equivalent to 20 per cent. For the other factor, namely population, we would recommend weight equivalent to 80 per cent. We have worked out a schedule of distribution on this basis, which is set out in the following paragraph.

59. We recommend that under Article 272 of the Constitution, in each of the years 1966-67 to 1970-71, a sum equal to 20 per cent of the net proceeds of the Union duties of excise on all articles levied and collected in that particular year, excepting regulatory duties, special excises and duties and cesses earmarked for special purposes, should be paid out of the Consolidated Fund of India to the States and distributed among them in the following proportion:

SCHEDULE OF DISTRIBUTION

States	*Percentage*
1. Andhra Pradesh	7·77
2. Assam	3·32
3. Bihar	10·03
4. Gujarat	4·80
5. Jammu and Kashmir	2·26
6. Kerala	4·16
7. Madhya Pradesh	7·40
8. Madras	7·18
9. Maharashtra	8·23
10. Mysore	5·41
11. Nagaland	2·21
12. Orissa	4·82
13. Punjab	4·86
14. Rajasthan	5·06
15. Uttar Pradesh	14·98
16. West Bengal	7·51
TOTAL	100·00

60. We deal in a later Chapter with the topic covered by para. 4(e) of the Order of the President. The scheme of distribution outlined in this Chapter is in consonance with our views expressed there.

CHAPTER 7

ADDITIONAL DUTIES OF EXCISE IN LIEU OF SALES TAX ON SUGAR, TOBACCO AND TEXTILES

61. Paragraph 4(d) of the Order of the President requires us to examine the present distribution scheme in regard to the proceeds of additional duties of excise in lieu of sales tax on cotton fabrics, silk fabrics, rayon or artificial silk fabrics, woollen fabrics, sugar and tobacco (including manufactured tobacco) and to recommend changes, if any, in the principles of distribution. We have however, to ensure that whatever distribution scheme we suggest does guarantee to each State an amount, in each of the financial years 1966-67 to 1970-71, which shall not be less than the revenue realized from the levy of sales tax on these items in the financial year 1956-57 in that State.

62. Before going into the principles of distribution, we would like to state briefly the background and the rationale of the scheme of additional excises. This is important because several non-official organizations and individuals have urged that we should on our own recommend an extension of the scheme of substitution of sales taxes by additional duties of excise to several other commodities, important ones being paper and related items, rubber goods, glass and glass ware, steel products and mineral oils and related items.

63. Under the Constitution, the power to levy Union excise duties is vested in the Union Government and that to levy tax on the sale or purchase of goods, except those in the course of inter-State trade and newspapers, in the State Governments. There is, however, no bar in the Constitution to the Union and the States extending to a larger number of commodities the scope of the present agreement that the Union Government would levy additional duties of excise in lieu of State sales tax.

64. The present arrangement, under which the State Governments do not levy any sales tax on textile, sugar, and tobacco owes its origin to the consensus of opinion that emerged at a meeting of the National Development Council held in December 1956. In anticipation of the Council's decision being implemented by an Act of Parliament, the President asked the Second Finance Commission to make recommendations as to the principles which should govern the distribution among the States of the net proceeds of the additional duties and

the amounts which should be assured to each one of them as the income derived by them from such taxes during the financial year 1956-57. The Council's decision and the recommendations of the Second Finance Commission were implemented through the Additional Duties of Excise (Goods of Special Importance) Act, 1957. The first schedule of the Act prescribed the rates of additional duties of excise and the second the scheme of the dstribution of the net proceeds among the States. The Act does not state that the States shall not levy sales taxes on the specified commodities, but merely provides that if in any year any State levies and collects a tax on the sale or purchase of such commodities, no sums shall be paid to that State in that year by way of share out of the net proceeds of the additional duties of excise, unless the Central Government by special order otherwise directs.

65. A scheme of centrally levied additional duties of excise in replacement of States' sales taxes combined with a distribution scheme is essentially in the nature of a tax rental agreement. It can come into operation or be expanded in coverage only if the Union and the States agree amongst themselves. The Finance Commission comes into the picture only for the purpose of determining the principles of distribution of the net proceeds. The present scheme has been in operation for almost eight years. During this period certain merits and disadvantages of the scheme have come to light. At present, on the one hand there is a demand from the trade and other interests that the scheme be expanded so as to cover some additional items and on the other almost all the States have argued before us that the operation of the scheme has not benefited them to the extent they initially hoped and that they would be disinclined to get the scheme expanded in coverage unless certain safeguards are provided to protect not only their existing revenues but also the prospective increases in their revenues. Some States have second thoughts even about the continuance of the existing arrangements. We deal with these aspects later in this Chapter.

66. The rationale behind the currently operative scheme of additional excises in lieu of sales taxes is that if the tax is levied at the first point, the chances of evasion would be minimized and that a uniform levy at the point of production of such mass consumption items as sugar, tobacco and textiles would be welcome to the trade, industry, and the consumer as it would save them from the administrative complexities involved in the collection and payment of sales

tax. It was recognized from the very beginning that no State should suffer because of the centralization of the levy, and hence each State was assured that it would continue to get annually from the Centre, by way of its share out of the proceeds of additional duties of excise, at least that amount which it raised in 1956-57 in the form of sales tax on commodities brought within the scheme of additional duties of excise. Our terms of reference as well as those of the Second and the Third Finance Commissions refer specifically to this assurance.

67. It has been suggested to us that the assurance of the guaranteed amounts is an indirect recognition of the logic that in the distribution of the net proceeds, the accent should be on compensating each State for the loss that it has suffered in its revenue by surrendering its right to levy sales tax on cerain commodities. The distribution formula should be so devised that each State gets almost the same amount as it would have got, had sales taxes on these commodities been in operation with the same order of incidence as the additional excise duties. Wider considerations such as needs of the States, relative economic and social backwardness and population, it has been emphasized, have absolutely no relevance so far as the determination of a distribution scheme relating to proceeds of additional duties of excise is concerned.

68. We first deal with the question of guaranteed amounts. In our terms of reference, it has been clearly stated that the share accruing to each State shall not be less than the revenue realized by that State in the year 1956-57 from the levy of the sales tax on the commodities which are currently subject to these additional duties of excise. We have thus to estimate the yield in each State in 1956-57 on such commodities.

69. The Second Finance Commission adopted an elaborate procedure for working out estimates of yield for the year 1956-57. It obtained from each State figures of collection of sales taxes for the years 1954-55 to 1956-57 in respect of the commodities brought within the additional excise scheme. It also explored the possibility of working out the estimates from the consumption data as available from the Fourth Round of the National Sample Survey, the estimates prepared by the Textile Commissioner, the statistics of the clearance or off-take of sugar prepared by the Sugar and Vanaspati Directorate and the statistics of consumption of tobacco contained in the report on the marketing of tobacco prepared by the Agricultural Marketing

Directorate of Government of India. Taking all the relevant statistics into account, that Commission worked out its own estimates of the likely revenue. These were primarily based on consumption estimates but a corrective on the basis of population was also applied. It was the view of that Commission that the figures taken by it, which were a mixture of consumption-based yield and population, were the nearest possible approximation to the income of each State from sales taxes on the relevant commodities during the financial year 1956-57. The Third Finance Commission accepted the estimates worked out by the Second Finance Commission but added to the figure of each State marginal sums representing the estimated yield in 1956-57 on account of sales taxes on silk fabrics. We have not attempted to work out a fresh set of estimates for the year 1956-57, as we feel that because of lapse of time a task of this nature will be even more difficult now than it was at the time when the Second Finance Commission framed its estimates. We, therefore, accept the estimates worked out by the Second Finance Commission, and later adjusted by the Third Finance Commission to take into account the bifurcation of the old Bombay State as also imposition of additional excise duty on silk fabrics.

70. We examined the issue whether out of the net proceeds of additional duties of excise, the total of the guaranteed amounts should first be set apart and then the balance be distributed in a certain manner, or the entire net proceeds should first be distributed in a particular manner and then the question of guaranteed amounts brought in. We feel that the latter procedure might create difficulties inasmuch as under certain circumstances it might happen that some States' share may fall short of the guaranteed amount. We have taken the view that the appropriate course would be the first and the more direct one, namely that of giving to each State the guaranteed amount first and then distributing the balance between different States on the basis of certain uniform principles.

71. In regard to the principles for the distribution of the balance of the net proceeds over the total of the guaranteed amounts, the Third Finance Commission considered that it would be equitable to distribute the excess collections partly on the basis of the percentage increase in the collection of sales tax in each State since the year 1957-58 when the additional excise duties were imposed and partly on the basis of

* On silk fabrics the substitiution of sales taxes by additional duties of excise was made in 1961.

population. There is no indication as to the relative weightage given to these factors. In our opinion, figures for collections of all sales taxes in a State are a more direct indicator of the contribution made by each State to the divisible surplus than population. Therefore, we recommend that the distribution of the balance over the total of guaranteed amounts may be made on the basis of the proportion of sales tax revenue realised in each State to the total sales tax collections in all the States taken together. For the purpose of determining the proportion for each State, we have utilized the data relating to actual collections of sales taxes over the years 1961-62 to 1963-64.

