Chapter I

Centre - State Relations

Fiscal dependence of the States on the Centre is typical of almost all the federations of the world and our country is no exception. But nowhere in the world Centre-State fiscal relations perhaps have been so much polemical as it is here. It gave rise to first class constitutional issues. Every Finance Commission from the second onwards and others eruditely interested in the subject have called for a solution but to no purpose. To put it in the words of Mrs. U.K. Hicks — "As things have developed financial relations are more complicated in India than in almost any other Federation, certainly more than they are in the U.S.A., Canada, Australia or Nigeria. A formidable problem of coordination is implied". Except for grants given on an ad hoc basis for unforeseen situations, devolution of resources from the Centre to the States flowed in our country through two district channels; the Finance Commission and the Planning Commission. The former is a constitutional body appointed by the President under Article 280 of the Constitution, every quinquennium, after the first one is appointed within two years from the commencement of the Constitution. Assistance determined by the latter on the other hand, are given under Article 282 which is actually not a substantive provision intended for transfer of resources from the Centre to the States. It is rather a

'miscellaneous' provision for grants in aid intended for validating expenditure outside the legislative power of the Centre to the States. It is this article 282, vis-a-vis, article 275, the provision of which is a substantive one, that have become the bone of contention in the transfer of resources from the Centre to the States. "It is clear to my mind", said Mr. P. V. Rajmohor, "that article 282 was not intended to enable the Union to make a grant to a State as such. I venture to my say that while article 282 may continue to stay for the purpose for which it was originally intended, a specific constitutional provision may be added to enable the Union Government to make conditional grants to States for implementation of any project, whether falling within or without the Plan Scheme on terms and conditions which will ensure a proper utilisation of the grants". Consequently, Article 282 has been overworked to a point where it has over shadowed Article 275, meaning that assistance under the 'miscellaneous' provision of the constitution has exceeded that given under the substantive one. The assistance under Article 282 was 48.7 p.c. of the total in 1952-53 and went upto as much as 80.2 p.c. in 1961-62. This is one of the disquieting aspects and calls for revision.

Total resources transferred from the centre to the States increased from Rs. 1390 crores in the First Plan to Rs. 2834 crores in

2. Chairman of the Finance Commission 1965, in his minute of Dissent to the same.

Table 1.1

Transfer of Resources from the Centre to the States

(in crores of rupees)

<table>
<thead>
<tr>
<th>Period</th>
<th>Share of Divisible taxes</th>
<th>Grants</th>
<th>Loans</th>
<th>Total Expenditure of States (Revenue and Capital A/c)</th>
<th>Total 5 as percentage of 6</th>
</tr>
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<tr>
<td></td>
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<tr>
<td>Total 1st Plan</td>
<td>325.5</td>
<td>214.8</td>
<td>822.4</td>
<td>1389.7</td>
<td>3351.9</td>
</tr>
<tr>
<td>(1951-52 to 1955-56)</td>
<td>(25.4)</td>
<td>(15.4)</td>
<td>(59.2)</td>
<td>(100.0)</td>
<td></td>
</tr>
<tr>
<td>Total 2nd Plan</td>
<td>710.1</td>
<td>700.4</td>
<td>1423.2</td>
<td>2833.7</td>
<td>5842.9</td>
</tr>
<tr>
<td>(1956-57 to 1960-61)</td>
<td>(25.0)</td>
<td>(24.7)</td>
<td>(50.3)</td>
<td>(100.0)</td>
<td></td>
</tr>
<tr>
<td>Total 3rd Plan</td>
<td>1196.0</td>
<td>1308.1</td>
<td>3101.4</td>
<td>5600.5</td>
<td>10719.5</td>
</tr>
<tr>
<td>(1961-62 to 1965-66)</td>
<td>(21.3)</td>
<td>(23.5)</td>
<td>(55.4)</td>
<td>(100.0)</td>
<td></td>
</tr>
</tbody>
</table>

(Compiled from R.B.I. Bulletin, Aug. 1967, p-1066)

* Includes States share of income tax, Union excise duties, estate duties and tax on rly. passenger fare.

