CHAPTER XI

CONCLUSIONS AND SUGGESTIONS

I

INTRODUCTION

The founding-fathers of the Indian Constitution visualised for India a federal constitution providing for a strong central government, strong enough not only to take care of its own responsibilities but to guide and coordinate the activities of the States also. The Constitution they enacted, on the one hand makes a clear demarcation of legislative subjects between the Union and the States thus adhering to the basic federal principle, on the other hand, it contains a large Concurrent List, thus embodying atypical Indian set-up, in which, ultimately, the balance tilts in favour of the Union. From a strong Centre, the framers did not mean weak States, which were allowed, in normal times, to act independently in a designated and by no means insignificant area of government.

In financial matters, the Indian Constitution effects complete separation in the taxing powers of the Union and the States and totally precludes the possibility of double taxation. The provisions concerning the financial relations between the Centre and the States have been designed with great care and circumspection. Here, the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the Central and State Governments have been precisely provided for. There is no overlapping in the taxing power and Concurrent List contains only three tax entries which are not of much significance. However, on scanning the tax entries in the Union and State Lists, one would find that the taxing power of the Union is large and elastic and the States are left with smaller and mostly inelastic taxing power.

Probably the founding-fathers were aware that the scheme relating to distribution of sources of revenue, embodied in the Constitution, would lead to financial imbalance between the Union and the States and the States inter se if the matter was left there, therefore, they devised a scheme of compulsory and
voluntary sharing of the resources collected by the Union. The
taxes levied and collected by the Union, thus, fall into four
well-defined categories: (i) taxes, the proceeds of which are
wholly retained by the Union; (ii) taxes, the net proceeds of which
are compulsorily shared with the States; (iii) taxes, the proceeds
of which may be shared with the States, if Parliament so decides
and (iv) taxes, the net proceeds of which are wholly assigned
to the States. To ensure that the transfer of funds from the
Centre to the States should be made in such a way as not to impair
the autonomy of the States, it was provided that the quantum of
such devolution of funds and the principles of their distribution
among the States *inter se*, should not be left entirely to the
discretion of the Central authority, but should be determined on
the recommendations of the Finance Commission, an independent
and impartial agency, which would, while making its recommendations,
assess the changing needs of the States and take into account the
imbalance between the States themselves. It seems that the
financial provisions of the Indian Constitution give enough room
for reconciling such conflicts of interest as may arise from time
to time between the Centre and the States.

Despite a unique constitutional mechanism devised by the
framers of the Indian Constitution to sort out the financial
relations between the Union and the States, the dissatisfaction
with the constitutional provisions and their working has been voiced
from time to time by the States. It seems that such tensions are
inevitable in a developing, dynamic economy, covering a vast
territory with wide social, cultural and economic differences and
regional imbalances.

There has been a persistent demand made by some States
that, as the things have developed in the last 30 years, a
tremendous imbalance in fiscal powers has come about with the
Centre's power growing at the expense of the States. They have
been asserting that the Centre-State financial relations under the
Indian Constitution have worked to their detriment and that
resources transferred to them are too meagre to meet their ever
increasing needs. The States have repeatedly expressed their
dissatisfaction over the allocation of assistance by the Planning
Commission, alleging that its decisions are influenced by political considerations and the bargaining capacity of the Chief Ministers of the States. While they have shown high regard for the Finance Commission, the States feel that the Planning Commission does not give adequate importance to the different needs of the States. The States have themselves been blamed for the sorry state of their financial affairs. Their poor performance in tax efforts and fiscal management has been pointed out by the successive Finance Commissions. All said, it is obviously made out that the States are in poor financial position and in some cases they are verging on insolvency. That this is so, is amply illustrated from their mounting indebtedness to the Union and by their frequent recourse to overdrafts from the Reserve Bank of India. Reasons are to be found for the financial plight of the States. The problem is multi-dimensional, however, its following aspects are more vital:

1. Tax resources of the States and devolution system.
2. Poor tax and fiscal management.

II

TAX RESOURCES AND DEVOLUTION SYSTEM

Devolutionary Nature of Centre-State Financial Relations

Centre-State financial relationship under the Indian Constitution is primarily devolutionary in nature. Though in all federations, State Governments receive financial transfers from the Central Government, the amount of such transfers is very large in India. For instance, in the year ended March 1972, gross transfers (in the form of divisible taxes and duties and grants and loans) to the States amounted to Rs. 3068 crores.¹ These transfers rose to Rs. 9,433 crores in 1980-81 and to Rs. 10,500 crores in