72. During the year 1956-57 the State of Jammu and Kashmir did not have any sales tax and, therefore, the question of giving any guaranteed amount to that State does not arise. The Second Finance Commission had taken the view that since the incidence of the additional duties of excise would fall as much on the people of this State as on the people of other States, Jammu and Kashmir should be given a share out of the net proceeds. That Commission had fixed the share of Jammu and Kashmir at 1¼ per cent of the net proceeds. The Third Finance Commission increased it to 1½ per cent. We do not consider it necessary to change the Third Finance Commission's figure.

73. Both the Second and the Third Finance Commissions had taken the view that an appropriate share of the total net proceeds should be retained by the Union Government as being attributable to Union territories, the figure recommended by both the Commissions being 1 per cent. With the establishment of Nagaland as a separate State, the President by an Order made under Section 23 of the State of Nagaland Act, 1962, assigned for the year 1964-65 and thereafter 0·05 per cent. of the net proceeds to that State. Since this percentage was taken out of the share of 1·00 per cent attributable to Union territories, in effect the share attributable to Union territories has got reduced to 0·95 per cent. We are of the view that the amount attributable to Union territories may be taken at 1·00 per cent of the total net proceeds.

74. On the basis of the principles outlined above, we recommend that in each of the years 1966-67 to 1970-71, the net proceeds of additional duties of excise on cotton fabrics, silk fabrics, rayon or artificial silk fabrics, woollen fabrics, sugar and tobacco including manufactured

tobacco, may be distributed among the States on the following basis:

(i) A sum equal to 1·00 per cent of the net proceeds of these duties in any year may be deemed as being attributable to Union territories and may, therefore, be retained by the Centre;

(ii) A sum equal to 1·50 per cent of the net proceeds in any year be paid to the State of Jammu and Kashmir;

(iii) A sum equal to 0·05 per cent of the net proceeds in any year may be paid to the State of Nagaland as its share;

(iv) Out of the remaining 97·45 per cent of the net proceeds, the following sums representing the revenue realised in 1956-57 by each respective State on account of sales taxes on the six commodities be first paid annually to the following States:—

States	*(Rs. in lakhs)*
Andhra Pradesh	235·24
Assam	85·08
Bihar	130·16
Gujarat	323·45
Kerala	95·08
Madhya Pradesh	155 17
Madras	285·34
Maharashtra	637·77
Mysore	100·10
Orissa	85·10
Punjab	175·19
Rajasthan	90·10
Uttar Pradesh	575·81
West Bengal	280·41
Total:	3,254·00

and (v) the difference between 97·45 per cent. of the net proceeds in any year and the total guaranteed amount of Rs. 3,254 lakhs would constitute the balance which may be distributed

among 14 States, namely all States other than Jammu and Kashmir and Nagaland, as follows:—

States	*Percentage*
Andhra Pradesh	7·42
Assam	1·98
Bihar	6·17
Gujarat	7·43
Kerala	5·65
Madhya Pradesh	4·62
Madras	11·13
Maharashtra	19·87
Mysore	5·21
Orissa	2·58
Punjab	5·01
Rajasthan	3·17
Uttar Pradesh	7·83
West Bengal	11·93
Total	100·00

75. Before we leave this subject, we would like to mention that the States in their representations to us have been critical of the way that the scheme of substitution of sales tax by additional duties of excise has so far been operated. Their main point of criticism is that whereas over the period 1957-58 to 1965-66, the rates of basic duties of excise on some of the items brought within the scheme have been raised, and even special duties of excise introduced, the rates of additional duties of excise have remained unchanged. If the substitution had not taken place, so runs the argument, the States would have had the opportunity of raising sales tax rates on these items and would have also benefited from the rise in prices, sales tax being an *ad valorem* levy. It is further argued that over the past eight years, sales tax revenues have shown a much higher rate of growth than the yield from the additional duties of excise and that if the scheme had not been introduced, the rate of increase in sales tax revenues from these items would have been closer to the rate for sales tax revenue on other items.

76. As against the above views of the States, it has been pointed out to us that over the period 1958-59 to 1965-66, the yield from additional duties has increased by as much as 45 per cent, the increase

in the yield from basic duties of excise on these commodities (excluding the yield from special duties of excise which fall in a distinct category) being hardly 21 per cent. The items covered under the scheme of additional duties of excise are essential consumer items; and it is not as if the States could have just gone on increasing the rates. Indeed on items of comparable nature like matches, kerosene, coal and vegetable products, the sales tax rates between 1958-59 and 1963-64 have either remained altogether unchanged or shown very little increase. An important reason why the Union Government had not revised the additional duties of excise rates with every change in basic rates is that sugar and textiles are items in the case of which often downward adjustments had to be made and the Union Government did not want that the States' revenues should be adversely affected by these downward adjustments. It is only in the case of tobacco that basic duties have been increased and never lowered. The increase in sales tax revenue in the States is *inter alia* due to enhancement of rates in the case of luxury and semi-luxury items and coverage of new items. It is argued that it would therefore not be correct to assume that the States would have managed to realize the same rate of increase in the sales tax revenue from these items as they have realized in the case of the total sales tax yield.

77. We have not thought it necessary to go into the validity of the arguments for or against the manner of the implementation of the scheme by the Union Government. We feel that if some sort of institutional arrangement existed and both the Union and the State Governments had the opportunity of explaining each others views, the implementation of the scheme would have been considerably better and misunderstandings less.

CHAPTER 8

COORDINATION BETWEEN SALES TAXES AND UNION EXCISE DUTIES

78. This Chapter deals with paragraph 4(e) of the Order of the President in which we have been asked to make recommendations in regard to (a) the effect of the combined incidence of a State's sales tax and Union duties of excise on the production, consumption or export of commodities or products, the duties on which are sharable with the States, and (b) the adjustments, if any, to be made in the State's share of Union excise duties, if the sales tax rates levied by the State exceed certain specified ceilings.

79. This term of reference involves the determination of two issues:

(i) Measurement of the impact of the two levies on production, consumption or export of various commodities and a finding as to the cases in which the combined incidence has an inhibiting effect on consumption, production or export; and

(ii) in the light of the finding on (i), construction of an adjustment formula under which the share of the States out of Union Duties of excise could be reduced if the States exceeded certain specified ceilings in regard to sales tax rates.

The first issue concerns economic aspects of commodity taxation, while the second concerns devolution of taxes from the Union to the States.

80. Before going into the problems of measurement of the incidence of these two levies and their economic consequences, it may be useful to explain briefly the nature and import of these levies. Both the Union duties of excise and the sales taxes levied by the States are taxes on commodities. Although from the point of view of the incidence on the consumer, there is no essential difference between the two levies, the two taxes are not identical or interchangeable. An excise is a levy at the production point whereas a sales tax touches a commodity at one or more points of sale or purchase between the stages of production and final consumption. For

each given commodity, there can be only one stage at which the commodity completes the production process, and so an excise levy should theoretically be only at one point. Since, however, the component parts might themselves have been the subject of excise levy, an excise duty on the final product may in practice involve multiple duty on the components unless the duty is based on the value added by manufacture, as is done in some countries. In the case of sales, however, the same commodity may pass through different stages of sales, thereby exposing itself for taxation at more than one point, depending upon the system of the sales tax levy. An excise levy ends at the production point and does not take into account, even indirectly, elements of cost that are incurred after the production stage, *e.g.* freight, insurance, distribution charges, etc. whereas a sales tax is on a more comprehensive concept of cost and touches not merely the cost at the production point, but also subsequent elements, including profits and the excise duty itself. An excise duty in India, being a Union levy, does not differentiate between one region and another and is uniform throughout the country. On the other hand the sales tax system and the rates of sales tax differ from State to State. Again, while most of the excise duties are specific, sales taxes are *ad valorem* levies. In a phase of rising prices, other things remaining the same, the sales tax yield automatically goes up.

81. In some countries where excise duties are exclusively reserved for the Centre, the levy of sales tax by States has been held to be unconstitutional on the ground that they are substantially the same as excise duties. Similarly the question has been raised whether *ad valorem* excise duties are not really sales-taxes. But the point that needs to be noted is that although on the surface sales taxes and excises may appear to be similar in nature, they have distinguishing features. Both have a positive place in a comprehensive system of taxation and are expressly mentioned in our Constitution.

82. In the wake of developmental planning and the search for resources over the last fifteen years, both Union excise and sales tax systems have expanded considerably, in depth as well as range. In 1950-51, the aggregate yield from the two levies was roughly Rs. 128 crores, representing 1·3 per cent of the national income in that year. By 1963-64, the level had risen to Rs. 998 crores, accounting for 5·8 per cent of the national income. On the basis of 1965-66 budget estimates, the total of the receipts comes to Rs. 1135 crores.

The growth rate in the case of excises has, however, been higher than in the case of sales taxes.