** Includes both statutory and non-statutory grants;

- Figures in bracket indicate percentage to the total (Col. 5)
in the Second Plan and further to Rs. 5600 crores in the Third Plan. These transferred resources account for 41.4 p.c. of the States' total expenditure both on revenue and Capital account in the First Plan. The percentage progressively increased to 48.5 and 52.2 in the Second and the Third Plan respectively. The share of loan finance which is made by the Planning Commission in the transfer scheme, again, makes interesting reading. It increased from 50.3 p.c. in the Second Plan to 55.4 p.c. in the Third Plan. The share of divisible taxes and duties made on the recommendations of the Finance Commissions, on the other hand, registered a decline during the same period from 25.0 p.c. to 21.3 p.c. In fact during the first three five year plans, more than 65 p.c. of the total resources transferred from the Centre to the States were outside the scope of the recommendations of the Finance Commissions.4

In the meantime, we cannot but note some interesting developments that have taken place in the sphere of Union-State fiscal relations which caused not only financial loss to the States but also made further inroads to the autonomy of the same in the existing set up of the relations. The reform of company taxation in 1959-60 in favour of the Central Government is a case in point. Amendment of the Income Tax Act in relation to the 'grossing' of dividend incomes earned by individuals adversely affected the States. (Formerly Joint Stock Companies had to pay a

Corporation tax in addition to the income tax. The income tax paid by these Companies was attributable to the dividend received by the shareholders. The dividend received by the shareholders consequently was increased by the amount of the income tax paid by these Companies on that part of income. This procedure of allowing a tax credit to a shareholder was known as 'grossing' and the income tax paid by the Companies formed part of the divisible pool.\(^5\) A strong case is also made out by the States against the constitutional provision empowering the Central Government to impose non-divisible surcharges not only on income tax but also on Central Excises. So far we know, this is an emergency provision of the Constitution. But unfortunately this provision has been made a permanent feature of the income tax structure, depriving thereby the States of a fair share even in normal peace time. It is moreover, permissible for the Central Government to impose special excises for its own benefit. Levies on income again, like compulsory deposits or annuity deposits are in effect, taxes on personal incomes but they do not come within the scope of sharing. This "limited definition of income tax for the purpose of

\(^5\) "Under the revised scheme the grossing up procedure was given up and in addition to the taxes paid by Companies they had to deduct income tax from the dividends paid by them. Thus under the revised scheme Company profits were subject to a tax non-refundable on corporate profits. The tax proceeds did not form part of the divisible pool as the Corporation tax is exclusively assigned to the Federal Government."

specifying the divisible pool has created problems, particularly with the general trend towards the conversion of proprietary or partnership concerns into joint Stock Companies. Though the States were compensated on the score of grossing up of dividends with special grants until the question was examined by the next Finance Commission, they were deprived of a share in an elastic and expanding source of revenue, since the special grants did not contain an element of built-in flexibility. The situation did not ease either, even with the examination of the question by the next Finance Commission, "while the collections from Corporation Tax have increased by well over 600 percent in the course of the last 12 years", the States argued before the 1965 Finance Commission, "the corresponding growth in the divisible pool of income tax was less than 50 percent". Similarly, Article 269 lists seven items which are to be levied by the Union Government but the entire net proceeds, except the portion attributable to Union territories, have to be distributed to the States without crediting them to the consolidated Fund of India, in accordance with the law of Parliament. Of these, however, only the inter-state sales tax and estate duty have been levied. There are items in the list which are likely to be highly productive from the standpoint of the States, but it is entirely in the hands of the Central Government to decide whether any of these taxes or duties should be imposed.

at all. "There is besides, the peculiar fact that a tax can be taken out of the scope of Article 269 simply by giving it a different name. The best example of this tax is the tax on railway fares which was levied and the receipts from which were distributed to the States as long as the tax lasted as a tax. It was, however, decided by the Government of India to merge the tax in the fares, so that what was earlier designed as a tax on fares now became simply an increase in fares. As the railways are publicly owned, the difference between a 10 percent tax on fares and a 10 percent increase in fares is not a difference in substance, but the change in nomenclature and classification had the effect of removing the additional receipts from the scope of Article 269."8