1981-82. There being increase in the absolute amount transferred from the Centre to the States and it continued to account for around 43 per cent of the aggregate receipts of the States. These massive transfers from the Centre to the States are the consequences of the fact that the Centre Government collects taxes not merely for itself but also for the States. The scheme woven into the fabric of the Indian Constitution seems to have visualised devolution of resources from the Centre to the States. The Centre being the major tax collector has also become a granter of grants and loans to the States. Though this constitutes "the backbone of the Union-State fiscal relations" in India, yet the scheme is attacked as a threat to their autonomy by various State Governments. It has been asserted on their behalf that the main cause of poor state of their finance is their inelastic and meagre tax resources. Alongwith this, the States have been assigned the primary responsibility of providing basic social and economic services to the community, which needs adequate resources with the States and their expansion at a rapid rate.

Many of the State Governments are categorically claiming more powers for imposing taxes on their own. For instance, Anandpur Sahib Resolution adopted by the Shiromani Akali Dal in 1973, committed the Dal to get all economic and financial powers for the State of Punjab. But the Resolution is not clear as to what taxing heads they want to leave for the Union. The Resolution merely says that the Federal Government should have control only over defence, foreign affairs, communications, railways and currency departments. But no where it says whether all the taxes will be collected by the States and that there will be a compulsory devolution of resources from the States to the Union or whether certain taxing heads will be left for the Union. As one would scan through the Anandpur Sahib Resolution, it appears that the federal structure visualised by it is more on the patterns of the United States Federation, where certain subjects were allotted to

5. Ibid.
the Federal Government and the rest were left for the States.

In regard to the remodelling of inter-State fiscal relations, several questions arise. One of them relates to the reform of tax system as to whether more tax powers should be given to the States so that devolution can be cut down.

The world experience indicates that the State's role as tax collector has diminished and that the Centre's role of tax collector has increased. It obviously visualises devolution of resources from the Centre to the States. For instance, in the United States of America, where the Constitution grants independent fiscal systems to both the Federal and State Governments, tax devolution, in the form of grants has come into existence and is now a permanent feature of federal-State fiscal relations there. In Canada, the trend of the Dominion assuming financial powers, which started with tax-rental arrangements in 1941, came to manifest itself in the form of tax-sharing in 1957. Though the system was reversed at the demand made by the richer States, resource transfers have been effected there for equalisation purposes. In Australia, where the division of functions between the Commonwealth and the States is such that an inherent imbalance arises in favour of the Commonwealth, need for resource transfer from the latter to the States arose at the very early stage of the Commonwealth. Same is the case with the Federal Republic of Germany, where the richer States have accepted the need for equalisation and transfer of resources from the Federation is carried on smoothly. It has been recognised as an essential part of a healthy federation in these countries, that resources are transferred from the Centre to the States and that the role of the States as tax-collector is decreasing.

Ours is a federation of a developing country where social and economic betterment of the country as a whole, and an approach of equality between different parts of the country is a sine qua non. This requires that the Union should have more resources, so that it is in a position to transfer resources to the States not merely with a view to augment their fisc but also to avoid regional imbalances. Obviously, the States have to look at the Union for finances, particularly for the schemes of social and economic development. Since India is also a socialist federation, it becomes imperative that there is a coordination between the efforts of the Union and the States and, if need be, States have to be guided and persuaded by the Centre in taking up certain projects and schemes.

**Increasing Taxing Power For the States**

We would now proceed to examine whether the fiscal system under the Indian Constitution admits of reforms.

It appears that the problem which the States are facing cannot be solved by recasting the tax entries, so as to transfer some of them from the Union List to the State List. The apparent advantage of such a reform, so to say, would be that it would make the States fiscally more responsible. For, more taxes one raises oneself to meet one's rising expenditure, the more prima facie one becomes fiscally responsible. But such an approach has a serious snag of disrupting the economic unity of the country. For instance, if the income tax entry is transferred from the Union List to the State List the consequence will be that a poor State like Bihar would collect very little revenue from this tax while under the present devolution it is getting much, because devolution is largely based on population. The accompanying table shows the amount of income tax assessed in each State (approximately the amount of tax the State would raise by levying and collecting the tax itself) and the relative shares of the States in the divisible pool of the tax under devolution. Besides, under the recommendations of the Seventh Finance Commission, the States are already receiving 85 per cent of the net proceeds from the tax. Therefore, it would not add much to the States revenue if the tax is given to them for levy. Further, if individual States will be having their independent tax collecting
Table XI(1)