83. In 1950-51, the aggregate excise revenue amounted to Rs. 63 crores. Only 15 items were subject to levy at that time. For the year 1965-66, the level of receipts, including additional duties of excise in lieu of sales tax and the special excise, is estimated at Rs. 819 crores. Among the tax receipts of the Union Government, the excise revenue occupies the most dominant position and accounts for as much as 42 per cent of the total.

84. As regards the yield of sales taxes, the growth rate over the past fifteen years differs from State to State. Taking all the States together the yield in 1950-51 was around Rs. 60 crores, accounting for 27·5 per cent of the aggregate State taxes. According to the budget estimates for 1965-66, the sales tax revenue is expected to be Rs. 316 crores, representing roughly 41 per cent of the total yield from State taxes. In the structure of States' finances, sales taxes occupy about the same position as excises in the Union finances, although the relative importance of sales tax differs from State to State.

85. We have been called upon to measure the combined incidence of these two taxes and the effect of the incidence on production, consumption or export of the commodities taxed. The incidence of a tax refers to the burden that the tax imposes on the tax payer. The incidence can be measured in terms of either 'formal' or 'effective' incidence. It is comparatively easier to measure the former than the latter. The Taxation Enquiry Commission of 1953-54 was asked to examine the incidence of Central, State and Local taxation on the various classes and in different States. That Commission worked out only the formal incidence and did not find it possible to measure the effective incidence. The study made by that Commission was carried forward by the Tax Research Unit of the Union Ministry of Finance and the latest year for which findings are available is 1958-59. Both these studies estimate the incidence of all the Central excises taken together as also of sales taxes on different classes of consumers. There is no commodity-wise analysis and hence these studies do not have much bearing on our work.

86. We examined the possibility of determining the proportion that the combined money burden of excises and sales taxes bears to the sale price of each taxed commodity, with the help of data

given in the Central Excise Tariff and information on the rates of sales taxes obtained from the States. We found that even this limited study bristles with many difficulties. As stated earlier while excises are mostly in terms of specific rates, sales taxes are *ad valorem* levies. This creates the problem of converting the excise rates to *ad valorem* rates. For the same commodity the excise rates differ for different categories, whereas generally in the case of sales tax there is no such differentiation. Further, there is so much diversity in the system of sales tax levy from one State to another that the question of bringing them to a uniform scale is a job in itself. Wherever the sales tax rates are on the basis of a single-point levy, the problem is simple. But where these rates are in terms of multi-point, double-point or a combination of various systems, the conversion of these levies into single-point rates creates many problems. As per proforma given at Appendix III (v) we tried to obtain from each State the data regarding total value of sales and total sales tax collections under each item. If these data had become available to us, the problem of converting multi-point and other levies into single-point levies would have been easier, but we found that most States were not in a position to supply these data. Finally, the total incidence of the excise duty and sales taxes on manufactured commodities may also have to include the incidence of excise duty and sales tax on their components; the determination of this multiple incidence is not always easy. In view of all these reasons, we found it difficult to pursue even the limited study of the proportion that the money burden bears to the price in the case of each excisable commodity.

87. Even if we were able to determine the proportion that the money burden of the two taxes bears to the total price of a commodity, it would not have taken us far in relation to the main task before us. We have to assess the effect that that money burden has on production, consumption or export of a commodity. Admittedly, the factor of taxation has a bearing on the price of a commodity and yet this is no more than one out of a host of important factors. Unless we are in a position to undertake for each excisable item detailed cost-analysis studies of the type that are usually undertaken by the Tariff Commission, we would not be able to determine whether its production, consumption or export is being hampered because of the excessive burden of these two taxes of because of some other factors. In order to recommend any ceilings on sales taxes we have not only to determine the *combined* incidence of the

two taxes, but also the *separate* incidence of each. Even if data were available, it would be analytically impossible to be precise about the effect of one or two variables when the number of variables is so large. We have found ourselves unable to undertake these detailed studies.

88. In the course of their representation to us, certain States have pointed out that in judging the reasonableness of the restraint that a tax imposes on production and consumption, one has to keep many factors in mind. In the case of certain commodities it may well be the objective of Government policy to limit the growth of consumption and production. In the case of such commodities no corrective action is called for. If the combined incidence of the two levies goes to inhibit consumption of essential consumer items to the detriment of the living standards, corrective action has to be taken. Similarly if taxation has an inhibiting effect on the production of intermediate and capital goods, it is definitely a matter for concern. Apart from the quantum of the tax there is also the manner of imposition and collection. If the taxes are levied or collected in a manner which will stand in the way of the efficient organisation and development of industry—if it will prevent the diversification or location of industry on rational lines or the organisation of procurement of raw materials or distribution of products in the most economic manner—there is a case for overhaul of the taxation scheme. In our present context, the question is also important from the point of view of promotion of exports. Most States have assured us that so far as this aspect is concerned, they themselves are very conscious of the need for exports and are devising suitable adjustments in sales tax levies with a view to reducing any disincentive effect that the sales taxes might have on exports.

89. We now turn to an examination of the manner in which a better coordination between Union excise duties and sales taxes levied by the States can be brought about. All the States concede the point that unrestricted and un-coordinated taxation might affect production as also exports and that, therefore, there is need for coordination between the tax policies of the Union and the States. As to whether this cooordination can be achieved through a system of ceilings on sales tax rates on certain commodities, combined with a financial sanction in the form of the possibility of a cut in the State's share out of Union excises in case a State exceeded the ceilings, is a matter on which the States have expressed strong views.

90. The States have pointed out that sales tax is the only elastic source of revenue left with them. Any attempt to place restrictions on their freedom in this field of taxation would affect their capacity to raise resources and would thus handicap them in relation to the requirements of the Fourth Plan. Sales tax is essentially of regional application and is almost the only major instrument left with them for shaping their economic and industrial policy. States have been using it, along with power tariffs, for giving incentive to industry and trade and any dilution of their power in this respect would mean setback to their efforts for encouraging the growth of industry and trade within their respective areas. Any ceiling on sales tax rates determined by the Finance Commission for a period of five years, it has been emphasized, will remove the element of flexibility from the taxation system of the States and would cut at the very root of the principle of States' autonomy, thereby weakening the federal structure. It has also been contended that the mechanism of adjustments in the share out of an item of devolution, depending on the observance of specified conditions by the States, might well be inconsistent with the constitutional provisions regarding sharing of taxes. Union excises are not compulsorily divisible, but, it is argued, once a tax is made divisible according to a certain formula, it acquires all the elements of a devolution item and any conditions imposed on the sharing scheme may not be legally valid. It has also been pointed out that the linking of the shares of excise duties with the rates of sales taxes might run counter to the principles that a Finance Commission may decide for distributing excises.

91. Certain States have expressed the view that between sales taxes and Union excises, it is the latter category of levies which in the case of most of the commodities impose a higher money burden. According to them, if at all any restrictions were necessary, the proper course would be to put ceilings on excise duties.

92. Out of the 68 items that are currently on the excise list, the problem of coordination between excises and sales taxes does not arise in 19 items, accounting for over 45 per cent of the aggregate excise revenue. Eight of these items, namely (i) cotton fabrics, (ii) silk fabrics, (iii) rayon or artificial silk fabrics, (iv) woollen fabrics, (v) sugar, (vi) tobacco (unmanufactured) (vii) cigars and cheroots and (viii) cigarettes are exempt from the levy of sales tax under the scheme of additional excise duties in lieu of sales tax. In respect of four other items common to excise and sales tax lists, namely, (i) cotton yarn, (ii) jute, (iii) steel ingots, and (iv) pig iron.

there is already a ceiling of 2 per cent on sales tax rates under the Central Sales Tax Act, 1956. Then there are certain other items known as 'special goods' in respect of which all the States are at present uniformly levying a sales tax at the rate of 10 per cent. The suggestion for this uniform levy was given by the Union Government and the States have accepted it. There are in all 15 items in this category out of which 7 items, namely (i) motor vehicles, (ii) tyres and tubes, (iii) cycles and parts thereof, (iv) refrigerators and air conditioners, (v) wireless receiving sets, (vi) gramophones and (vii) certain iron and steel products are now in the excise list. In the case of these items, no upward revision is likely in the near future; at any rate, since the current rates have been fixed after consultation with the Centre, in future also the revision would be after mutual consultation. Thus out of the 68 commodities, it is in the case of 49 commodities that the question of coordination between excise and sales tax arises. The States' view generally is that if on a proper study of the facts, it is found that in the case of a few selected items out of these 49, a coordinated tax policy is called for, that could certainly be effected. But the proper course, they point out, for such coordination is not the mechanism of a financial sanction in the form of reduction in the share out of a devolution item but a periodic exchange of views between the Union and the State Governments on problems of taxation and related subjects, with a view to evolving coordinated lines of action

93. It has been pointed out to us that there is no need to resort to a scheme of linking the share out of Union excises with sales tax rates as the existing powers with the Union Government under article 286(3) of the Constitution together with Section 14 of the Central Sales Tax Act, 1956 are adequate for controlling the upper limit of sales taxes in the case of such items as might be deemed to be of special importance. If such action is necessary and the States agree, so runs the argument, the Union Government could further enlarge the existing list, after providing for compensation to the States for loss of revenue, rather than resort to a financial sanction of the type contemplated in the term of referrence.