The tax on railway passengers fares was levied but was merged with railway passenger fares from April 1, 1961, and the States have been given compensatory grants since then. It was Article 269 of the Constitution that provided for the levy of these taxes, to the benefit of the States and "the Union Government is interposed merely an agent for ensuring uniform rates and methods of collection. But there was no attempt by the Central Government to consult the States about these taxes."9 It is yet another way how the States nurtured genuine grievances as having been deprived of an elastic and expanding source of revenue. It is the transmutation of Sales Tax on mill made textiles, sugar and tobacco (including manufactures tobacco) into additional duties

of excise since 1957-58. Though the States have been guaranteed the minimum amount which they derived from the Sales Tax on these commodities in 1956-57 and the surplus, if any, in the yield of the additional duties of excise was to be distributed in accordance with the recommendations of the Finance Commissions, it has altered the pattern of distribution among the States, inter se, since the successive Finance Commissions took into account the factor of population, inter alia, in the distribution. It may be noted that the States agreed to the proposal of transmutation without knowing the manner of allocation subsequently evolved. The question of its distribution by the Finance Commission apart, trenchant criticism has been levelled by the State Governments against the scheme; 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 were raised and even special duties of excise were introduced, the rates of additional duties of excise have remained unchanged. If the substitution had not taken place it is argued, 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, the Sales Tax being an ad valorem levy. It was 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 that of sales tax revenue on other items.
The most important difficulty that has arisen in recent years is that the constitutional provisions on the centre-state financial relations have not proved adequate for the needs of a planned economy. "The convention that the Finance Commission should cover non-plan expenditure only, while the Planning Commission should concern itself with plan expenditure, has been established by executive decision. The dichotomy that has been established between plan and non-plan expenditure has also brought with it a dichotomy between plan and non-plan financial resources, apart from making the task before the Finance Commissions extremely difficult." There is nothing in the Constitution to indicate that plan expenditure would be outside the scope of the Finance Commissions, or even that the Finance Commission should have nothing to do with Capital expenditure. Mr. Rajmanner's minute makes interesting reading on this score. "It follows from a construction of the relevant articles of the Constitution as they stand, that the Finance Commission is concerned with the total assistance to be given to a State, other than by way of loans, whether classified as capital or revenue. There is no legal warrant for excluding from the scope of the Finance Commission all Capital grants; even the Capital requirements of a State may be properly met by grants in-aid under Article 275(1), made on the recommendations of the Finance Commission .... Apparently, even the view taken by the Government of India is not that it is

beyond the power of the Finance Commission to provide for the requirements of the plan. The Third Finance Commission made a recommendation by a majority that the total amounts of grants-in-aid should be of an order which would enable the States, along with any surplus out of the devolution, to cover 75 percent of the revenue component of their Plans." This part of the recommendation was not however, accepted by the Government of India for reasons more practical than legal.

"The legal position, therefore, is that" the minute continued, "there is nothing in the constitution to prevent the Finance Commission to take into consideration both Capital and revenue requirements of the States in formulating a scheme of devolution and in recommending grants under Article 275 of the Constitution. But the setting up of the Planning Commission, inevitably has led to a duplication and overlapping of functions to avoid which, a practice has grown up, which has resulted in the curtailment of the functions of the Finance Commission." Consequently, the fourth and the fifth finance Commission were categorically debarred by the terms of their references from going into plan expenditure. This practice, certainly was not anticipated by the framers of the Constitution. According to Mr. K. Santharam, Chapter 1 of Part XII of the Constitution which regulates the financial relations between the Union and the States is based on two major assumptions. The first is that the main assistance required from the Centre would be in the nature

12. Transition in India (Asia Publishing House) 1964, p. 116
of shares in taxes and grants towards the recurring revenue expenditures of the States. Though under Article 283, the Government of India is empowered to make loans to States or give guarantees in respect of loans raised by them, it was contemplated that normally the capital needs of a State would be met by its own borrowing. The second assumption is that the Finance Commission would be the Chief instrument for determining the subventions and grants and the discretionary paragraph under Article 282 would be used only for special emergencies like famines of floods or other natural calamities. Both these assumptions have now broken down on account of the adoption of the policy of planned development under the guidance of a central Planning Commission. Extensive use of Article 282 has instead been made in the disbursements of Central Loans towards the Capital account of the States over the Plan periods as follows:

