CHAPTER 3. RESOURCE ALLOCATION AS A PROCESS OF FISCAL ADJUSTMENT.

While the provision of an institutional arrangement, periodical or irregular, for ensuring resource equilibrium to lower levels of Governments in a federation is an essential part of any ordinary system itself, planned economic development in a federation poses special problems not only to the theoretical aspects of resource allocations but also to the transfer mechanism. Such a practical problem has arisen in the context of financing of irrigation projects (examined in the subsequent paras) which has almost necessitated an amendment to the general rule contained in the constitution. Since large sums are being allocated by Union to the States by an organisation other than the one having constitutional sanction (viz. Planning Commission), an examination of both theoretical and operational principles behind such transfers, together with an exercise in an operational model of Professor Buchanan, are undertaken below. Since any institutional arrangement for financial transfers in a federation would soon be found to be obsolete and inappropriate, in the Indian context, constitutional arrangements regarding obligatory and optional distribution of Union's Tax proceeds, together with a positive suggestion for the distribution of income-tax proceeds between Union and States on a permanent basis etc., are examined to focus on the areas requiring change. Certain ideas or operational principles behind the distribution of Income-tax and Union Excise duties are also considered with suggestions for improvement. These aspects constitute the inspection process into resource allocations at the macro level. In Micro-inspection of Andhra Pradesh finances it has been examined whether the resources allocated to it and by it, present any of those issues observed in Union State relations (like irrigation projects).
In the micro-study, the technique to be adopted if a function has to be transferred to Union or Local Governments was also mentioned. Further the necessity for institutionalising transfers of funds from State Government to Local Governments was pointed.

PROBLEMS IN THE FINANCING OF BIG IRRIGATION PROJECTS.

In a developing federal economy resource allocations have to be made for the provision of Socio-economic infra structure. Planned allocations take the form of transfers for specific projects. Therefore same quantum of financial transfers, it may be noted, may result in different growth rates since impacts of those different projects (represented by a given quantum of fund), on the fiscal positions of States are dissimilar. For instance, growth in State "A" with investment mix biased towards industrial projects or those projects which yield immediate returns (from the time perspective), will be more prominent as compared to State "B" whose investments yield returns after long time. (1) Therefore, problem of allocation of projects between Union and States as well as in between States assumes significance. (2)

(1) In this context the net result of the impact of technological developments in both agricultural and industrial States as they influence the terms of trade between them and their relative fiscal benefits are worth noting. The experience of international trade may be suitably adopted to federal States for explaining variations in growth rates of income and hence fiscal capacities. Broad analysis was indicated by Gianni G. Zandano vide "Economic Development, terms of trade and tax policy" IEJ Sept., 1964.

(2) Sri K. Santanam says that the demands by States for big industrial projects is justified and that it is the price that centre has to pay to States for the sacrifice of (State's) autonomy, vide his "Union State Relations", p. 59.
Indian Constitution allocates Agriculture and Irrigation, and power to States and major and heavy industries to Union Government. Eventhough irrigation projects cost huge amounts they must be financed by States themselves. While this is so, some irrigation and power projects were undertaken by Union Government. It was mentioned that since these projects are of inter-state importance and require foreign expertise, they were taken up by Union. But, as the practice of allotting some irrigation and power projects to itself by Union Government and excluding some others or allocating for State's operation cannot be fully justified, it has to be examined. Finance, inter-state nature, national importance and the requirement of high technical skill are some considerations that support the case for Union's operation of irrigation and power projects. Since availability of finance and technical skill are common to all projects, by whomsoever they are operated, only those factors of inter-state nature and national importance should guide centralisation of this function. While physical planning of project which requires more than one State's cooperation is best suited for central operation, application of the criteria of 'national importance' is vague and open to criticism. Hence it should be given purposive and meaningful interpretation in the present context. The same has been attempted below.

Since in the planned economic development, food production occupies pivotal role, assigning to it the criteria of national importance is just. But this objective of achieving self-sufficiency

1. Hirakud, Bhakra Nangal and Tarapore Atomic Power projects are some examples.
in food production should be given operationally significant expression in planning physical allocation of resources in different regions or units of the federal economy. How should the investment pattern be framed? Should it be on the basis of unit-wise self-sufficiency in food production or on the basis of overall self-sufficiency for the federal economy as a whole? While the former approach may not involve serious problems, the latter one involves. If one or few units have to model their Agricultural investments with a view to achieve self-sufficiency in food for entire federal economy, naturally they will have to undergo stresses and strains, which may take the shape of foregoing industrial development in the immediate short period. From federal view, how this loss of economic advantage by these units should be compensated in the short-run and how the resulting regional income inequalities could be rectified in the long-run are the main issues. Further could other States that concentrated on either industrial development and more particularly on producing and trading in non-food crops be made to compensate those States supplying food? States producing non-food products have the dual advantages of higher incomes owing to their commercial crops besides the subsidised food which they get. In these circumstances the federal Government should necessarily

1. Case study of Punjab farmers cropping pattern by N.C.A.E.R. pointed that the difference in income between food and non-food is to the tune of 28%. Hence it may be argued that increase in regional agricultural incomes, which constitute nearly 50% of States' incomes, vary according to cropping pattern. The State with high percentage of cultivated area under food crops suffers a net disadvantage in growth of income as compared with a State with the cropping pattern more biased towards non-food and commercial crops. Cropping pattern in Punjab" by N.C.A.E.R. (1966) reviewed by A.R. Rajapurohit in Sunday Standard"dt. 25-9-1966 p. 9.
think of either capital grants to the huge projects undertaken by the States under the criteria of national importance or take them over on itself for finance and operation in federal or Unions sector.\(^1\) Since returns from irrigation projects are slow and low, these projects cause considerable strain on State's finances by way of interest payment in the immediate short run.\(^2\) This is the rationale behind States demand that irrigation projects costing over Rs. 10 crores should be operated by Union Government.