94. Certain States have argued that a scheme of ceilings on sales tax rates would be inequitable as between industrially and commercially advanced States with a fairly large urban sector and the States which are predominantly agricultural. In the case of the former, the sales tax yield occupies a much more pivotal position in their finances than in the latter; if ceilings are

imposed, their finances would be more adversely affected than the finances of agricultural States. As against this argument, the commercially backward States point out that the sales tax revenue on inter States sales accruing to the advanced States is largely paid by consumers in other States and that in the distribution of Central Sales Tax—a source of revenue which the Central Government should have distributed on some equitable basis—the backward States have been discriminated against, under the present arrangements according to which each State keeps what it collects on behalf of the Central Government.

95. We feel that in view of the fact that adequate data for determining the combined incidence of the two taxes and their economic effects are not available, the question of proceeding to the next stage *viz* that of fixing the ceiling and devising a formula for adjustment in the share out of excises does not arise. The procedure for framing a scheme of ceilings on sales tax rates and for its implementation should be the same as in the case of additional duties of excise in lieu of sales tax. Both can be evolved by mutual agreement; their successful functioning again depends on mutual understanding.

96. In view of what we have stated above, we do not recommend any scheme of ceilings on the sales tax rates of any of the excisable commodities and the question of suggesting a formula for adjustments in the share of the States out of Union excises does not, therefore, arise.

CHAPTER 9

PRINCIPLES GOVERNING GRANTS-IN-AID OF REVENUES

97. Article 280(3) (b) of the Constitution requires us to make recommendations as to the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India.

98. The First Finance Commission considered the matter in detail and recommended that budgetary needs of the States should be an important criterion for determining the assistance required by the States, but that in arriving at the needs, appropriate allowances have to be made based on a number of considerations. The first consideration was that the budgets should be reduced to a standard form by eliminating non-repetitive items. Second, due consideration should be given to the tax effort by the State and the extent to which the State itself had made efforts to raise resources in relation to its tax potential. Third, allowance should be made for the scope for economy in expenditure. Fourth, the system of grants-in-aid should be designed to avoid large disparities in the standards of basic social services. Fifth, grants-in-aid may be given to help individual States to meet their special burdens, if such burdens are of national concern and if they are likely to cause undue strain on the States' finances. Sixth, grants-in-aid may be given for broad national purposes with a view 'to further any beneficient service of primary importance in regard to which it is in the national interest to assist the less advanced States to go forward'.

99. The Second Finance Commission considered these principles unexceptionable. It, however, added that the eligibility of a State to grants-in-aid and the quantum of such aid should depend upon its fiscal need in a comprehensive sense. That Commission also felt that the gap between the ordinary revenue of a State and its normal revenue expenditure should as far as possible be met by sharing of taxes and that grants-in-aid should be the residuary form of assistance. Although it recognised that specific purpose grants may be given, no such grants were given by that Commission.

100. The Third Finance Commission also was in agreement with the general principles enunciated by the earlier Commissions. It, however, felt that the 'fiscal needs' as assessed by the Commission should take into account not only non-plan expenditure but also

plan expenditure; it also felt that it would be advisable to attach strict conditions of utilisation to any grants-in-aid given for activities meant to serve national purposes but that States should have freedom to reappropriate funds from one allocation to another in respect of grants meant generally to strengthen the State sector.

101. The above principles laid down by the previous Commissions are still valid and we agree with them except to the extent that we do not recommend the inclusion of plan grants and special purpose grants in grants-in-aid, for reasons which are given elsewhere in this report. In applying these principles and working out the grants-in-aid admissible to States, our terms of reference require us to have due regard to certain special considerations which were not specifically mentioned in the terms of reference to the earlier Commissions. Among these considerations are the expenditure devolving on the States for servicing of their debt, the creation of a fund out of part of the proceeds of estate duty, and the scope for economy consistent with efficiency which may be effected by the States in their administrative expenditure. We have dealt with some of these considerations in other parts of this Report. The procedure followed by us to work out the fiscal needs of the States is also discussed in the following chapter in connection with the determination of the quantum of the grants-in-aid under article 275(1) of the Constitution.

CHAPTER 10

FORECAST OF REVENUE AND EXPENDITURE —ARTICLE 275 GRANTS.

102. Paragraph 4 of the Order of the President requires us to make recommendations in regard to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 and the sums to be paid to those States other than the sums specified in the proviso to clause (1) of that article. In making our recommendations, we are required to have regard, among other considerations, to a number of factors specified in the terms of reference.

103. For the purposes of the scheme of devolution including the grants under article 275 recommended by us, we have accepted the estimate of yield of Central taxes and duties as furnished to us by the Ministry of Finance. We have also assumed that the grant in lieu of the tax on railway passenger fares will remain at the present level of Rs. 12.5 crores per year.

104. The Third Finance Commission considered that 'the total amount of grant-in-aid should be of an order which would enable the States, along with any surplus out of devolution, to cover 75% of the revenue component of their plans'. Such a procedure may help to avoid a situation in which, as a result of the Commission's award, while certain States will have just sufficient means to meet specified revenue commitments, other States will be left with considerable surpluses. Although we agree that it would be within our province to recommend that the grants-in-aid of the revenues of the States should also take into account part or whole of the cost of the revenue component of the State plans, for several reasons, we doubt whether in present circumstances it will be desirable for us to do so.

105. Certain States pleaded for grants for special purposes. The Third Finance Commission suggested in its report that the utilisation of a grant of this kind for a special purpose could be reviewed from year to year by Parliament under article 275 of the Constitution. We have been unable to find any sanction for such an annual review by Parliament under article 275 of the Constitution. Even if a special grant could be made under article 275 such a grant would get merged with the general revenues of the States. A review by the subsequent Finance Commission of the utilisation of the grant may be possible, but cannot be of any practical value. We have,

therefore, not made any special purpose grants but have included certain special requirements in our forecasts of expenditure.

106. In October 1964 we were informed by the Government of India that the question had been under consideration for some time, whether the expenditure incurred by the State Governments on Police forces maintained for the security of their border with foreign countries should be the liability of the Central Government and that the Government of India had since decided that the entire expenditure incurred by the States on such forces as have been maintained for this purpose with the approval of the Central Government would be met by them. No expenditure on this account will therefore have to be met by the States during the Fourth Plan period out of their own revenues and we have accordingly excluded this expenditure from our assessment of the forecast. The Government of Assam have claimed that the Government of India should, as a special case, extend a similar treatment to the expenditure incurred by them on their border with Nagaland. The decision communicated to us by the Government of India is not applicable to this claim and we have included in our assessment of Assam Government's police expenditure the cost of maintaining law and order on Assam's border with the neighbouring State of Nagaland.

107. Although it would constitute part of the States' normal revenue expenditure, we have excluded from our assessment the cost of participation by States in the new all-India services which are proposed to be created for the Education, Medical, Agriculture, Forest and other Departments in the States. The main reason for its exclusion was that decision had so far not been taken by all States on the actual number and grades of posts to be included from each Department and there was no sufficiently firm decision or material on the basis of which reasonably reliable estimates of additional cost could be made. Not all States had given estimates and the estimates which had been received did not show a reasonable degree of consistency.

108. The Second and Third Finance Commissions took into account, in their assessment the likely expenditure on the cost of relief measures, necessitated by unforeseen natural calamities like famine, floods and droughts. The amounts so included were estimated by the Second Finance Commission roughly on the basis of the average annual expenditure incurred over a decade. We have reassessed the amounts likely to be required by each State for this

item on the basis of the figures of gross expenditure for eight years ending with 1964-65 (RE). Where the reassessed figure was lower than the figure adopted by the Second and Third Finance Commissions, we have retained the latter figure. Since eight years' figures were not separately available for Maharashtra and Gujarat, the amounts asked for by them have been adopted for these States. The annual amounts included by us in our estimates of expenditure are given below:

(Rs. lakhs)

S. No.	States	Annual estimated expenditure on relief from natural calamities included in our assessment
1.	Andhra Pradesh	75
2.	Assam	40
3.	Bihar	140
4.	Gujarat	80
5.	Jammu and Kashmir	28
6.	Kerala	10
7.	Madhya Pradesh	30
8.	Madras	50
9.	Maharashtra	60
10.	Mysore	33
11.	Orissa	123
12.	Punjab	197
13.	Rajasthan	93
14.	Uttar Pradesh	75
15.	West Bengal	535
	TOTAL	1569

FOOT-NOTE :

(1) West Bengal's expenditure under head "64-Famine Relief" included some expenditure which was not normally included under this head in other States. The figure of West Bengal is, therefore, not strictly comparable with those of the other States.

(2) No provision is made for Nagaland since no expenditure has been incurred under the head "Famine Relief".

109. We have included in our assessment estimated expenditure on the continuance of any existing schemes for the subsidised distribution of milk and foodgrains and for rural electric supply.