Table 1.2

<table>
<thead>
<tr>
<th>Plan</th>
<th>Loans from Centre (Rs. Crores)</th>
<th>Capital Account of States (Rs. Crores)</th>
<th>Percentage of (2) to (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Plan</td>
<td>822</td>
<td>997</td>
<td>82</td>
</tr>
<tr>
<td>Second Plan</td>
<td>1423</td>
<td>1908</td>
<td>75</td>
</tr>
<tr>
<td>Third Plan</td>
<td>3099</td>
<td>3459</td>
<td>87</td>
</tr>
</tbody>
</table>

(Source: Finances of State Governments, Reserve Bank of India Bulletin, May 1966)

In the existing setup which was largely born out of practice than of legal sanctions there are three broad categories
of fiscal transfers: shared taxes, grants and loans. Shared taxes at present, comprise:

(1) Divisible taxes which are (a) obligatorily shared, i.e. the income tax and (b) permissively shared viz. excise duties;

(2) Taxes and duties collected by the Centre but wholly accruing to the states, i.e. (a) Estate Duty and (b) Additional Duties of Excise;

Finance commissions are charged with the task of recommending the share of such taxes between the Centre and the States on the one hand and the manner of allocation of the States share among them inter se, on the other. Disbursement of the loans are the exclusive responsibility of the Planning Commission. As regard 'grants', the Finance Commission and the Planning Commission both determine it, the former deciding the non-plan side and the latter, the plan side. During the first three plan periods, the nature and direction of the loans from the Centre to the States are as follows: 13

A: Grants met from revenue:


2. Grants under substantive portion of Article 275(1)

3. Grants under Proviso to Article 275(1)

4. Grants under Article 278
5. Grants in-aid under Section 74 of States reorganisation Act.
6. Payment to Police force.
7. Grants for agricultural schemes, dairying, rural development etc.
8. Grants for forest development.
9. Grants for community Development Schemes
10. Grants for educational schemes, scientific departments and community listening schemes.
15. Grants for labour and employment schemes.
16. Subsidy for acquisition of gold.
17. Grants for natural calamities
18. Assistance for raising emoluments of low paid employees.
19. Payments to State Governments on account of reduction in their share of Income Tax consequent upon changes in Company taxation.
22. Others.

B. Grants met from Capital:
1. Local Development Works
2. Industrial Housing and Slum clearance
3. State roads of economic or inter state importance.
4. Grants from Central Road Fund;
5. National water supply programme.
6. others.

The list is exhaustive.

Turning to the recommendations of the Finance Commissions in the matter of transfer of resources, we see that budgetary needs for all practical purposes and difficulties also, have been equated with actual needs. "Grants in aid", said the Third Finance Commission, "should obviously be made to meet the residuary fiscal needs of the States, after offsetting the estimated amounts made available by the devolution of taxes." The First Commission considered that the budgetary needs of the states should first be estimated by a detailed examination of the forecasts of revenue and expenditure submitted and then these should be reduced to a comparable basis by the exclusion of abnormal, unusual and non-recurring items of expenditure. Adjustments in this analysis should be made to take account of the extent of tax effort made by each State individually; and also the measure of economy it had effected in administration. This would help a broad judgement of the quantum of assistance that would be justified. Level of social services attained by a State and any special disabilities arising out of its constitution should qualify a State for further assistance. In addition, grants should also be made for broad purposes of national importance to bring up deficient States to an acceptable minimum level.
The above principles were evolved by the First Finance Commission and the Second and the Third also accepted these principles as eneceptionable. The Second Finance Commission considered that the eligibility of a State to grants-in-aid and the amount of such aid should depend upon its fiscal need in a comprehensive sense, i.e. including the provision needed for the Plan. In the enumeration of principles, the First Commission acknowledged that it was not sufficient to cover the budgetary needs but also the fiscal needs arising out of development programmes undertaken. The Second Commission also suggested that the gap between the ordinary revenue of the State and its normal inescapable expenditure should as far as possible be met by sharing the taxes. Grants in aid should largely be a residual form of assistance given in the form of generally unconditional grants. The same principles have been followed by the Third Finance Commission but all of them have been uniformly handicapped by paucity of reliable informations on this score.