State-wise assessment of Income-tax (excluding tax on Union Salaries) for the years 1973-74 to 1976-77 and the relative share of the States in the divisible pool of Income-tax under the Sixth Finance Commission

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>States</th>
<th>Income tax assessment (in crores of rupees)</th>
<th>Percentage share in Income-tax divisible pool</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>127.29</td>
<td>7.76</td>
</tr>
<tr>
<td>2.</td>
<td>Assam</td>
<td>14.28</td>
<td>2.54</td>
</tr>
<tr>
<td>3.</td>
<td>Bihar</td>
<td>26.73</td>
<td>9.61</td>
</tr>
<tr>
<td>4.</td>
<td>Gujarat</td>
<td>245.71</td>
<td>5.55</td>
</tr>
<tr>
<td>5.</td>
<td>Haryana</td>
<td>24.03</td>
<td>1.77</td>
</tr>
<tr>
<td>6.</td>
<td>Himachal Pradesh</td>
<td>3.62</td>
<td>0.60</td>
</tr>
<tr>
<td>7.</td>
<td>Jammu &amp; Kashmir</td>
<td>8.47</td>
<td>0.81</td>
</tr>
<tr>
<td>8.</td>
<td>Karnataka</td>
<td>92.83</td>
<td>5.33</td>
</tr>
<tr>
<td>9.</td>
<td>Kerala</td>
<td>64.05</td>
<td>3.92</td>
</tr>
<tr>
<td>10.</td>
<td>Madhya Pradesh</td>
<td>70.43</td>
<td>7.30</td>
</tr>
<tr>
<td>11.</td>
<td>Maharashtra</td>
<td>416.08</td>
<td>11.05</td>
</tr>
<tr>
<td>12.</td>
<td>Manipur</td>
<td>1.57</td>
<td>0.18</td>
</tr>
<tr>
<td>13.</td>
<td>Meghalaya</td>
<td>0.78</td>
<td>0.18</td>
</tr>
<tr>
<td>14.</td>
<td>Nagaland*</td>
<td>0.67</td>
<td>0.09</td>
</tr>
<tr>
<td>15.</td>
<td>Orissa</td>
<td>14.32</td>
<td>3.73</td>
</tr>
<tr>
<td>16.</td>
<td>Punjab</td>
<td>73.92</td>
<td>2.75</td>
</tr>
<tr>
<td>17.</td>
<td>Rajasthan**</td>
<td>13.20</td>
<td>6.50</td>
</tr>
<tr>
<td>18.</td>
<td>Sikkim</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>19.</td>
<td>Tamil Nadu</td>
<td>194.57</td>
<td>7.94</td>
</tr>
<tr>
<td>20.</td>
<td>Tripura</td>
<td>0.70</td>
<td>0.27</td>
</tr>
<tr>
<td>21.</td>
<td>Uttar Pradesh</td>
<td>120.53</td>
<td>15.23</td>
</tr>
<tr>
<td>22.</td>
<td>West Bengal</td>
<td>104.87</td>
<td>8.89</td>
</tr>
</tbody>
</table>

* Figures for Nagaland relate to net collections.
** Sikkim did not levy Income-tax.

machinery, it would not only add to the cost of collection, but it would also lead to inefficiency. Already, the arrears of uncollected income tax run into crores of rupees.

We may consider now whether the transfer of some items of excise from the Union List to the State List is going to help the matter. Though the step would add to the revenue of the States, but it would enhance the imbalances between the industrial States and non-industrial States. It may be added that though the Union is already voluntarily sharing excise duties with the States and such has been the inability of the States in the matter of collection of taxes that the sales tax on textile, sugar and tobacco has to be converted into excise duties, the collection of which was entrusted to the Union, though the total collections were remitted to the States.

The only tax the States can justifiably introduce, if they would do that, is a tax on expenditure. But it would lead to utter chaos if the States are permitted to do so. As one cannot compute expenditure without computing income, two sets of agencies would be needed computing income, the Central and the State. If at all there is to be an element of expenditure taxation, it will have to be along with income taxation or at least along with its computation by a single agency. Besides, the earlier practice has shown that the yield from this source does not commensurate to the cost of its collection. Therefore, the States are not going to be benefitted if they attempt this measure. There is yet another alternative, leaving the system as it is, the States might opt for a supplementary income tax. It can be done by reducing the rates of Central income tax and allowing the States to collect a supplementary income tax. In that way, each State would be deciding for itself the rate it wants to adopt. But it would merely end up in imposing greater burden on the tax payer. Several States imposed professional tax and ultimately, most of the States

10. The tax was levied under the Expenditure Tax Act 1957, but was repealed by the Finance Act 1966.
had to abandon it because of various difficulties, one of which was that it was not a lucrative source of revenue and collection costs were not commensurate with the yield.