Implications of an irrigation project operated by State Govt. with an outlay of, say, Rs. 150 crs., and an industrial project costing similar amount but is operated by Union Govt. are compared\(^3\) and it was concluded that "the nature of investment project certainly makes a difference to the finances of the State Government. Then the question arises as to how this imbalance can be rectified? There are only two possible solutions. One is locating industrial projects to compensate the loss or burden on States' finances due to big irrigation projects. Secondly centralising the big irrigation projects costing over a certain limit say Rs. 20 to 30 crores."\(^4\)

Here is a case that requires a careful consideration by Union Government for making necessary change in the 7th Schedule of Indian Constitution. The constitutional amendment may be that "even the

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2. For instance vide Memo. submitted by A.P. Govt. to F.C. (1961) p. 13 whose investments in Nagarjunasagar project by the end of 2nd Plan was Rs. 39 crs. They involved interest payment of Rs. 1,39 crs. per annum. The total outlay on this project was estimated to be Rs. 140 crs.
3. This was done in "Economics of irrigation projects" by S. Ramayya, Commerce dated 28-9-1963, p. 534-35.
4. Ibid. p. 534-35.
irrigation projects whose benefits are apparently local, but whose costs are huge and that such a project can only be taken up by State Govt., only at a cost, a loss and inconvenience to its economy and finances, may be made eligible for central operation. 1

SOME THEORETICAL AND OPERATIONAL ISSUES IN RESOURCE ALLOCATION.

Resource allocations in federal economy are based on twin arguments of economy and equity. Firstly, the controversy between Scott and Buchanan regarding the efficiency of federal allocations in between States needs a mention since Scott contended that federal transfers may prevent free mobility of factors of production as dictated by market criteria which may result in less than optimum national product. 2 But Buchanan finally pointed that "in most cases the transfers seem to have the effect of encouraging the flow of resources in the direction indicated to be desirable by market criteria." 3 Above controversy regarding efficient allocation of federal funds between different States is based on the principle of equi-marginal productivity or equi-marginal returns, whose theoretical and operational validity to underdeveloped economies is questionable, since in these countries required shifts in resources are not marginal but structural. Even the model presented by Md. Anisur Rahman, according to which central planning authority can shift investments from region to another, implying an irreversibility of regional investment decisions, is also questionable. Shifts and

1. (a) This should be added as a clause to item No. 56 of Union list of the 7th Schedule or Public interest should be redefined as to include financial interest. (b) Dr. K.L. Rao announced in Lok Sabha on 3-9-66 that centre was considering the proposal to take over big irrigation projects costing over Rs. 10 crs.
2. A.D. Scott, "A note on grants in Federal Countries" Economica, Nov. 50
and switches from one region to the other are determined by the principle of "marginal productivity of investment in Spatial Context'’. This model is inapplicable to any developing federal economy since its basic principle of regional variability of investments on equi-marginal returns itself is inapplicable.¹

Secondly, resource allocations are also advocated on equity basis. In a federal economy every citizen is subjected to fiscal pressures by federal and respective State Govts.; hence aggregate fiscal impact on citizens of different States will be different owing to differences in regional economic development. According to equity principle every citizen should bear same or equal fiscal pressure in whatever part of federation he happens to reside, which implies that regional fiscal neutrality is the aim of federal fiscal authority. Therefore fiscal residuum² in rich State will be 'negative' indicating positively larger benefits than the tax pressures, while in the poor state the fiscal residuum is 'positive'¹. For attaining "horizontal equity" between individuals of different states in the federation, the federal Govt., has to transfer resources from high to low capacity areas through grants.³ While this principle itself is laudible translating it into operationally significant and rationally acceptable method opens some questions like:

1. (a) "Regional allocation of investment" by Md. Anisur Rahman, QJE Feb. 1963, p. 26-39. (b) Argument of Mr. Rahman presumes an arrangement of investment projects of a programme (Agriculture,) in order of their net results in different regions from different view points like optimising consumption or savings. Such an arrangement is difficult even in developed economies since costs and benefits of investment decisions cannot be fully estimated and even those estimates cannot escape value judgements, which may be either accepted or disputed on welfare grounds. In under developed countries where even the basic infra-structure has yet to be provided, ordering investments from regional perspective cannot but be arbitrary.
(a) Is perfect regional equity practicable and desirable? (b) Can perfect equity between individuals of federation or that of States be maintained at all times? and (c) Can the production optimum in an underdeveloped economy be obtained consistent with both 'efficiency' and 'equity' principles when applied to federal transfer process? Therefore Indian planners, who were aware of difficulties when they pointed the need for regional balancing, could not allocate investments purely based on equity principle. On the contrary, it was pointed that the regional investment pattern of Union Govt., resulted in a furtherance of regional imbalances.

Prof. Buchanan, basing on individualistic theory of governmental finance, formulated the concept of fiscal residuum and the transfers required. Similarly Prof. Musgrave constructed 7 models for the transfer of resources from Federal Govt., to States based on the assumptions of needs, capacities, performances and inducement programmes. It may be examined whether these models could be applied to Indian Union. However Dual allocations by F.C, and F.Cs. limit the scope for the application of any of the above two models in a serious manner.

1. 2nd Plan p. 36-37, 3rd plan, p. 143-53.
2. "Balanced regional growth" by P.K.Chowdary, E.W.Dt. 8-10-60, p. 1501-4. Also refer the article 'Regional allocation of resources in India' by L.Lefeber in "Pricing and fiscal policy" (Ed) by P.N. Rosensien Rodan, p. 18-29.
4. Refer "Approaches to fiscal theory of political federalism" by Prof. R.A. Musgrave in "Public Finances, needs, sources and utilisation" NBER (1959) p.97-122. Prof. Lakdawala also recognises the need for the transfers to be based on requirements of real services for the purpose of equalisation in a federation. However he chose to examine the resource transfers made by P.C, on per capita basis in relation to some rough tests of states position, vide Union-State financial relations, p. 94.
APPLICATION OF MUSGRAVE'S AND BUCHANAN'S MODELS TO RESOURCE ALLOCATIONS.

To work out Prof. Musgrave's models present state of statistical information is not sufficient. For example his models comprise incentive plans according to which grants can be conditioned to the performance of the States in resource mobilisation, which under the present state of Indian statistical data, is not possible. He also developed the models based on need - which can have manifold criteria. Moreover a comprehensive need index is somewhat difficult. So far F.Cs. took only the budgetary need as the criteria for allocating grants, which is only one of the several indices of needs (Roads, etc) but not a comprehensive index of need. Hence application of this model to Indian economy requires comprehensive information and complicated calculations.

Buchanan's concept of fiscal residuum helps us to justify transfers to individuals of same income groups in different regions by federal Government, since citizens in the federation should not be discriminated through fiscal pressures of different levels of Governments. Hence transfers from low fiscal pressure areas (where benefits exceed burdens) to high fiscal pressure areas are necessary to achieve equal fiscal residuum and spatial fiscal neutrality of similar income groups in the federation. Prof. Buchanan worked out a Hypothetical case for exhibiting the quantum of transfers required from one State to the other or what transfers are to be made by federal authority for attaining fiscal equity.