"The comparative determination of the tax efforts of the states", says the Third Finance Commission, "cannot be in absolute terms. It has to be related to their tax potential and this calls for a special study. Similarly, the assessment of the measure of economy effected or the degree of efficiency reached in a state's administration is a complicated exercise which, in any event, we could hardly undertake with the organisation and time at our disposal."

15. Ibid., p 24.
for itself cases of optimatal tax eftor by a State, the Second Finance Commission thought a State to have done its part if it raised additional revenues which it promised for the Plan. So far so good. But nevertheless it cannot be denied that it is at most an adhoc measure, not free from criticism. For, in general, states are interested in presenting to the Planning Commission rather an inflated picture of their revenue potential in a bid to acquiesce as large a size of the Plan for each as possible, and to that extent the Finance Commission's (1957) assumption of additional taxation proposal of States for the plans as indicator of tax effort is unexceptionable. But there may be leeway in individual cases where a State may play truant thinking that it would not make much of a difference in the determination of the size of its Plan between the minimum, and the maximum range and/or the marginal increase in the size would not be proportionate to tax effort to be exerted, much to the chagrin of the subjects, since, other considerations than tax effort also played a dominant part in the determination of the State Plans. West Bengal, for instance, is a case in point where

16. "Additional Taxation has to be ultimately the fixed with reference to what is considered feasible in a particular State .... It is not gear on what basis the relative levels of additional taxation or Central aid are fixed. Apparently, the ultimate decision is rather on an adhoc basis" - 'States' Finances in India'—K. Venkataraman P.77. George Allen & Unwin Ltd. 1968. Also, K.V.S.Sastri, Federal-State Fiscal Relations in India, Chapter II. Oxford University Press, 1966.
where it decidedly presented before the Planning Commission during the Third Plan deliberations a deflated estimate of its additional taxation measures which was eventually turned out in achievement to be more than its estimate of Rs. 40 crores. In respect of evolving an index for judging the efficiency in expenditure on the part of States, the Third Finance Commission reported that it had, like its predecessors been compelled to cover budgetary gaps of all States whether caused by normal growth of expenditure, the maintenance costs of completed scheme and mounting interest charges or even by a measure of improvidence. This approach is also not entirely innocuous and the weakness inherent in the very terms of reference and constitution of the Finance Commission.

"The periodical appointment of the Finance Commission, charged with the function of looking after the non-plan expenditure only, encourages State Governments to take upon themselves large commitments towards the end of an award period, so that these may be legitimately included in the claims from the Finance Commission. It is also natural that a State will be reluctant to impose any new taxation in the benchmark year designated by the Finance Commission, because it is to the interest of the State Government to get a large deficit admitted by the Commission." The approach to transfer of resources made by the Indian Finance Commissions from the Centre to the States, therefore, is anything but approximations. According to Mrs. U.K. Hicks, "the device of

17. For a detailed discussion, see the authors article in Capitalon 'Scope for raising more resources through Taxation in West Bengal' dated 9-7-70.
balancing current budgets on request is, if anything, worse than the tax targets sanctioned. It gives a State even less incentive for good management. This method has been followed by the British Treasury in the West Indies and its failure has been most striking. The more ambitious islands widened their deficits by tucking into current expenditure a number of items which were strictly speaking on capital account. The lazy ones stopped bothering to collect taxes. One island after another achieved a deficit and nestled comfortably into the fold of grant-aid".

"In the context of general devolutions and differential grants in aid, the principles of allocation for devolution rather lose their importance. The Finance Commissions, it would have been noticed, have largely relied on population and to some extent on derivation and they have not been able to adopt any other criteria in the absence of adequate statistics. It has been shown that population need not necessarily have redistributional effects if the richer states are also more populous. Besides, density of population can also have an important bearing on needs. Moreover, the principles of allocation based on population may work at cross purposes with those enunciated by the Planning Commission and may urge a State to relax efforts on this score. The State income under such circumstances, may be a better guide for such allocation. The ratio of the quantum of resources transferred to the non-plan