110. In March 1965, after we had received the forecast from the States and concluded our discussions with the representatives of most States, the Government of India sent us a copy of their communication to the State Governments suggesting an increase in the upper monetary limits adopted for debiting the expenditure on individual works or schemes to revenue. From the commencement of the Fourth Plan, it was proposed to increase the existing monetary limits, *i.e.*, Rs. 20,000 for individual works and Rs. 1 lakh for works of the same

character forming part of a scheme to Rs. 1 lakh and Rs. 5 lakhs respectively. The State Governments were requested by us to indicate the increases in their estimated revenue expenditure during the Fourth Plan period occasioned by this enhancement of limits. The States reported varying amounts. Since we have not been able to get any reliable and consistent basis for the increases claimed by the States as a result of this letter of the Government of India, we have not taken into account for any State, the effect of this change of classification on the revenue during the Fourth Five-Year Plan.

111. For the purpose of our estimates, we have not taken into account as expenditure, the estimated loss that will be incurred during the Fourth Plan period by enterprises (including electricity schemes) departmentally managed by the State Governments.

112. We have added in our estimates of expenditure the requirements of the States for payment of annual interest on loans outstanding at the end of the Third Plan period (public loans, Central loans and other loans) on the basis of annual outstanding amounts as at the end of each year (*i.e.*, net of repayments) as reported by the State Governments and the Accountants-General. Interest liability on account of other non-plan loans likely to be raised during the Fourth Plan period has also been allowed in our estimates of expenditure, on the basis of information obtained from the State Governments. The interest liability during the Fourth Plan period on account of the above two classes of loans is as follows:

(Rs. crores)

S. No.	States	Amount
1.	Andhra Pradesh	76·95
2.	Assam	30·20
3.	Bihar	86·08
4.	Gujarat	50·81
5.	Jammu and Kashmir	20·14
6.	Kerala	40·48
7.	Madhya Pradesh	73·53
8.	Madras	79·13
9.	Maharashtra	97·81
10.	Mysore	58·66
11.	Orissa	62·37
12.	Punjab	75·53
13.	Rajasthan	58·01
14.	Uttar Pradesh	104·21
15.	West Bengal	73·73
	TOTAL	987·64

113. We have also included in our assessment of expenditure the requirements for payment of full interest on Fourth Plan loans that will be raised by the States during 1966—71. We have not allowed for capitalisation of any portion of the interest. We have utilised the data obtained from the Planning Commission for our estimates of borrowings by the individual States. For Central loans we have not provided any interest for the year of borrowing while for other loans we have provided for interest for half a year, in the year of borrowing. The amounts estimated by us on this account for each State, for interest payments on the gross Fourth Plan loans are as follows:

(Rs. crores)

S. No.	States	Amount
1.	Andhra Pradesh	43·48
2.	Assam	16·10
3.	Bihar	41·31
4.	Jammu and Kashmir	8·90
5.	Gujarat	25·30
6.	Kerala	22·00
7.	Madhya Pradesh	37·97
8.	Madras	41·61
9.	Maharashtra	51·15
10.	Mysore	29·92
11.	Orissa	31·58
12.	Punjab	29·99
13.	Rajasthan	29·46
14.	Uttar Pradesh	68·38
15.	West Bengal	45·14
	TOTAL	522·29

114. Paragraph 4(a)(iii) of the Order of the President requires us to take into account, for the purpose of determining the needs of States for assistance under article 275(1) of the Constitution, the expenditure likely to devolve upon the States for the servicing of their debt. Elsewhere in this report we have expressed our opinion that the service and amortisation of the market borrowings of the State Governments must form part of the revenue liabilities of the State Governments. We have accordingly included in our assessment expenditure on these items estimated on the basis of the existing practices adopted by the State Governments. This has resulted in

allowing provisions only at nominal rates for some States and for other States at adequate rates which will enable full repayment of the loans on maturity. We feel that the entire question of indebtedness of the States and the soundness of the existing borrowing, interest payment, repayment and accounting practices in this respect should be reviewed on the basis of detailed study and report by a competent body to be set up for the purpose. The rate at which contributions to the sinking fund should be charged to the revenue account by States and the steps necessary to make the accumulations available for the purposes for which they are intended should constitute part of the terms of reference to that body about which we have made further recommendations in a later chapter of this report. We consider it proper to include in our estimates of revenue expenditure, provision for contribution to sinking funds for public loans on the basis in force at present. The amounts included for the five years for the various States on account of sinking fund provision for public loans (including Fourth Plan loans) are as below:

(Rs. crores)

S. No.	States	Amount
1.	Andhra Pradesh	4·94
2.	Assam	11·19
3.	Bihar	9·04
4.	Gujarat	28·41
5.	Jammu and Kashmir	—
6.	Kerala	3·63
7.	Madhya Pradesh	7·19
8.	Madras	8·90
9.	Maharashtra	46·85
10.	Mysore	15·00
11.	Nagaland	—
12.	Orissa	31·49
13.	Punjab	12·15
14.	Rajasthan	16·90
15.	Uttar Pradesh	61·97
16.	West Bengal	28·56
	TOTAL	286·22

115. The instructions in our letter requesting for forecasts of revenue and expenditure from the State Governments required that expenditure on schemes financed by non-plan grants from the Centre

should be included under expenditure and that an explanatory note indicating the Central grants likely to be received should also be furnished. Some States furnished such information but certain other States provided expenditure estimates after deducting the Central grants expected by them. In forecasting their expenditure, State Governments have assumed the continuance of non-plan grants on the existing basis for the following items: (i) labour and employment schemes, (ii) implementation of gold control rules, (iii) rehabilitation of displaced persons, (iv) subsidy in respect of interest on loans for flood control schemes, (v) civil defence expenditure, (vi) expenditure on outside police force borrowed in connection with emergency (in respect of Assam), Additional Punjab Armed Police Battalion deployed in Lahul and Spiti (in respect of Punjab), (vii) Administration of Lahul and Spiti (in respect of Punjab), and (viii) expenditure on Uttar Khand Division (in respect of Uttar Pradesh). The deficits and surpluses arrived at by us are, therefore, derived after taking credit for the non-plan grants expected to be received by the States for such schemes.

116. The Third Plan schemes, more especially in the social service sectors, create liability for 'committed expenditure' during the Fourth Plan period. The expenditure on this account in 1966-67 has been calculated by us on the basis of the estimated level of revenue plan expenditure in 1965-66 in each State as ascertained from the Planning Commission and its composition as assessed on the basis of information furnished by the States. Provision was also made for an annual growth rate of 3·5 per cent. in the committed expenditure. The total amount included in our estimates on account of committed expenditure of Third Plan Schemes for all States for the five-year period comes to about Rs. 1,230 crores.

117. In scrutinizing the forecasts of revenue and expenditure presented by the States, we have taken into account the normal caution with which estimates ranging over a large variety of items and over a long period of five years, have to be prepared in the interest of sound finance. Most States produced successive revised forecasts either revising the original figures on the basis of further information or including fresh items of expenditure not included in the original forecasts. We have accepted the revisions wherever they were justified on the basis of the latest actuals. While revising expenditure estimates on account of inclusion of such new items, the Commission has taken into account the possibility of accommodating part of the

expenditure on these new items by means of marginal reappropriations in the large aggregate amount of the expenditure budget.

118. Paragraph 4(a)(v) of the Order of the President requires us, while recommending grants under article 275 of the Constitution, to take into consideration the scope for economy consistent with efficiency which may be effected by States in their administrative expenditure. In examining the forecasts of revenue and expenditure we have kept this aspect in mind. We have excluded from our assessment of expenditure items such as loss in the working of public enterprises. We have also assumed full realisation of current interest dues from States corporations.

119. Our terms of reference specify that in making recommendations for assistance to States by way of grants-in-aid, we should have regard, among other considerations, to the creation of a fund out of the excess, if any, of the net proceeds of estate duty (over a limit to be specified by the Commission), for repayment of States' debt to the Central Government. We have given our views elsewhere in this report why we do not think there would be an advantage of any consequence in adopting a scheme of the kind suggested by implication in this part of our terms of reference; in view of that position, we have not allowed any transfers of revenue from the proceeds of estate duty for creation of the proposed fund. We have, however, independently considered the subject of States' indebtedness to the Union Government in another part of our report.

120. It was represented to us by almost all States that their present levels of expenditure for maintenance of public works, more especially roads were grossly inadequate and that application of past growth rates for forecasting the non-plan expenditure on public works during the Fourth Plan period would not meet the need for improving the existing conditions of roads. Some States have, therefore, urged the continuation of the special purpose communications grant while some others have made substantial additions in arriving at the base figure of 1966-67 expenditure on public works in their forecasts. We agree that there is need for improving the standards of public works maintenance in States but for reasons given elsewhere we have not recommended any specific purpose grants. However, to meet the needs of the situation and for according a uniform treatment to the different States, we have estimated the 1965-66 expenditure on public works with reference to past trends over actuals of 1963-64 and have made due allowance for the enhanced standards of maintenance.