Based on that idea, fiscal residuum calculated for States of Indian Union are presented in the Table No. 3.1. Based on "Fiscal residuum" for each income group, the transfer to be made for persons within the same income group, but belonging to different States of Indian Union, are given in Table No. 3.2. It may be noted

1. Refer B.P. Adarkar's 'Principles & problems of Federal Finances'. p.194
### TABLE No. 3.1 FISCAL RESIDUUM IN THE STATES OF INDIAN UNION, 1958-59 (Figures in Rupees)

<table>
<thead>
<tr>
<th>Name of the State</th>
<th>Income group below Rs.180/- per annum</th>
<th>Income group between Rs.180/- to Rs.336/- per annum</th>
<th>Income group above Rs.336/- per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Aggregate per capita benefits, tax burden, (-)</td>
<td>Aggregate per capita benefits, tax burden, (-)</td>
<td>Aggregate per capita benefits, tax burden, (-)</td>
</tr>
<tr>
<td>Income group</td>
<td>Fiscal residuum</td>
<td>Aggregate per capita</td>
<td>Fiscal residuum</td>
</tr>
<tr>
<td>Income group</td>
<td>Fiscal residuum</td>
<td>per duum.</td>
<td>per capita</td>
</tr>
<tr>
<td>2. Assam</td>
<td>36.93</td>
<td>23.05</td>
<td>13.88</td>
</tr>
<tr>
<td>3. Bihar</td>
<td>30.88</td>
<td>13.67</td>
<td>27.15</td>
</tr>
<tr>
<td>4. Bombay</td>
<td>40.00</td>
<td>25.36</td>
<td>14.64</td>
</tr>
<tr>
<td>6. Kerala</td>
<td>37.50</td>
<td>20.05</td>
<td>17.25</td>
</tr>
<tr>
<td>7. Madhya Pradesh</td>
<td>34.00</td>
<td>19.07</td>
<td>14.93</td>
</tr>
<tr>
<td>8. Madras</td>
<td>36.38</td>
<td>18.28</td>
<td>17.50</td>
</tr>
<tr>
<td>10. Orissa</td>
<td>30.00</td>
<td>26.07</td>
<td>3.93</td>
</tr>
<tr>
<td>11. Punjab</td>
<td>44.69</td>
<td>26.30</td>
<td>18.39</td>
</tr>
<tr>
<td>12. Rajasthan</td>
<td>33.62</td>
<td>16.65</td>
<td>17.03</td>
</tr>
<tr>
<td>13. Uttar Pradesh</td>
<td>31.65</td>
<td>14.81</td>
<td>16.84</td>
</tr>
<tr>
<td>14. W.Bengal</td>
<td>41.13</td>
<td>24.50</td>
<td>16.63</td>
</tr>
</tbody>
</table>

For source and note on data see Statistical Appendix No. 1.
### TABLE No. 3.2

DEVIATIONS FROM MEAN PER CAPITA FISCAL RESIDUUMS FOR DIFFERENT INCOME GROUPS IN THE STATES OF INDIAN UNION 1958-59.

<table>
<thead>
<tr>
<th>Income-Group</th>
<th>Below Rs. 180/- per annum.</th>
<th>Between Rs. 181/- to 336/- per annum.</th>
<th>Above Rs. 336/- per annum.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Residuum</td>
<td>Rs. 15.89</td>
<td>Rs. 16.69</td>
<td>Rs. 16.28</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of States</th>
<th>(+)</th>
<th>(-)</th>
<th>(+)</th>
<th>(-)</th>
<th>(+)</th>
<th>(-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. A.P.</td>
<td>3.70</td>
<td>2.90</td>
<td></td>
<td></td>
<td></td>
<td>3.31</td>
</tr>
<tr>
<td>2. Assam.</td>
<td>2.00</td>
<td>7.19</td>
<td></td>
<td></td>
<td></td>
<td>3.43</td>
</tr>
<tr>
<td>3. Bihar.</td>
<td>11.26</td>
<td>0.46</td>
<td></td>
<td></td>
<td></td>
<td>0.87</td>
</tr>
<tr>
<td>4. Bombay.</td>
<td>1.25</td>
<td>1.95</td>
<td></td>
<td></td>
<td></td>
<td>1.64</td>
</tr>
<tr>
<td>5. J &amp; K.</td>
<td>3.49</td>
<td>4.29</td>
<td></td>
<td></td>
<td></td>
<td>3.88</td>
</tr>
<tr>
<td>6. Kerala</td>
<td>1.36</td>
<td>0.59</td>
<td></td>
<td></td>
<td></td>
<td>0.97</td>
</tr>
<tr>
<td>7. M.P.</td>
<td>0.96</td>
<td>1.76</td>
<td></td>
<td></td>
<td></td>
<td>1.30</td>
</tr>
<tr>
<td>8. Madras.</td>
<td>1.61</td>
<td>0.21</td>
<td></td>
<td></td>
<td></td>
<td>0.22</td>
</tr>
<tr>
<td>9. Mysore.</td>
<td>3.58</td>
<td>4.18</td>
<td></td>
<td></td>
<td></td>
<td>3.77</td>
</tr>
<tr>
<td>10. Orissa.</td>
<td>11.96</td>
<td>0.76</td>
<td></td>
<td></td>
<td></td>
<td>0.35</td>
</tr>
<tr>
<td>11. Punjab</td>
<td>2.50</td>
<td>1.70</td>
<td></td>
<td></td>
<td></td>
<td>2.11</td>
</tr>
<tr>
<td>12. Rajasthan</td>
<td>1.14</td>
<td>0.28</td>
<td></td>
<td></td>
<td></td>
<td>0.69</td>
</tr>
<tr>
<td>13. U.P.</td>
<td>0.95</td>
<td>0.15</td>
<td></td>
<td></td>
<td></td>
<td>0.96</td>
</tr>
<tr>
<td>14. W.Bengal</td>
<td>0.74</td>
<td>0.06</td>
<td></td>
<td></td>
<td></td>
<td>0.35</td>
</tr>
</tbody>
</table>

**Note:** All the above fiscal residuums represent benefits received over the burdens imposed by the overall fiscal system. The Mean residuum is the arithmetic Mean of all the items in that income group.