22. i.e. Family Planning etc.
23. U.K. Hicks, Ibid. p. 11
revenue account of the State has also been suggested to provide an index of the equity of the transfers. Other considerations in the transfer problem also present themselves. In a poor federation, it may so happen that some States are better off than others, causing the former to maintain higher standards of service to the latter. A national policy in the field of essential social and development services in the broader national interest under such circumstances is what is called for. This gives rise to the principle of 'national minimum' for purpose of allocation of resources. According to Dr. B. R. Misra, "the ideal allocation of resources between the federation and the States should be in accordance with the principle of 'national minimum' for people living in different States." Unlike individuals", says Mr. D. T. Lakdawala, "who can migrate to richer areas, and whose migration state should help if it leads to better national productivity, States cannot. Since they continue to exist, they must be given the necessary wherewithal to continue to a level not much below the national average so as to avert the danger of undermining the feeling of federal unity and posing a threat to security and progress. This job in India has largely devolved on the Finance Commissions, ......"26

It is not this principle evolved by Dr. B. R. Misra or for that matter by Mr. D.T. Lakdawala that should alone primarily

weighed within the scheme of transfer of resources; there are others equally, if not more, important, which should merit consideration in a developing economy. Efficiency consideration, for example, demand that investment of resources be directed to the most productive regions, particularly in a developing federation. In continuation of our argument, Mr. Lewis goes a step further and suggests that "while concentrating on regions which seem clearly to have the most potential, the planners must not neglect the basic infrastructure needs of the others, for economic no less than political reasons." We can extend our considerations to the case of each State or region with reference to the relative per capita income indices and such other basic indices such as total per capita poverty of a State, population etc. Such an amalgamated approach to ascertain the per capita income for the year 1960-61 of Indian States (i.e. 90 p.c. per capita income, 10 p.c. area) was made by Mrs. Hicks. The relative backwardness of a State or for that matter a region can be ascertained by such indices as the relative industrial development, the number of factory workers to total workers, the number of literates per thousand of population, the number of hospital beds per lakh of population, surfaced road mileage per lakh of population, etc.

28. W.A. Lewis, Development Planning, 1965, P. 70
30. Quoted in the author's article "Scope for raising more resources through Taxation in West Bengal" in Capital, dated 9th July, 1970.
Federal Finance is only a financial counterpart of federation, and cannot, therefore, avoid its limitations. The scheme of division of resources under the Indian Constitution makes a clear bifurcation of taxes to be levied by the Central and State Governments. And "the division of functions and resources is based on efficiency consideration". There also is no overlapping tax jurisdiction between them. Consequent on such a basis of division of functions and resources, the States are saddled with the liability to perform expanding and expensive functions in normal conditions but are assigned relatively inelastic sources of revenue. To help the States tide over their difficult financial position in the discharge of such onerous functions vis-a-vis their resources, the Constitution also envisages the appointment of quinquennial Finance Commissions as the balancing factor. "Unlike other federal Constitutions, the Indian Constitution did not attempt to make the allocation of resources correspond with allocation of functions. Elsewhere, imbalances which developed later were sought to be met by grants on certain defined principles. But it has not been so in India. The States were ab initio made dependent on Central subvention for fulfilling their responsibilities". In a bid to obviate the inequality arising out of the distribution of taxing powers vis-a-vis the States three important devices were adopted. The first was embodied in the articles 270 and 272 relating to the compulsory sharing and permissive

32. R. K. Bhargava, Theory and working of Union Finances in India, P. 79. George Allen & Unwin Ltd.
33. A. K. Chanda, Transfer of Larger Resources Possible through Adjustments; Statesman, dated 2nd April 1969.
participation by the States in the yield of income tax and collection of federal excise duties respectively. The second has reference to Article 268 of the Constitution that specifies some duties in the union list but which were to be collected by the States. Stamp duties and excise duties on medical and toilet preparations belong to this category. This article is designed to ensure a uniform basis and rate for the taxes mentioned Article 269 is yet another device under the second category, the object of which is to specify a list of duties and taxes which are to be levied and collected by the Government of India, but are assigned to the States. Dr. Sastri called these devices otherwise meant for easing the financial situation of States ingenious ones because they only make the difficulties associated with tax sharing and assignment more prominent. These financial provisions "embody the fruits of uncommon imaginative faculties in that they embrace the whole gamut of variations on the themes of revenue sharing and revenue assignment." Deficit financing by the Central Government and borrowing powers of both layers of Government again, impinge on Centre-State relations. The hardship of price rises consequent on deficit financing affects State finances more unfavourably because of their relatively inelastic revenues. In so far as State revenues have buoyant aspects, States may not complain. But they have non-buoyant aspects as well, such as the inflexible rates of additional duties under Article 269 of the Constitution. Here the States may express genuine grievances against the Centre.