121. On the receipts side, we have not included any transfer from Central Road Fund since the amounts are intended to be utilised for financing developmental outlays in the Plan. These receipts may, therefore, be counted as resources for financing the Fourth Plan. We have also excluded any expenditure which was proposed in the States' forecasts to be financed out of Central Road Fund grants.

122. We have allowed transfer to Zamindari/Jagir Abolition Fund from the revenue account in the case of States which have been making such provision from the revenue account. We have taken the view that land reform measures were largely in the nature of basic social reform and that as such the net burden falling on the States exchequer on account of this reform might appropriately be met out of the revenue budget itself. Even if the Zamindari Abolition Bonds were treated as public loans, some provision for their amortization would have to be made in the revenue budget on the same basis as amortization provision for public loans. Further, increases in land revenue receipts on account of Zamindari Abolition measures accrue in the revenue budget. In view of all this, we felt that it would be proper to make provision in the revenue budget for payment on account of Zamindari/Jagir abolition operations.

123. We have included in the revenue receipts the proceeds of betterment levies and of sale of State property.

124. In the assessment of non-tax revenues of the States, we could take into account only the revenues likely to accrue from schemes completed by the end of the Third Plan period. Receipts arising from the Fourth Plan schemes, including interest on fresh lendings, have been left out since the size of the Fourth Plan and its distribution among various sectors for each State are yet to be finalised. These receipts may, therefore, be counted as resources for financing the Fourth Plan.

125. While examining the forecast of receipts and expediture, we found that some States have shown transfer of proceeds from certain taxes like tax on motor vehicles, sales tax on motor spirit, sugar cane cess, education cess, electricity duty and toll on bridges to funds set apart for meeting specific items of expenditures. Some of these items formed part of non-plan revenue expenditure already included in the forecast while others constituted Fourth Plan expenditure or capital expenditure outside the plan with which we are not concerned. We took the view that we should allow for such transfer of tax revenues not only where the Fund is meant for financing the non-plan revenue expenditure but also when it

is specifically earmarked for a particular purpose outside the non-plan revenue account. This would have the effect of making the balance in these funds which is not being used for non-plan purposes, available for plan expenditure.

126. For determining the needs of the States for assistance under article 275(1) of the Constitution, it was necessary to examine in detail the forecasts of revenue and expenditure furnished by each State, taking into account the trends of growth of revenue and expenditure in the past and the facts and arguments produced in support of the detailed items in the discussion and correspondence with the State Governments.

127. The interest receipts from Electricity Boards and other autonomous enterprises had been estimated by several States on the assumption that they would be unable to pay the entire amount due under this head and that there would be a further increase in arrears, over the levels existing at the end of the Third Plan. In our assessment for the purpose of determining the revenue gap and the requirements of grants under article 275, we have assumed that the States must treat as resource their entire interest dues—excluding interest on Fourth Plan loans. We have not assumed any reduction in the arrears of interest as outstanding at the end of the Third Five-Year Plan, except where expressly indicated otherwise, in the States' own forecast.

128. Many States included in the forecast demands for large increases over present levels and past trends under police expenditure, grants to local bodies and pay and allowance of State employees. These demands by the States were not always supported by firm decisions and detailed data. The Commission therefore decided to include only those increases in expenditure, which were based on firm decisions of the State Government incorporated in orders which committed the Government to liability on that account. As a consequence of this decision we had to leave out a few cases on which proposals calculated to involve commitments are at various advanced stages of consideration and action has been held up awaiting the report of a Commission or the passing of an Act by the Legislature. These are listed in Annexure 1, Part 1. We recommend that in case these propopsals mature into commitments before the President issues orders under article 275 of the Constitution, and the Union is approached by the State Governments, those requirements may also be taken into account by the President in determining the amounts to be granted under article 275.

129. Our estimates of revenue and expenditure take into account all firm Government orders (including orders granting interim reliefs in pay and D.A.) and enactments up to the end of June 1965. We had hoped to take into account all revisions of estimates of States' expenditure on account of pay and allowances of employees of State Governments and local bodies and school teachers intimated to us by the Governments upto the end of July, 1965 on the basis of firm Government orders creating the liabilities but we have not been able to do so in respect of the liabilities created by the orders listed in Annexure 1, Part 2 either because there was not sufficient time after their receipt to reassess the estimates, or the proposals were not accompanied by the basic particulars and other data necessary to enable us to determine the need for additional grants-in-aid. We recommend that the effect of these liabilities may also be taken into account in fixing the article 275 grants to be included in the Order of the President.

130. An assessment of needs of the type undertaken by us cannot obviously take into account various items of requirements which might emerge during the next five years and which cannot be foreseen at this time. An appropriate procedure will have to be evolved to take such needs into account and to afford Central assistance wherever necessary.

131. Our assessment of revenue receipts and non-plan revenue expenditure of different States for the five-year period 1966-67 to 1970-71 made in the manner explained in the preceding paragraphs works out to the following estimates of non-plan revenue gap:

(Rs. crores)

S. No.	States	Non-Plan revenue gap during 1966-71
1.	Andhra Pradesh	202·73
2.	Assam	144·96
3.	Bihar	108·21
4.	Gujarat	113·55
5.	Jammu and Kashmir	66·10
6.	Kerala	188·61
7.	Madhya Pradesh	162·03
8.	Madras	207·32
9.	Maharashtra	44·72
10.	Mysore	202 52
11.	Nagaland	58·46
12.	Orissa	231·85
13.	Punjab	75·03
14.	Rajasthan	130·41
15.	Uttar Pradesh	306·75
16.	West Bengal	183·44
	TOTAL	2426·69

132. After meeting the revenue deficits estimated for the five-year period, the amounts accruing to the following States as their shares of the various taxes and duties (i.e., shares of income-tax, estate duties, Union excise duties, additional excise duties and grants in lieu of tax on railway passenger fares) result in the surplus noted against each State for the five-year period. We do not recommend any grants under article 275 for them:

(Rs. crores)

S. No.	States	Surplus
1.	Bihar	89·25
2.	Gujarat	8·00
3.	Maharashtra	215·66
4.	Punjab	29·83
5.	Uttar Pradesh	17·02
6.	West Bengal	13·97
	TOTAL	373·73

133. The revenue deficits for the five-year period are in excess of the amounts accruing to the following 10 states as their shares of the various taxes and duties (i.e., shares of income-tax, Union excise duties, additional excise duties, estate duty and grants in lieu of tax on railway passenger fares) by the sum shown against each and we recommend that annual grants equal to one fifth of the sum may be given to each of them under article 275 of the Constitution:

(Rs. crores)

S. No.	States	Deficit (5 times annual grant)
1.	Andhra Pradesh	36·10
2.	Assam	82·60
3.	Jammu and Kashmir	32·85
4.	Kerala	104·10
5.	Madhya Pradesh	13·50
6.	Madras	34·20
7.	Mysore	91·20
8.	Nagaland	35·35
9.	Orissa	145·90
10.	Rajasthan	33·65
	TOTAL	609·45

CHAPTER 11

GENERAL OBSERVATIONS AND SUGGESTIONS

134. We now deal with certain questions of a general nature which are of importance in connection with the topics constituting our terms of reference and the recommendations made by us on these topics.

I. Institutional Provision for Inter-Governmental Consultation—

135. While we were considering the requests of several States in regard to the sharing of centrally levied taxes, and in particular when we discussed with them the implications of our term of reference contained in para 4(e) of the Order of the President—i.e. adjustment of a State's share of Union Excise Duties if the State's sales tax exceeds a specified limit—, we noticed that a very wide-spread misunderstanding about the Union Government's policy is prevalent among them. The general charge is that the Union Government has a tendency to neglect shared revenues, even shared parts of one and the same item, in favour of non-shared revenues and that there had not been adequate exploitation of the assigned taxes mentioned in article 269 of the Constitution. Each State illustrated this view with what it thought was an apt case. Some States had a feeling that as the Constitution now stands, a temptation on the part of the Union Government to neglect the State's needs is inescapable. A general review of inter-governmental financial relations to be followed by constitutional amendment, if necessary, was also urged. A more general feeling, however, favoured more frequent consultations among the State Governments, and between State Governments and the Union Government on all matters of common financial interest.

136. It was neither necessary nor possible for us to go into the merits of these opinions except in so far as they appeared to affect the prospects of a cooperative and coordinated policy in regard to complementary and alternative sources of revenue such as Union excises on the one hand and sales taxes of States on the other. Article 274 of the Constitution would appear to have been purposefully framed to forestall and to remedy misunderstandings such as these. This article provides in effect that no proposal which in any way affects existing or prospective financial interest

of a State shall be presented to Parliament except on the recommendation of the President. An explicit provision for a recommendation by the President should normally entail some mechanism other than the usual briefing and advice from the concerned Ministry at the Centre. While on several important subjects of common financial interests, consultations with individual States and groups of States have been held in the past there is no regular provision or convention about preliminary consultation with concerned States before the President makes a recommendation to Parliament.