2. In the table above (+) sign indicates that the fiscal residuums of the given State exceeded the mean residuums of all States. It implies that, in case of fiscal adjustments, the income group of this State has to contribute that much amount to the central fiscal to enable it to transfer to the Income groups of those states that are below the mean residuum. Similarly (-) sign, indicates that a particular income group of the state is below the mean residuum and hence it requires a flow into the region by way of federal grant to that extent for achieving fiscal equity.
from Table No. 3.1 that individuals belonging to all income groups in each State gained through excess benefits of public expenditure over tax payments to respective fiscal levels. But only difference is the individuals belonging to different States in the same income group are not benefited to the same extent. This concept helps us in locating excess benefits and burdens of individuals and equalising them by means of transfers. Since individuals of same income group in different States are differently benefited, what is required is to find out the "mean" benefit point and arrange for inter-regional transfers accordingly for the same group. Hence if a State is having excess benefits over the "mean", that portion is to be transferred to other States. If such process takes place between persons of different States then the system of transfers can be perfectly distributive.

Nextly, in evaluating actual transfer of grants made by Union Government some practical difficulties arise. At the present stage of development, transfers made by Union Govt., on either P.C's or F.C's. recommendations are mainly for the purpose of positive allocation rather than for equity or redistributive purposes. According to Prof. Buchanan as the fiscal system of either of the State Units (we may add even that of federal Govt.) is shifted more towards the operation of benefit basis (i.e., is made less distributive) the required transfer between high income state and low income state is reduced. Further in his opinion, process of taxing surplus states for transferring to poor states through grants is inferior.

"Any method of adjustment which involves federal collection of revenue and specific or block grants is inferior to the tax adjustment method in so far as the equity criterion alone is considered."¹ Even while some of the "technical problems make precise application of equity principle in real world extremely difficult" they "should not serve to prevent its use as a proximate standard for inter-governmental fiscal policy".² Hence required degree of variations in fiscal policy by States for maintaining federal equity can also be ascertained. Further, differences in fiscal pressures indicate the scope for positive fiscal action in mobilising additional revenues by the States. Thus this model can help the assessment of efforts of States in mobilising their resources in the context of planning rather than for allocation purposes in the early stages of economic development. Nevertheless regional fiscal pressures pattern can help Union Govt. in choosing States for Central sector investments or special levy by it.

ORGANISATIONS RESPONSIBLE FOR RESOURCE ALLOCATIONS.

In Indian Union Planning Commission and Finance Commissions, the former without the constitutional sanction and the latter with it, are operating in distributing funds from Union to States. Presence of two authorities for the same function and overlapping of powers and functions of those bodies are pointed by experts and F.Cs. alike.³

1. Ibid p. 186.
2. Ibid p. 184.
3. (a) D.R. Gadgil 'Planning and Economic policy in India' (1962) p.231-32.
(d) F.C. (1965) and
(e) Minute by Dr. P.V. Rajamannar, p. 89--90 of F.C. 1965 report.
Since the Planning Commission, described as "Super Cabinet", assessing capital and Revenue requirements of State is also in a position to perform the functions of F.C.s., elimination of one where two are functioning would certainly improve both efficiency and economy. Moreover, in resource allocation F.C. occupied a special place, since the assistance to be given by Union for plan projects either through grants or loans is practically dependent on its recommendations. Hence a body like Finance Commission cannot operate in the same field. Therefore relative scope and functions of two Commissions should be clearly defined by amending the constitution and Planning Commission should be made a statutory body independent of Government. For this reason resource allocation needs immediate review.

CONFLICT BETWEEN PLANNING COMMISSION AND FINANCE COMMISSIONS.

Overlapping of functions of P.C. and F.C., subordinating and obscuring the importance of the later and thereby removing its content are matters that are too well known but how it took place is worth noting. In so far as F.C., had to cater the needs of budgetary gaps of States which were in turn influenced by the plan of each State as approved by P.C., F.C., functioned as if it was a subordinate to P.C. Secondly, F.C., could recommend devolution of Revenue resources, while capital resources are kept outside its purview even though constitution did not prevent it. P.C., could decide both Revenue and capital requirements of States. But recently,

it was pointed out that "It followed from a construction of the relevant articles of the constitution, as they stand, that the F.C., 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 F.C., 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 Finance Commission". ¹ Thirdly, under present set up the outcome of some policy prescriptions of P.C., has to be undone by F.C.s. This is evident from the quantum of loans and the interest liability they imposed on the States. Most of the loans to the States given by Union Govt., were given for "a variety of purposes, but largely to implement the plan",² and "As a rule most of the objects of expenditure and investment by State Governments are determined by joint consultation (of State and Union Govts.,) either directly or through the Planning Commission".³ Thus the plan loans to States which are mostly due to P.C., have a bearing on the working of F.C., and have to be solved by it.⁴

These aspects focus on the existing inconsistencies between the functions of P.C., and F.C.s. Reorganisation and clear definition of powers and functions of P.C., concerning the inter-governmen-tal financial allocations is needed for which necessary steps were

4. Report of F.C. (1965). It recommended an export body to examine the borrowings and the principles of amortisation of these borrowings by States. It emphasised the need to survey the intergovernmental borrowings immediately.
already indicated by F.C., (1965). It was shown that P.C., the organisation responsible for resource allocation, does not fit in the programme of resource allocation since it cannot effect all transfers.

**FINANCE COMMISSION AND RESOURCE ALLOCATIONS.**

Eventhough constitution did not preclude F.C., from dealing with capital revenues of States in practice all the 4 F.C.s, considered only Revenue requirements of States. Therefore F.C.s, could not play their expected role in resource allocations. Finance Commission, in spite of constitutional sanction did not function successfully in resource allocations in the context of planning. Its failure as an instrument of planning was pointed out by quoting a passage from the Report of F.C., (1957) wherein F.C., expressed its desire to place conditions on the utilisation of grants recommended by it, but did not impose any conditions since it felt that the grants recommended by it covered a less than third of the outlay and a little over a third will come by way of specific assistance from the Union under Plan\(^1\). Prof. D.R. Gadgil’s comment on this para, fails to appreciate the difficulty faced by that F.C., eventhough his contention is beyond controversy.\(^3\) In the circumstances as they then stood, alternatives left for F.C., were (1) to question the allocations made by P.C., by assuming full responsibility and laying conditions on the utilisation of grants in toto or (2) accept those devolutions made on the advise of P.C., to States as given and hence keep them out of its consideration and impose conditions on that part of grants which they themselves were making. Of these two the later course appeared to be more convenient, though objectionable

in strict legal sense. But it did not impose any conditions even on its grants since for majority of states they were either for plan purpose or for specific need. Moreover, grants given by P.C., were conditioned. In such a situation any further imposition of conditions on the utilisation of those grants by States could have affected the spirit of federalism, the protection of which is one of the implicit duties of Finance Commission.