Borrowing inside the country can normally be indulged in by both the layers. But the Centre by virtue of its better credit worthiness and standing in the market is in a position to raise loans on better terms and in larger quantities than the States. The States can borrow on their own without the consent of the Central Government so long they have no outstanding loans from the latter, but in practice, in view of their heavy indebtedness to the Centre, they can and in fact, do borrow from the market with the consent of the Central Government, thereby rendering the restrictive clause inoperative. Here, however, their limited ability to borrow in relation to the Central Government that matters.\textsuperscript{35}

The most sorry aspect of such impact of Union operations on State Finances in respect of deficit financing and loan financing is that union finances gain at the expense of the latter. To the extent Union Government extends loans to the State Governments from moneys created out of deficit financing, the interest cost of the latter accrues as profits of the Reserve Bank of India which again, comes to be credited to Central revenues as profits of State enterprises. The Union or the Central Government also raises foreign loans at rates of interest much lower than that charged for state loans.\textsuperscript{36}

The impact of Union financing on State finances has other aspects also. "Union-State financial relations come into

\textsuperscript{35} Sec. D. T. Lakdawala . Union-State Financial Relations p. 39

\textsuperscript{36} Benoy Das Gupta . Our Plans and our Public Finance A. Mookherjee & Co. Ltd. p. 36
prominence when the Central Government enhances the emoluments of its employees and the State Governments are consequently forced to adopt similar increases in the State without the necessary where­withal to finance such increase. The States have then to look to the Centre for assistance. The process began during the Second Plan when the Centre increased the emoluments of its employees and also gave assistance to the states for increasing the emolu­ments of low paid employees. This increase was given till the year 1960-61, since the further requirements were to be taken note of by the Finance Commission. Subsequently there have been periodical increases in dearness allowances by the Central Government. State Governments have complained that the unilateral increases forced on them are difficult to finance since their resources on the non-plan and plan account have been fully taken into account by the Finance and Planning Commissions.

In the realm of Centre-State relations, the issue that still remains supreme relates to conditional and unconditional grants. The Planning Commission in India is inured to the practice of affording conditional grants to the States whereas the Finance Commission, unconditional grants. And discretionary assistance to the States by the former has overtime, far outweighed the unconditional grants made by the latter. Now the question is have the States derived any real advantage from the discretionary grants or for that matter, has the former secured the fulfilment of the objectives of planning by so doing in a better and purposeful way?

To answer the question we have to consider the merits and demerits of conditional and unconditional grants and examine their relevance to our cases. Conditional grants by the Centre to the States are given to induce the States to follow enthusiastically the Central policy. Conditional grants combine the advantages of national planning and local interest and administration in matters left generally to States. "The rationale of conditional grants depends on the presumption that the Centre is a better judge of people's interests even in functions which belong to the States. This presumption is a priori justifiable within a limited sphere. The Centre has not necessarily more foresight or better wisdom, nor has it a better judgment regarding the welfare function. .... Its equitable and successful working demands that the States have enough general financial ability and specific interest to be ready to bear the burden." If conditional grants are given on a large scale, the States' resources may be overstrained and they may be tempted, as the Indian States during the Plan period, to resort to deficit financing and overdrafts from the Reserve Bank of India to avail those grants from the Centre.