It appears, therefore, that there is no scope for adding any new tax heads to the taxes which the States already have the power to levy. It may be emphasized here that the existing arrangements for devolution enables the Finance Commission to canalise larger resources to the relatively backward States and thus assist in the process of removing of regional imbalances, so as to achieve balanced economic development of the whole country. More powers for the States to tax, would inevitably benefit the richer ones at the cost of the poor, which might have the effect of disrupting the economic unity of the country.

Besides, the State have not used fully the powers they already have. The scope for taxing agricultural income and wealth by the States is far from exhausted. In fact after 1967, some of the States were trying to follow what may be termed as popular slogans. They were frittering away their resources for purposes of a few votes. For instance, after 1967, some of the States abolished land revenue. Obviously, the step brought them some votes. But, in fact, they damaged their own resources. It may be stressed here that the States should not feel reluctant to mobilise their resources from the farm sector which accounts for roughly 50 per cent of the gross national income.

It is, therefore, desirable that the State Governments should concentrate on the resources which have been already allotted to them, go through them again, re-examine them and find out what is wrong where. So far no State has appointed a commission to examine the resources with them and none of them has tried to find out whether it can increase the revenue with the help of these resources. The States, it is suggested, should research on their own resources rather than put the entire blame on the Centre.

Omission on the part of the States to levy tax on agricultural income has been a great source of tax evasion and
conversion of black money into white.\textsuperscript{11} It has been repeatedly emphasized that the distinction between the agricultural and non-agricultural income for purposes of taxation, should be eliminated. The Wanchoo Committee had recommended: "There is urgent need for agricultural income being subjected to a uniform tax more or less on par with the tax on other incomes so as to eliminate the scope for evasion of direct taxes imposed by the Union Government."\textsuperscript{12} The Committee suggested that the Constitution should be amended to transfer agricultural income to the Union List for the purposes of taxation.\textsuperscript{13} Such a suggestion has also been made by Prof. Nicholas Kaldor, the Economic Advisor to the British Government, who was in India some years back.\textsuperscript{14}

Agricultural income tax can provide a good source of revenue to the States and the States should be persuaded to impose it. It is submitted that the agricultural income tax should not be merged with the general income tax for several reasons. First, it may be taken as further inroad in the fiscal autonomy of the States. Secondly, farm sector varies from State to State, richer States like Haryana and Punjab may be in a position to have high rates of tax than the poorer States like Orissa and Bihar. This flexibility has to be left with the States. If the States are persuaded to levy this tax, some of their dependence on the Centre, it is submitted, will decrease.

\textbf{Devolution of Resources}

We have already seen that the Indian fiscal system is primarily devolutionary in nature. Presently, the share of the States in the Central taxes consists of: (a) 85 per cent of the net proceeds of personal income tax except those attributable to the


\textsuperscript{13} Ibid.

\textsuperscript{14} See Bhargava, 5.
Union Territories, Union emoluments and Union surcharges; 
(b) 40 per cent of the Union duties of excise on all articles 
excluding cesses levied under special Acts and earmarked for special 
purposes; (c) 100 per cent of the net proceeds of the Union excise 
duty on generation of electricity; (d) 100 per cent of the net 
proceeds of additional duties of excise on textile, sugar and 
tobacco except those attributable to Union Territories and 
(e) 100 per cent of the net proceeds of estate duty in respect of 
property other than agricultural land, except those attributable 
to Union Territories. In addition to this devolution, the States 
are receiving annual grant of Rs. 16.25 crores in lieu of railway 
passerenger fares. The Seventh Finance Commission also recommended 
Rs. 1173.12 crores by way of grants-in-aid to eight States. As a 
result of the recommendations of the Seventh Finance Commission, 
a total sum of Rs. 20842.97 crores was contemplated to be made over 
to the States during the quinquennium 1979-80 to 1983-84. With the 
result of this devolution, the States' share on accrual basis, 
comes to about 53 per cent of the total tax revenue of the Union. 
Yet these resources have not been sufficient. In their memoranda 
submitted to the Seventh Finance Commission, the State Governments 
sought the enhancement of the quantum of the devolution to the 
extent ranging between 50 to 75 per cent of the Union revenue. 
The West Bengal Government Memorandum suggested constitutional 
fixation of States' share of revenue at 75 per cent of the total 
revenue of the Centre.15 We may work out this suggestion in 
revenue receipts of the Union were Rs. 12,807 crores and capital 
receipts were Rs. 6,585 crores. Both together amounted to Rs.19,392 
crores of which Rs. 8,091 crores were made over to the States, 
leaving a balance of Rs. 11,301 crores. The Union had to take 
recourse to deficit financing to the tune of Rs. 1,550 crores. 
This raised the total amount with the Union to Rs. 12,851 crores 
on account of budgeted resources. Of this amount, the Union 
allotted Rs. 4,847 crores for defence, foreign affairs and servicing 
of debts. Rs. 1,557 crores were allotted for the development of