The suggestions that F.C., should influence States in restricting the growth of their non-development expenditure, and using it as planning instrument are not well conceived in the context of the existence of P.C.,. While such a function may result in duplication of effort neither the time nor the organisation available to F.C., permit such a function. Necessity for Planning Commission is therefore clear. Nevertheless broad considerations as laid down by 1st F.C., have been accepted implicitly by subsequent commissions.

REGIONAL ALLOCATIONS MADE BY PLANNING COMMISSION.

While the above change is inevitable, considerations governing allocation of resources by P.C., should be probed since in the determination of size of resources allocated to States for their plans by-lateral negotiations of the Governments of States with the Planning Commission have a place. While considerations regional balancing or per capita distribution of resources to States do enter into their deliberations, allocations are approved by P.C., only after careful examination of individual projects and programmes from its own perspective. Financing methods are also suggested by P.C., i.e. whether taxation or loans or grants are to be used as well as the

nature and conditions governing them to each project and state. Nevertheless the basic criteria adopted by it are not made explicit which is necessary for assessment of justice or economy in their allocations as also to serve the purpose of democratic planning.

The Planning Commission, for the first time, while formulating 4th Plan, proposed certain guide-lines for the allocation of Union's aid to States for developmental purposes. According to which states get 70% of the total financial allocation in proportion to their populations, while the remaining 30% is allocated on the basis of (1) special needs of border States (2) commitments of States to spend larger amounts on continuing schemes of irrigation and power, (3) requirements of backward regions, hill areas etc., Subsequently in July 1968 meeting of National Development Council a consensus regarding general criteria applicable to Central aid to States has been reached. According to N.D.C's consensus four criteria viz., (1) population (2) per capita income (3) per capita tax effort in relation to per capita income and (4) continuing major irrigation and power schemes, have been accepted. Now let us examine these bases separately as well as the weightage to be given to each of them.

A. Population basis, though just, should further be refined so as to give some weightage to lower crude birth rate of individual States; which is sensible in the context of controlling growth of population. Population should get maximum share say 60% while crude birth rates should form the basis for the distribution of 50% of the aid on the population basis.

B. Per capita income basis, though it is easy to calculate and acceptable to all, should further give scope to a basis of per capita income of economically active population, which will focus on the actual condition of State economy. Acceptance of per capita income basis presumes uniformity of methodology and construction of State Income Accounts in all States. Given such precondition, per capita income or the refinement suggested may be given a weightage of 15% of Central aid to States.

C. Per capita tax effort expressed as per centage of per capita incomes appears to be quite sensible. But in its acceptance some troubles may arise. In evaluating States tax efforts for the purpose of allocating Central aid the problem concerns with the selection of the rate of taxation as well as the State which can be taken as standard. If all-India per capita States tax effort expressed as per centage of national per capita income is taken as standard, it cannot be representative. Nevertheless tax effort should get 15% weightage in the distribution of central aid. It may be pointed that economy in expenditure based on proper expenditure Control machinery and Scientific cost Accounting approach should also be included as another criteria.

D. Continuing major irrigation and power schemes may be given 10% weightage. Proper thing should be to transfer those schemes that cost more than Rs. 10 crores, to the Union Govt., as was suggested in this chapter. Since cessation of central aid under this criteria may become operative with the completion of the project, but completion of the construction of the project does not necessarily result in optimum returns to the State's economy. Hence while the best alternative should be that of transfer of these projects to Union Govt., Union's aid allocation according to this criteria may be accepted as a stop-gap arrangement.

All these criteria would help the attainment of regional balancing while at the same time punishing the lazy States and sympathising over-burdended States. Hence as a working and tentative criteria suggestions of N.D.C. may be accepted while the refinements suggested and difficulties pointed herein may be given serious thought and a fair trial.

PROBLEMS RELATED TO DIVISIBLE POOL.

Divisible pool itself is the creation of constitution, according to which Income Tax proceeds must form part of the pool and Union Excise duties may be included subject to the vote of parliament. Some other taxes are collected by Union on behalf of States but they do not form part of divisible pool except that the cost of collection is deducted by it. While the allocation of divisible pool between Union and States as well as the allocation of the proceeds of the Centrally collected taxes to the States has to be based upon the economic realities of the country and formulated within the frame

1. This was originally suggested by Sir Walter Layton for the benefit of Centre and States.
work of the constitution,\textsuperscript{1} the problem is whether any fixed formula can be applied for the allocation of this fund between Centre and States on one hand and in between the States on the other. Hence the review of conditions under which these tax revenues were made divisible, both with reference to economic realities and constitutional provisions, has to be undertaken by F.C.s. For example, if the distribution of proceeds of a particular tax, which have been so far distributed optionally assumes a greater quantitative significance than the obligatory part (even after allocating a lion's share, say 90% of the proceeds, to the States), then change in the constitutional provisions become imperative, for there is no Secrecy in making a particular tax distributable at option or obligation since these very ideas are based on some historical situations which might have had altered substantially during later years.

Let us take a concrete instance of Income tax. During the 20's of this century, under Rule 14 and 15 of Devolutions of Govt. of India Act, 1919, Income tax was used as a "balancing factor" between States and Central Govt.\textsuperscript{2} This was nothing but a change over from the provincial contributions to their gradual abolition. This position altered, when it was reviewed by F.C. (1952) which considered it as undesirable "to concentrate on income tax as a 'balancing factor' in the adjustment of resources between Centre and Units. We think that an increase in the States share of this tax should not be used as a major factor in the devolution of further revenues to the States".\textsuperscript{3} So the proportion of Income tax

\textsuperscript{2} This was the recommendation of Joint Select Committee of Parliament on Draft Rules made under Govt. of India Act, 1919.

In this context the suggestion that entire Income tax should be distributed to the States gains strength from arguments which point that divisible share of Income tax itself was reduced due to elimination of corporate incomes as well as exclusion of levy of surcharges on Income tax (exclusively for Union's purposes). Counter argument is that while Union Govt., may lose interest in the collection of tax, the States may take full interest in its collection. As an illustration the growth of unaccounted money which escaped Income Tax is pointed. Income tax divisibility between Union and States was determined, among other things, by the criteria of stimulating "their interest in the collection" of that tax. This has some implications. First question is: has there been any administrative coordination between Union and States regarding assessment and levy of Income tax? Even if such a provision exists, when lion's share of tax goes to either Union or other States, special interest taken by a State in Income Tax collections, need not result in any positive material benefit.