137. Thus, though procedural requirements of article 274 have all along been observed, such observance may be capable of further improvement in such manner as would more fully carry out the purpose of this article and would convey greater reassurance to the States. Contacts among States, and between the States and the Union Government, for discussion of matters of common financial interest ought to be much more regular than they have been in the past. Zonal meetings and meetings of the National Development Council are concerned with such a large number of important questions that they cannot always be expected to give to specific financial issues the close and detailed attention which they deserve. The real intention of article 274, namely that all aspects of the impact on State governments of financial proposals to be made to Parliament should have been previously studied and approved by the President of the Union can be better served if regular meetings at policy, as well as implementation, levels are held among representatives of the Union and State Governments. The proceedings of such meetings will be helpful to all concerned, including the President, in promoting clearer understanding and firmer approval of common financial policies. Once the practice of regular consultation is established it will tend to cover a growing area of common financial interest, not confined to tax-sharing, but extending to exchange of experiences which may lead to greater and greater co-ordination in policy and procedure, the need for which appears to have been pointed out by the Taxation Enquiry Commission even a decade ago. In countries having comparable financial relationships between a Central and several State Governments the functioning of similar institutional devices of regular consultation has produced valuable results. It would appear that the time is ripe in India to make at least a beginning in this respect.

II. Establishment of an Organisation in the Ministry of Finance for continuing the Commission's work.

138. The First Finance Commission had recommended the establishment of a small organisation preferably as part of the Secretariat of the President, for making a continuous study of the finances of the State Governments, the rates of taxes in operation, the effects of the further measures of taxation undertaken by them, the working of their commercial enterprises and their effect on the State finances and cognate matters. It was intended that this organisation should also obtain direct from the State Governments periodical information in regard to the progress of various social services such as education, medical and public health and other material and data, tabulate them and make available the results of these studies in the form of papers to the successive Finance Commissions. Although this recommendation was accepted by the Government, only a small Cell was established, initially in the President's Secretariat and subsequently transferred to the Finance Ministry following the recommendations of the Taxation Enquiry Commission.

139. The Second Finance Commission also recommended that a nucleus staff with experience of the work of the Finance Commission should be retained within the Finance Ministry and made available to future Commissions. It also suggested that arrangements may be made by the Finance Ministry for the necessary statistical and other research work likely to be of assistance to the future Commissions. The Third Finance Commission also stressed the importance and necessity of arranging for the compilation of reliable statistics relevant for the determination of the needs of the states, their taxable capacity and the efficiency of their administration.

140. The Cell maintained in the Finance Ministry, however, consists of only some ministerial staff. No data except the *Conspectus of Central and State Budgets* has been made available to us by the Cell. The work of the Finance Commissions could be facilitated, if adequate arrangements are made to make a continuous study of State revenues and expenditure. For instance the result of such studies would probably have enabled us to deal more satisfactorily with our terms of reference relating to an examination of the scope for economy in administrative exependiture and a study of the combined incidence of States' sales tax and Union excise duties on production, consumption or exports than we have been able to do.

We, therefore, suggest that the present Cell maintained in the Finance Ministry may be re-organised and strengthened by the addition of personnel with suitable research experience who would be able to continue to collect and analyse the relevant material.

III. Natural Calamities

141. The Government of India has a scheme for assistance to States to meet expenditure on natural calamities in excess of the provision made by the Second and Third Finance Commissions in their schemes of devolution on the basis of the past average annual expenditure. In the course of their discussions with us, many States have urged that the conditions governing the grant of assistance under the scheme were too stringent and that the scheme should be liberalised so as to meet more adequately the needs of the States. The complaints related in particular to certain items of relief expenditure which were held to be ineligible for assistance under the scheme, the provision necessitating local inspection by officers of the Government of India, and the manner in which the excess of expenditure over the fixed amounts provided by the Finance Commission was shared between the Centre and the States. We have refixed the amounts included in the expenditure forecast on the basis of actual expenditure for eight years. We suggest that the working of the existing scheme may be reviewed and modifications made wherever required in consultation with the States.

IV. Transfer to Local Bodies

142. The forecasts of State expenditure accepted by us include large amounts by way of transfer of resources and grants to local bodies. These involve a large step-up over current levels of transfers. Although the amounts admitted by us are what are payable according to commitments incurred by the State Governments on the basis of existing laws or orders, most States were unable to supply us statements showing the break-up of the amounts among different heads of expenditure. We have admitted the amounts on the basis that the expenditure will have to be incurred exclusively on items which are ineligible for inclusion in the Plan, but it should be easy to take this reservation into account while finalising plan arrangements with each State.

V. Borrowing

143. The subject of borrowings by State Governments has come before the Commission in two contexts. By its terms of reference

the Commission has been asked to pay regard among other things, to any further expenditure for the servicing of their debt likely to devolve upon States, which are in need of assistance by way of grant-in-aid of their revenues under article 275, and to the creation by them of a fund out of the excesses, if any, over a limit to be specified by the Commission, of the net proceeds of estate duty on property other than agricultural land accruing to a State in any financial year, for the repayment of the States' debt to the Central Government. Even the total net proceeds of estate duty on property other than agricultural land accruing to States are so small in relation to the existing and prospective burden of borrowing by States from the Government of India, that unless the approach underlying this part of the Commission's terms of reference is carried substantially forward a satisfactory solution to the problem will not be found. On their side the State Governments have as a rule expressed grave concern at the mounting burden of their debts, and they have in effect requested the Commission either to provide them with enough resources for the service and amortization of their debts or to find some other way out of what many of them feel is an impasse.

144. The Commission must, therefore, squarely face the whole problem of the budgetary implications of borrowings by State Governments. In one specific respect, namely the service and amortization of the market borrowings of State Governments, the Commission is definitely of opinion that both these must form part of the revenue liabilities of State Governments. While interest liability has in the past been readily accepted as a revenue liability, amortization provision has been allowed as a legitimate charge on revenue only in the case of States which are not in need of grants in support of their revenues under article 275. The acceptance of the item of amortization as a legitimate part of revenue expenditure is, in our opinion, unaffected by the source from which the revenues are derived—revenues levied and collected by States, revenues accruing to States under the scheme of devolution, and grants out of the Consolidated Fund of India made in support of revenues of States as recommended by the Finance Commission. While almost all States have urged a claim for adequate strengthening of their revenues to enable them to make a suitable provision for amortization of their market borrowings, only a few among them have made any substantial provision for the same in their budget.

145. It is likely that this lack of adequacy and of uniformity of budget provision has been at least partly due to the view taken so

far that provision for amortization of market borrowings is admissible only to the extent to which a State's revenue resources, other than grants to which they are entiled under article 275, can bear the financial burden. We have accepted as legitimate items of revenue expenditure the provision already included in the budgets of State Governments on acount of amortization of their market borrowings. We recommend that an early inquiry through a representative and expert body should be undertaken to decide the principles of a scheme of amortization of public borrowings by the States. The recommendations of this body should form the basis on which all State Governments should be given an opportunity to recast their expenditure forecasts of the next five years. As the programme of public borrowings by State Governments is normally formulated in consultation with the Government of India there should be no difficulty in ascertaining the factual position of each State in regard to its amortization needs under an approved scheme. As the several guarantees given by a State Government to third parties constitute a contingent liability which it owes to the public the soundness of the practices currently followed in this respect should also be examined by the body to be set up to consider the question of public indebtedness of State Governments.

146. By far the more important in regard to amounts involved, and more complicated in regard to underlying policies is the problem of borrowings by States from the Government of India. The Central Government as a creditor of State Governments is in a peculiar position. Cases in which a State Government approaches the Centre with a request for a loan for a purpose which it decides by its unaided judgment as being in need of such finance are becoming very few. As a rule most of the objects of expenditure and investment by State Governments are determined by joint consultation either directly or through the Planning Commission. At least in some cases the Centre is keen on offering an inducement to a State Government to undertake a fresh responsibility. While the ultimate judgment of the State Government is in no way fettered, over a growing area of public expenditure, the relations between the two authorities are developing into an unlimited partnership. Whatever may be the position in law the Government of India cannot appraise the credit of a State Government, and certainly not of a number of State Governments, differently from its own credit. A survey of the soundness of the present system of inter-governmental borrowing is necessary as much in the interests of the States, as that of the Government of India.

147. It is necessary to be clear about the purpose and nature of a loan before its service and amortization can be put on a sound basis. When borrowing was largely confined to meeting either distress expenditure or the provision of a public amenity no serious doubt existed as to the burden both of interest and repayment being borne by revenues over an appropriate number of years. The mere fact that certain items of expenditure resulted in the creation of durable assets did not alter the fact that the expenditure had to be finally met out of revenue. Only items of expenditure which created a productive asset, bringing in a net revenue which would pay for interest and repayment, could be classified as investments and kept out of the revenue budget. A number of items fell between the two clearly defined classes, as being partly a revenue amenity and partly a capital investment. The extent to which each such item constituted a burden on general revenues had to be determined by the extent of its being an amenity and not an investment. This in substance was the prevailing practice of State and Central Governments till the developmental functions of both the State and Central Governments became increasingly important.