15. "Centre-State Relations Document", reproduced in The Indian 
Journal of Public Administration, 1117-26, October-December, 
1977.
industry and minerals. The like amount was allotted to meet the fiscal and general economic services as well as transport and communication. For the cost of collection of taxes, administration etc., a sum of Rs. 957 crores was allotted. The total expenditure of the Union during this period amounted to Rs. 8,903 crores, which came to 70.72 per cent of the total resources mobilised by it including deficit financing. If the West Bengal proposal is accepted, then the Union has to allot Rs. 8,091 crores and it will be left with only Rs. 4,848 crores out of the total revenue and capital receipts. The Union has to allot Rs. 4,047 crores for defence, foreign affairs and servicing of debts, thereby nothing would be left with it except the money it would manage by deficit financing. Therefore, the Union has to slice its annual budget to such an extent that it will have not merely to abandon all developmental projects but also it will not be able to meet its routine administrative expenditure. This gives a lie to the statement of the West Bengal Government that they donot want a weak Centre, in fact, it will mean that Centre will become very weak.

We may look back to the history towards the end of the Mughal empire when the local Chieftains and Subedars collected their own revenue and very little was contributed to the Central fisc, with the result that the Mughal empire became very weak and ultimately disintegrated. If the West Bengal Government's suggestion is implemented, it will result in, more or less, the same situation. The Central Government will become very weak which may lead to disintegrate the Indian Union.

We may now examine the Anandpur Sahib Resolution. Although the Resolution is very evasive about the financial relation between the Union and the States, yet from the scheme it spells out, it appears that the taxing power on all items will vest in the States (this implication is drawn from the suggestion made in the Resolution that the Union should have power only over defence, foreign affairs, communication, railway and currency departments) and, therefore, it seems that devolution of resources will be the

16. Ibid.
other way round, i.e., the States will pay out of their resources to the Union. This will virtually be the position as was that under the Government of India Act, 1919 and if the experience of 1919 Constitution has any lesson for India, it is this that such a scheme is bound to fail and that the Central authority cannot exist on the mercy of its units.

It is submitted that in the overall context of the Centre-State financial relations, the main issue is not that some of the so-called elastic sources of tax, which are assigned to the Centre should be transferred to the States. But it is that of progressiveness in the distribution of resources among the States *inter se*, so that the States which are not in a position to raise enough resources themselves and may be in a danger of crippling backward, may be helped to enable them to progress rapidly and come to the average rate of growth of the nation. Unfortunately, in this respect, our devolutionary system has failed and what we find is this that the richer States are becoming richer and the poor States are becoming poorer. Obviously, a second look at our devolutionary system is needed so that distributive justice could be dispensed with in real sense.

**Enlarged Divisible Pool**

This brings us to examine the question: Is it possible that the divisible pool may be enlarged? At present sharing is confined to the proceeds from income tax and Union duties of excise. We may examine the possibility of corporation tax being included into the divisible pool. Corporation tax has been a growing and elastic source of revenue and the increase in its proceeds has been far more rapid than that in income tax. In 1950-51, when the Constitution came into force, the yield from corporation tax was only Rs. 40 crores as against Rs. 133 crores from income tax. The figures for corporation tax jumped from Rs. 54.3 crores in 1958-59