The advantages of unconditional grants for outweigh those of conditional grants, especially in a developing federation. It has a two-fold objective. "The units of federation have different levels of economic prosperity, and they, therefore, can afford different levels of service for their own people. At the same time it is not in national interests that more than a certain extent of

disparities in State services (or as a matter of fact State incomes) be allowed to persist ....... If the States would be interested in and under pressure to supply some services, in any case, the only barrier being the ability to pay, unconditional grants, not being hampered by the sharing rule, will do the job of equalisation much better than the conditional grants. They would also leave enough freedom to the States to follow their own needs and tastes in detail. Unconditional grants and tax sharing are also a better way to solve the dilemma between needs and power to gather money from own resources that all the States find themselves in." 40

The rigours of Central assistance are greater than is necessary. "The Centre itself has been forced to recognise the defects of a rigid procedure and the few instalments of simplification and rationalisation have stemmed from this fact. The Planning Commission has stated that the present restrictions and manipulations of grants in aid have not been really effective in giving a proper lead to State Governments in implementing State plans. While the Commission felt that the distribution of subjects under the Constitution between the Union and State Governments does not give to the Centre sufficient powers to ensure economic and social development of the country as a whole either on an adequate scale or on uniform lines, the Commission admitted that rigid

40. D. T. Lakdawala - Ibid, P.16
procedures for administering Central assistance inhibit action in the States". 41

Central assistance for the plan scheme comprises centrally assisted schemes as well as centrally sponsored schemes. Such assistance varied from one half to three fifths of the States' plan outlay. The following excerpts from Prof. Lakdawala's work would immediately make it clear. "It was in theory meant to fill the gap between the own resources of the States (including statutory grants) which could be spared for the Plan and the total costs of the State Plan. There was, however, nothing rigid about the size and investments of the State Plans and the Central assistance was meant to influence, and did influence, them. In fact it is this aspect which lends great importance to Centre-State financial relationships. We must ask ourselves, not only on what principles Central assistance was meant to be and actually distributed among different States, but also how far it subserved the purposes for which it was given and whether it succeeded in stimulating the right response from the States.

The amount given as planning assistance grants and loans to State is estimated on the basis of schematic patterns which vary widely, the only common element perhaps being the sharing insistence. They, however, materially differ from the conditional grants in other federations in so far as they aim not only at State activity in specific directions but are parts of an overall Plan. Their major purpose is to ensure coordination, horizontal

and vertical, of State developmental plans, to see that certain national priorities are observed, and that the States put forth their best tax and other efforts. As we shall see, slowly the conditions, have been practically made so flexible as to ensure their importance by and large at the time of discussion of the Plans, not at the stage of their implementation*. 42

From the above, it immediately transpires that conditional grants of the Planning Commission remains conditional only on paper at the stage of discussion than on implementation, though they ought to be conditional all through. "The working of the system also revealed that there is little or no control (as distinguished from review) by the Central Government." 43

Finally, we would do well to note what Professor Gadgil has to say in this connection: "The present system of Central grants suffers from most of the defects attributed to a bad system of grants. However, its most glaring defect is the manner in which it is insidiously undermining the autonomy of States. This happens, chiefly, in two ways. Firstly, most State Governments are tempted by offers of grants to undertake the activities to which grants are attached and in the form in which the centrally framed scheme is presented. This often leads to serious misdirection of effort in the context of particular circumstances of individual States. Secondly, the administration

of grants, with the usual examinations as to admissibility of expenditure, etc., planes very considerable power, often unfairly used, in the hands of inspecting officers of the Ministries and the Planning Commission. The total result is the undermining of the initiative of State authorities and the building up of feeling of resentment. There is also the uncertainty, in some instances, regarding finance for continuation of activities already initiated. A number of these defects would be removed and the State Governments would begin to operate more freely, if the basic principles governing the structure and operation of the entire system could be first laid down by the Finance Commission, the system rationalised in the light of these and then subjected to periodic examination by successive Finance Commissions. The recommendations of the Finance Commission would themselves be based on calculations about the results of the efforts to be made by the State Governments. Consequently, the total required for the plan could not become available without appropriate and adequate effort on the part of the States.

Secondly, when it is proposed that the Finance Commission should provide for all needed revenue resources, it is not suggested that they should be made available without any condition being attached. With a full provision, there need be no such hesitation on the part of the Commission. It is relevant to note in this connection that the Finance Commission, 1957, was inclined to

recommend conditional grants but refrained on the ground that it was providing only for partial finance. The procedure stated above will also make for securing the well known principle that the authority spending should also be the same authority responsible for raising the necessary amount.