148. In 1955 the Government of India advised the State Governments that all expenditure on capital assets, that is durable or fixed though not necessarily productive or self-liquidating assets, should be held eligible for being serviced out of loans, and that the amortization of such loans need not be treated as a charge on revenue except to the extent that the State Governments were bound to provide in accordance with any law or with any specific undertaking given in the case of any loan [Appendix III (xi)]. In its initial stages this practice, which ran counter to the more discriminating policy of the earlier period of keeping out of the revenue budget only productive and self-liquidating items of capital expenditure, did not produce serious results, though it appears that some at least among the State Governments had repeatedly urged the claims of the more orthodox policy. The diversion of large items of unproductive or inadequately productive capital expenditure from the revenue to capital budgets made it possible to show a balanced revenue budget and to go on balancing the capital budgets also by fresh borrowings. As the sources and purposes of borrowings were numerous and ever on the increase, no serious question about the soundness of the new system projected itself for some time on the attention of Governments. But as the burden of Central loans began to pile up and as the unproductive i.e. non-revenue earning

nature of a large part of it *e.g.* education, health, protective irrigation, etc. became clear, the States felt that any further continuance of this policy by the Government of India could only mean that the Centre would ultimately take care not only of the interest, but also of the repayment liability of the whole debt, at least of that part of it which was not clearly productive of a net return equal to these obligations. As we have noted above more than one State has urged us to take this view of their indebtedness to the Centre.

149. As recently as March of this year the classification of expenditure as between capital and revenue accounts has received attention from the Finance Ministry of the Government of India. [Appendix III (x)]. While it is recognized that only clearly productive items of capital expenditure can be kept out of the revenue budget no definite provision has yet been made to ensure the observance of this salutary principle. Even when the general principle is accepted its application, or rather its reapplication in a developmental pattern of expenditure, is bound to raise a number of difficult procedural and financial issues. Apart from the current and prospective application of a more rational principle, the scrutiny, classification and treatment of accumulated indebtedness would need an elaborate, expert and representative deliberation. We are convinced, however, that in the interest of financial soundness such an inquiry ought not to be delayed any further. In regard to periods, rates of interest and other terms of each loan made by the Government of India to a State Government a much more specific and discriminating approach, than it has been possible to adopt in recent years, appears to be called for. It is only in the light of a thoroughgoing investigation of past commitments and of future borrowings that the exact impact of Central loans on State budgets can be measured, and incorporated into the scheme of devolution and grants which it is the function of the Finance Commission to recommend.

150. The overshadowing of current budgets by plan budgets, and generally of maintenance by developmental objectives has naturally created a ready acceptance of higher expenditure targets and of continued borrowing. A few State Governments readily admitted that their budgeting was optimistic in regard to revenue, that is they had budgeted for higher figures of revenue than they hoped to receive. This unusual attitude was sought to be defended partly as a target for achievement and partly as an apparent justification for higher expenditure budgets than were justified. Somehow this

was thought to be consistent with a welfare State. Even with this leavening of optimism budgets were not balanced in every case. Such situations, it was claimed would be met by ways and means overdraft. While as yet such attitudes and occurrences are rare the very fact that they are beginning to come to the surface indicates that a thorough revision of the policy underlying borrowing by States, especially from the Centre, is urgently called for. In their turn borrowers from State Governments are developing attitudes which reflect similar ideas of optimism and complaisance. A sounder and more rational arrangement between the purposes and the terms of loans must be reinstated to secure and enhance the strength of the fiscal system.

VI. Statistical data required by the Commissions.

151. The earlier Finance Commissions had emphasised the need for collecting reliable Statistical data on a continuous basis and making them available to Finance Commissions at the very commencement of their work. We have mentioned elsewhere that very little information had already been collected and compiled. We had to make our own arrangements for collection and analysis of the statistical data required by us. We issued a questionnaire to the State Governments requesting them to furnish information on 30 subsidiary points which were relevant to the work of the Commission. The questionnaire will be found in Appendix III(iv).

152. The task of the Commission involved the assessment of revenue receipts and expenditure of the States over the Fourth Plan period. This in turn required the estimation of the past and current growth rates of a number of components of receipts and expenditure. The data available in the budget papers could not be used for trend analysis without adjustment. There were many elements which made it difficult to compare the data over time. Changes introduced from time to time in budget classifications and accounting practices, step-up in receipts on account of additional taxation measures and take-over by corporations of departmentally run industrial and commercial enterprises are some of the major causes of non-comparability in the statistics of revenue receipts and expenditure of the States. Some of the items of statistics that should be collected are the following:—

(i) Information on additional taxation and other elements necessary for adjustments to make budget figures comparable over time;

(ii) rates of the principal taxes, duties and fees levied and the changes made from time to time in the rates;

(iii) details of schemes outside the plan financed partly or wholly by the Central Government or commodity committees;

(iv) regular comparable data on arrears of taxes in different States;

(v) loans advanced by State Governments to corporations, electricity boards etc.; rate of interest and other terms and conditions;

(vi) debt position of the States—Central and Public Debts—interest rates, terms of repayment and provision for apropriation;

(vii) number and pay ranges of State Government employees and employees of local bodies including Panchayat institutions and teachers in aided schools;

(viii) data on financial and economic results of irrigation (commercial), multipurpose river schemes and departmentally run commercial and industrial enterprises; and

(ix) details of transfer of resources to local bodies in each State and the manner of utilisation of these funds.

153. It has been stated in the Chapter on Income-tax that we have been obliged to accept collection as the only available measure of contribution for the distribution of income tax proceeds amongst the States. It may be said that a better indicator of contribution would be provided by measures of income orginating in an area or accruing to the residents of an area but adequate data are not available. An early attempt should be made to collect such information in future.

154. Successive Commissions have felt the need to have reliable data on State's contribution to excise duties, on the basis of consumption. The commodities concerned fall under two categories: (i) excisable goods consumed by households, and (ii) producer and intermediate goods. There is no readily available information in respect of the second category. As regards the first category, the National Sample Survey collects information on household consumer expenditure annually, but State-wise information is not available for any round except for the 13th round (1957-58); the 13th round data were considered by the Third Commission and found not usable

for the purpose of distribution of excise duties. We urge that information on consumption data, both household and non-household, on excisable articles should be collected and maintained on an up-to-date basis.

155. Our terms of reference include the study of 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. We have said elsewhere that due to lack of statistics, we are not in a position to study the problem. Only one or two States have made any real attempt to collect information on commodity-wise yield of Sales tax. Even in those States, the information collected is far from satisfactory. We recommend that immediate steps should be taken to collect commodity-wise information on Sales tax and excise duties. This information would be useful to the State Governments themselves.

156. Some States urged that *per capita* income should be taken as a criterion for the distribution of excise duty and income-tax. We examined the available data on State income and found that they are not comparable from State to State and therefore not usable for the purpose. We urge that the process of building up reliable and comparable estimates of State income should be accelerated.

CHAPTER 12

SUMMARY OF RECOMMENDATIONS

157. Our recommendations to the President in regard to devolution and grants-in-aid are set out below :—

Under article 269 of the Constitution:

I. **Estate Duty.**—In each of the five years commencing from 1st April, 1966 :—

(i) Out of the net proceeds of the duty in each financial year, a sum equal to two per cent be retained by the Union as proceeds attributable to Union Territories ;

(ii) The balance be apportioned between immovable property and other property in the ratio of the gross value of all such properties brought into assessment in that year ;

(iii) The sum thus apportioned to immovable property be distributed among the States in proportion to the gross value of the immovable property located in each State ; and

(iv) The sum apportioned to property other than immovable property be distributed among the States as follows :—

State	Percentage
Andhra Pradesh	8·34
Assam	2·75
Bihar	10·76
Gujarat	4·78
Jammu and Kashmir	0·83
Kerala	3·92
Madhya Pradesh	7·50
Madras	7·80
Maharashtra	9·16
Mysore	5·46
Nagaland	0·09
Orissa	4·07
Punjab	4·70
Rajasthan	4·67
Uttar Pradesh	17·08
West Bengal	8·09
	100·00

II. **Grant in lieu of taxes on Railway Fares.**—In each of the five years commencing from 1st April 1966, the amount of grant made available on the basis of the recommendations of the Railway Convention Committee be distributed among the States as follows:—

State	Percentage
Andhra Pradesh	9·05
Assam	2·79
Bihar	9·99
Gujarat	7·11
Jammu and Kashmir	
Kerala	1·85
Madhya Pradesh	9·85
Madras	5·81
Maharashtra	8·98
Mysore	3·98
Nagaland	0·01
Orissa	2·12
Punjab	7·43
Rajasthan	6·40
Uttar Pradesh	18·23
West Bengal	6·40
	100·00

Under article 270 of the Constitution:

III. **Income-tax.**—In each of the five years commencing from 1st April, 1966 :—

(i) the percentage of the net proceeds in any financial year of taxes on income other than agricultural income, except in so far as these proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments to be assigned to the States be 75 (Seventy Five) per cent;

(ii) the percentage of the net proceeds of taxes on income which shall be deemed to represent proceeds attributable to Union territories be 2½ (Two and a half) per cent; and

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