For example in state "A" where it is estimated that unaccounted money liable to Income tax was of the order of Rs. 50 crs.; and that under the present rates of taxation Union Govt., can collect by way of Income tax the tune of Rs. 25 crs.; under the present allocation of States share all States together can get only 75% of the collections, i.e. roughly about 19 crs., Even this sum of Rs. 19 crs., is further distributed in the proportion of 20:80 of collection and population ratios. Since the additional tax collected within the State may not form a significant proportion
of the total tax revenue, the increase in revenue collection will not benefit the State materially. As a result, the benefit to the State is not significant. On the other hand, there is sufficient reason while the States may not take interest in the collection of the tax since the amount of tax evaded is likely to find its way into State's coffers through increased sales tax proceeds, Motor vehicle taxes, Motor spirit taxation, Betting tax or in the form of new investment by those individuals which will help the State's economy. Therefore, the contention, that to sustain State's interest in tax collection total income tax may have to be shared by the States alone, has to be rejected.

NEW FORMULA FOR ALLOCATION OF INCOME TAX BETWEEN UNION AND STATES.

Opposing above contention F.C. (1961) argued that "in the case of a divisible tax in which there was an obligatory participation between Union and the States a sound maxim to adopt should be that all participating Governments, more particularly the one responsible for levy and collection, should have a 'significant continuing interest' in the yield of the tax." Here the words "significant continuing interest in the yield of the tax" have to be interpreted in a meaningful way, which has not been done so far by either of the F.C's (1961) or (1965). Probably above statement may be interpreted to mean that Union Govt., can be expected to have significant interest in the yield of the tax "to itself" provided that no single State can get larger quantum of Income-tax share than its own self. In other words, Union's share should be larger than the share of richest and populous State. This can be assured if Union's share is determined in the following manner. First of all let total divisible pool be distributed between all States on the assumption that Union Govt., is not a partner. Under this, there is

likely to be only one State that can get the maximum per centage of
the share of revenue. Now let this per centage of tax revenue be
allocated to Union Govt., and residual revenue be allocated to States
based on the per centages primarily determined. Under this arrange­
ment Union can have a significant and permanently larger share to
enable it to continue its interest in the yield and satisfy the demand
of the States for larger share of assured revenues. ¹ This change
besides being final has also revolutionary implications for federalism
and financial relations which have been worked out in Chapter 9.
RATIONALE OF ALLOCATION OF INCOME TAX POOL ON OBLIGATORY BASIS.

Second aspect of Income tax relates to its obligatory distribu­
tion, as compared to optional distribution of Union Excise duties.
When Indian constitution become operative, relative positions of
Income Tax and Union Excise duties was different from what has been
prevailing in subsequent years. For instance in 1950-51 taxes on
Income in Central revenues occupied 30.6% of revenues as against
46.4% by Union Excise duties. Changing trend was perceptible even
by the time that 1st Commission took up the work. In 1952-53 (B.E)
Income tax came down to 25.7% i.e. 5% less than 1950-51 level and
Union excise duties increased by almost the same per centage.
Perhaps the historical perspective of the relative importance of
Income tax and Union Excise duties in the Central revenues during
1938-39 to 1946-47 might have dictated the framers of Indian
constitution to make Income tax compulsorily divisible between States.
As against 16.8%, 49.1% and 39.1% of the Income tax in Union's
revenues, Union Excise duties constituted only 8.8%, 11.4% and 12.6%
in the years 1937-38, 1944-45 and 1946-47 respectively. ² Probably
framers of Indian constitution felt that larger quantum of a most
elastic source of income should be made divisible between Union and

¹. Above formula is in response to the suggestion of Dr.P.V.Rajamanmar
to devise a scheme that may be included in the constitution. For
So when once a major tax with substantial revenue yield has been allotted for obligatory distribution (Income tax) the marginal needs of States could be met, probably it was thought by them, by transferring revenues at the option of the Union Govt., from a source which was relatively unimportant. But subsequent developments in State's finances led F.C.s., to take recourse to the "permissive sharing contemplated under Art. 272 of constitution" which "was not only justified but even necessary".¹ F.C. (1961) suggested that "the viability of States could best be secured by a larger devolution of Union Excise duties and this should be effected by providing for the participation of States, by convention, in the proceeds of all Union excise duties. It would give a great deal of psychological satisfaction to the States and dissipate any suspicion that the Union is pursuing a policy of excessive centralisation" of resources.² Incidental point is the concept of "balancing" should be viewed from the present circumstances alone. Therefore, the proceeding paras point out the need to discard the opinion regarding obligatory and permissive nature of distributions. These have to vary with changing requirements of current circumstances. Hence obligatory distribution of even Union Excise duties is logical. Need for such an immediate change is all the more evident when it has been realised that "the gap between ordinary revenue of a State and its normal inescapable expenditure should as far as possible be met by sharing of taxes",³ and since "Income tax has ceased to be an expanding source of revenue it once was"and also 'it is unlikely that there will be any large increases in revenue from that tax (Income tax)'.⁴

². F.C. (1961) p. 21, para 44.
PLEA FOR CONSTITUTIONAL REFORM.

Suggestions for constitutional reform relating mainly to division of Income tax proceeds were made from time to time. Even prior to the commencement of the constitution in 1950, the demand that states may be entitled to a share even in that part of the Income tax levied on the Companies was present and the same was repeated.\(^1\) It was also pointed that tax on Union emoluments as well as surcharges levied on Income tax at present by Union for its own purpose should also form part of divisible pool. Regarding surcharges it was pointed out that the basic rates have been stagnant while the surcharges exceeded the basic rate and therefore, there is also a need for merging surcharges with basic rates or at least the income derived through surcharges should also be made divisible. Second suggestion for reform relates to making Union excise duties divisible on obligatory basis which was already discussed. Thirdly Prof. Lakdawala suggested that the proceeds of wealth, expenditure and gift taxes as well as Corporation taxes may also be included in the divisible pool since they are different form of Income tax. Exclusion of these is not rational.\(^2\)

1. In fact suggestion of the white paper on Indian constitutional Reforms, 1931 for the exclusion of Income tax on companies from divisible pool was incorporated in the Govt., of India Act, 1935. But on the other hand Expert Committee on financial provisions of constitution (1947) suggested the inclusion of company income taxation in the divisible pool. All States requested F.C., (1961) that Corporation tax may also be made divisible. Govt. of Maharashtra suggested a clear cut formula for the division of Corporation tax transferred to Centre consequent to changes in Income tax Act of 1959-60 budget.

Finance Commission (1957) was aware of some of these aspects but did not consider them since "they are against the provisions of constitution." It is not the body competent to question the provisions of constitution, on the other hand, it has to restrict its functions in accordance with the letter and spirit of Articles laid down in the constitution. But the need for constitutional reform exists since the original conditions governing a certain activity under a particular Article of Constitution have completely changed and are likely to continue to change in even in future.

Finance Commission (1961) clearly pointed that because the constitution could not visualise the requirements of programmes of economic development, a greater degree of reliance had been increasingly placed on the permissive provisions of constitution viz., Union Excise duties and Plan grants under Art. 275 and 282, which has in turn diluted the spirit of autonomy of States. Examination of grants system in chapter 9 suggests a different type of constitutional reform, namely, the need to replace Finance Commissions by Grants and Loan Council on the Australian model. Hence it suggested (F.C.) (1961) that the time for rethinking on financial relations is ripe.

**SOME MINOR PROBLEMS.**

Starting point in the assessment of States is the evaluation of their budgets and any gap in Revenue resources has to be covered by shared taxes and grants. A point worth considering here is that for the purpose of distribution of tax Revenues, performances of are

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not relevant and several bases are applied. But, for the distribution of grants a different set of criteria are applied. If, on the application of these grants criteria, it is found that a State is having surplus Revenue over its requirements, grants are not given to it. If there is no gap it means that grants are unwarranted. The question is, if such a surplus state is also slack in its tax effort, is there any other provision in the mechanism of financial relations which can normally induce concerned State into fiscal action by means of conditional transfers? Evidently for this purpose shared taxes are unsuitable since these principles must be applied uniformly, conditioning of either Income tax or Union Excise duties for inducing the State is undesirable. Only grants mechanism can meet this situation. Since this State is already surplus one even the grants mechanism fails to activate States efforts. This is a hypothetical case, since in Indian economy so far this situation can be effectively met because part of the allocations are made by P.C. Supposing that such a Commission was either non-operative or non-existent, can F.C. be given freedom to point out clear cases of under-taxation by that State after special studies of revenue and expenditure structure and accordingly effect the transfers made to it? According to F.C., (1965) this is inadmissible since the very root of budgetary gap is the result of States Budgetary action on both Revenue and expenditure sides. Therefore the solution would be to empower F.C. to exercise its discretion by including Revenue and outlay performances as a criteria for allocating divisible amount of a tax pool, say Income Tax etc.

Second aspect relates to Union's fiscal performance. Under the present set up, F.C. can allot only the amount collected by Union Govt. under various divisible taxes. Nowhere is provision in either constitution or the Act on F.C. (1955) that permits it to probe efficiency of Union's revenue mobilisation. This point is relevant in the context of "Black money" in the economy that escaped central tax net. To the extent this "black money" could have formed part of the divisible pool a State's might have lost their share permanently. But the only solace is that States might have benefited partially to the extent that these amounts were spent on goods and services that were taxed by them. However, in this case, the growth of State's revenue is at the cost of others loss. This aspect assumes greater significance in view of the estimates of Black money between Rs. 50 to 200 crores by various economists. Hence it is necessary to empower F.C.s. to probe into the Revenue mobilisation of Union Govt. whose performance had direct relevance to the divisible pool of the States. This is a desirable change in the functions of F.C.s.

**PRINCIPLES OF ALLOCATION OF TAX PROCEEDS.**

It is imperative to review to principles governing the distribution of shared taxes to the States, since not only the quantum of transfer is relevant for preserving the spirit of federalism but also the acceptability and justice in the principles governing such quantum are equally important. Again historical practices should be reviewed and applied with caution, keeping in mind the developments in the pure theory and applied techniques. For instance population received much greater weightage than other relevant factors both in the distribution of Income tax and Union Excise duties for the simple

1. Probably this phenomena explains the buoyancy of the resources of few industrial States where "unaccounted" money concentrated itself and brisk activity of U-sector was present.

reason, that operationally it appeared to be rational and convenient
criteria from the then existing techniques and state of understanding
of economy. Therefore, principles of distribution underlying differ-
ent divisible taxes are reexamined.

**Allocation of Income Tax - Different Bases:**

Present practice of distributing the proceeds on the basis of
population and collection,¹ requires a review to facilitate an
appreciation of the rationale of other suggestions. If economic
situations and improvement in technical apparatus permit, they may
be adopted.

The first two suggestions relate to state's contributory
aspect of Income Tax proceeds, besides collection already mentioned.
F.C. (1952) pointed that collection is no guide to the contribution
since "the bases of income creation are far more diversified and
widely spread than the facts of collection would seem to suggest".
Hence it concluded that the "concept of economic allegiance on
which the principle of contribution is based is open to objection".
Further "the bases of residence and origin - in so far as they can
be identified" - "may not give proper results in the allocation of
proceeds of a central tax like Income tax among the States of a
country".² Therefore while the basis of collection (either
unadjusted or adjusted with reference to residence of tax payer)
will not secure by itself an equitable distribution among States,
it cannot be ignored altogether. This trend of argument regarding
collection, origin and residence bases of Income tax may now be
reexamined.

¹ For other suggested bases see Report of F.C. (1952) p. 73.
² F.C. (1952) p. 74.
(A) Residence as the basis of distribution will be appropriate in case of tax on personal incomes or salaried groups where the residence of the tax payer, whether it was collected at the source from the company itself or the tax payer himself, are not relatively difficult to determine; while its applicability to corporate incomes is most difficult. (B) Origin basis could not be applied as statistical data is not available to F.Cs. and developments in the application of input-output techniques to economy were not conceived and properly appreciated. Now origin basis may be included in the devaluation of Income tax proceeds along with the collection basis.\(^1\) The need for adopting it arises from the desire to keep the basis of the distribution more rational and scientific. In federalism the concept of distinctiveness is politically accepted by giving separate powers to States; therefore, in economic sphere also distinctive fiscal contribution of a State to the nation in general and to its neighbouring States in particular should be recognised, provided it is possible. The input and output techniques as applied to regional social accounts (vide Appendix A) helps us in locating the origin of incomes. For example, growth of output and income of a State can be due to both internal production and the flow of goods in course of trade. Trade co-efficients of a State can indicate the origin of incomes and hence they can be applied as guide lines in affecting the divisible share. For example, if higher proportion of collection of Income tax is attributable to inter-state trade with a particular State, then it is just that the State of origin should be given some weightage in the distribution if Income tax proceeds.

\(^1\) In between collection and origin, the former is most convenient and easier to operate, while the later requires elaborates statistical information.
(C) Allied with the problem of origin is per capita income basis about which F.C. (1952) did not "form any idea regarding the possible use of such data for the purpose of distribution of income tax" and subsequent F.C.s did not raise the issue at all. Per capita income is the result of volume of economic activity and population. Here the quantum and nature of inflow and outflow of goods as well as their value assumes significance. The coordination of money flows with that of trade flows points the sources of higher per capita incomes of a State. Similarly the movements and growth of population effects the per capita incomes. A mere low or high per capita incomes do not account for free movement of labour as well as the trade, its nature and co-efficients. Therefore, per capita income cannot be taken as a guide for distributing the Income tax. However, since origin indirectly enters into the concept of income of a State it must be given some weightage.

(D) Economic backwardness and the needs as indicated by different indices are not appropriate for the distribution of Income tax proceeds, since they indicate why a state could not contribute to Income tax pool, but not its contribution. Similarly, industrial labour as basis of distribution of Income tax is not tenable, since this demand is based on the plea that huge costs of maintaining "law and order situation" that arises due to industrial labour. Since maintenance of law and order is equally serious problem in non-industrialised States, in one form or other (e.g. decoit menace in M.P. and Refugees problem, West Bengal pose problems of law and order), it cannot be taken as basis for Income tax distribution.

1. Prof. R.N. Bhargava advocated this basis (with suitable adjustments for population and density) for enabling backward States to catch up the level of advanced States. But present state of national and State Income Accounts and partial acceptability of equity objective of federal finances render per capita income basis as neither practicable nor desirable. Vide "Indian Public Finance", p. 43 for his viewpoint.
While population basis is sensible, even this has to be reviewed according to emerging situation. In the context of economic development for raising the standard of living of masses, population growth is a menacing problem. Hence will it not be sensible to review the manner in which the weightage is given to it? While mere number of heads may be a partial guide, the state with lower rate of growth of population particularly with lower birth rate should be given additional encouragement. Accordingly F.Cs. should earmark part of the Income tax proceeds allocated to states on population basis for the measures to check its growth. This consideration may also be given some thought.

As collection and population stood out as bases of distribution of Income tax, in view of the points suggested, the scheme of distribution should give some weightage to origin basis and earmark part of Income tax pool for population control measures by States. The proportion of collection and population were fixed at 20:80 according to F.C. (1952), 10:90 F.C. (1957), 20:80 according to F.Cs. (1961 and 1965). New scheme of distribution may include 10% origin, 10% collection and 80% population. 50% of Income tax proceeds allocated on population basis may be earmarked for population control.

**Allocation of Union Excise Duties.**

Population basis is applied in absence of reliable data on consumption of commodities subject to Union duties. F.C. (1952) distributed total proceeds on population basis. F.C. (1957) pointed that since consumption basis, though appropriate, may operate against poor state, population basis should be adopted. Hence it suggested that 90% of proceeds may be distributed on population and 10% may be utilised for other adjustments. F.C. (1961) made the basis of distribution of Union excise duties, according to
one view, "a veritable Pandora's Box" by allowing not only population, but also the relative financial weakness of State, disparity in the levels of development reached, percentage of scheduled castes and tribes and backward classes in their population etc. This was criticised by F.C. (1966) since "the element of grant was allowed in its considerations". It also pointed that consumption, representing the "contribution", cannot be sole criterion for the distribution of Union Excise duties. So also mere population cannot be sole criterion for the distribution, eventhough it may be a good index of need. It, therefore, applied the criteria of Economic and Social backwardness by selecting appropriate indices. It gave population a weightage 80% and Economic and Social backwardness a 20% weightage. As regards to distribution on consumption basis, it did not possess the required data on consumption. In this context it may be said that Input - output approach to commodity distribution and consumption can give an exact idea of consumption by different states.

ALLOCATION OF PROCEEDS OF TAXES RENTED TO UNION GOVERNMENT.

Now there are a group of taxes that are centralised for the purpose of economy and uniformity in administration but their proceeds are distributable to States. These have been, in fact, rented to Union by States. In the distribution of these taxes, States demanded that they must be assured not only that minimum

1. Vide "A suggested frame work for decision on inter-state financial allocation in India" by S. Ganguli in Arthaniti July, 64, p.150.
3. Short note on the applicability of input-output technique to problems of federal economy in general and federal finances in particular is given in Appendix A.
4. Additional excise duties in lieu of sales tax, Tax on Railway passenger fares.
amount which they got in the years when centralisation took place, but also a share in the prospective returns. Further, it was argued that the central levy of additional excise duties has resulted in a net loss to some of the States.¹ Main source of loss to States is the adoption of specific rates of duty by Union Govt. rather than advalorem rates. State's grievances can be redressed if the levy of additional excises are made on the basis of value of the products. Many States contended that adjustments in the rates of commodities liable to Union excises was made in basic rate that helped Union Govt. only (since 80% of the proceeds are retained by centre) rather than in additional excises which are distributable in toto between States. Therefore, it was suggested that additional duties should be merged with basic duties on these commodities and the total proceeds should be distributed amongst States. F.C. (1957) clarified that future or prospective incomes as interpreted by some States was not tenable under the term "present income" and hence it guaranteed those amounts that States collected in 1956-57. Additions accruing over and above this guaranteed amount was distributed on the basis of percentage increase in sales tax proceeds and population by F.C. (1961).² F.C. (1965) distributed the sums left after covering guaranteed amounts purely on the basis of the "proportion Sales tax Revenue realised in each State to the total sales tax collected in all States taken together".³

The basic contention of States when they argued for a share in future increases of tax incomes relied on the concept of "economic allegiance". The question is to what extent this allegiance could be

¹. For instance see Memorandum submitted by Govt. of A.P. to F.C. (1965) p. 250-51 (1964).
². Vide page, 26
³. Vide page, 34.
admitted in the programme of distribution of tax proceeds collected and distributed by Union Govt. In none of the reports the line of demarcation is clearly drawn. The issue is while it cannot be ignored altogether, the significance attached to it under different taxes is different. For instance, the origin and collection bases in Income tax distribution, consumption basis in Union Excise duties distribution, the demand for a share in future income by all States indicated State's desire for receiving back their part of contribution to the nation (federal) in so far as it is identifiable and practicable. Undoubtedly in any scheme of rational distribution, "contribution" principles must invariably find place by at least a fixed per centage, say 10%, of the tax proceeds, while the remaining 90% may be distributed based on either population, Economic and Social backwardness, in crease in the States collection of tax Revenues etc. After all, it is not unjust for States to demand a part of its citizen's sacrifice by way of contributions to the Union Govt. to be returned to them.