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17. A large number of States urged before the Seventh Finance Commission that the revenues of the Central Government from the corporation tax should also be shareable with the States in the same manner as income tax. Report, 65, 1978.
(the year in which it was taken out of the divisible pool) to Rs. 106.6 crores in 1959-60, while that from income tax slumped from Rs. 172.8 crores to Rs. 149.2 crores in the same period. In 1973-74 corporation tax yielded Rs. 582.6 crores while income tax (inclusive of surcharge) could fetch Rs. 745.2 crores. And in 1980-81 the yield from corporation tax amounted to Rs. 1515.0 crores leaving income tax far behind at Rs. 1426.0 crores. Therefore, it is universally felt that inclusion of corporation tax in the divisible pool will have healthy influence on the States finances. Rajamannar Committee has recommended the inclusion of corporation tax in the divisible pool. It may be recalled that the Expert Committee on Financial Provisions of the Constitution had recommended the inclusion of corporation tax in the net proceeds of income tax divisible among the State. The Committee perhaps was aware of the fact that during the period of economic development and industrialisation, corporation tax would become a major source of revenue and, therefore, the States should also get their legitimate share from these revenues. It is submitted that State have a case for a claim to a share in corporation tax. It is further submitted that corporation tax should not be merged with the proceeds from income tax as is desired by many writers but it should be taken to a separate head and made divisible compulsorily as is the case with income tax. It will need an amendment of the Constitution. For this purpose a new Article 270A may be added to the Constitution in the following form:

18. Report, Centre-State Relations Inquiry Committee (Chairman Dr. P.V. Rajamannar), 218, Government of Tamil Nadu, Madras, 1971.
Article 270A (1) Taxes on income of the companies shall be levied and collected by the Government of India and distributed between the Union and the States in the manner provided in Clause (2).

(2) Such percentage, as may be prescribed of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union Territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed.

(3) In this article prescribed means -

(i) until a Finance Commission has been constituted, prescribed by the President by order, and

(ii) after a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of the Finance Commission.

We may now examine whether surcharge can also be brought into the divisible pool. The idea behind the levy of surcharge is that the Central Government should be invested with some reserve of power to raise additional resources to meet unforeseen and special needs. The justification for the continuance of the levy of surcharge may be found in the ever increasing needs of the Central Government occasioned by sudden exigencies happening one after the other. The natural calamities like floods, draught, famine and man-made calamities such as industrial unrest, communal and religious riots occur quite frequently requiring special funds to cope with them and to provide relief to their victims. A State Government in such distresses can survive only when the Centre lends its generous hand of help. For instance, the State Governments were recommended Rs. 10055 lakhs per annum as relief on account of natural calamities by the Seventh Finance Commission. 21 Rajamannar Committee has

recommended for the merger of surcharge with the basic rates of income tax. ²² Probably, the Committee, in its zeal to plead the States' case lost sight of the purposes for which the Central Government has been utilizing the levy of surcharge. It is submitted that it is not desirable that the surcharge should be merged with the basic rates of personal income tax. The Centre should be allowed to retain it as provided in the Constitution, as this gives to the Central Government a needed measure of flexibility in raising revenues for special needs.

It has been seen earlier that the Union duties of excise have come to stay as the largest and the most elastic of the Central taxes, leaving income tax far behind. During the year 1977-78, the revenue from the Union excises including additional duties of excise (Rs. 274 crores) was Rs. 4500 crores which was more than the total tax revenue of Rs. 4384 crores pertaining to all the 22 States. The Union excise duties brought Rs. 5825.20 crores in 1979-80 and were estimated to be Rs. 6264.81 crores in 1980-81. Though it is optional with the Centre to share the proceeds of this revenue with the States, but as it has happened, the States have been given a share in these duties ever since the First Finance Commission reported in 1952.

It is being argued that sharing of Union duties of excise with the States should be made compulsory, so that the States' financial position is strengthened and they no longer depend on the Centre in regard to their share in these duties. ²³ It may be pointed out that, as the things stand today, neither the Finance Commission would attempt to take out Union duties of excise from the divisible pool nor the Central Government could afford to withdraw the States' share in this source of revenue. ²⁴ Further, if the excise duties

²² The Committee further recommended that no surcharge should be levied except with the consent of a substantial majority of the States Report, 218, 1971. See also P.K. Bhargava, "Bases of Distribution of Income tax and Union Excise", Yojana, 11-14, November 16, 1978.


²⁴ The Seventh Finance Commission observed that "it is not possible to conceive of a scheme of fiscal transfer from the... continued
are made compulsorily shareable, it is not going to augment the States' share of the divisible pool. However, if the States derive some psychological satisfaction by making it a compulsorily shareable tax, this may be done so by making a necessary constitutional amendment.

Distribution of Resources Among The States Inter se

Correction of disparities among the States should be the main objective of sharing revenue inter se the States. The Sixth Finance Commission rightly observed that "the resources belong to the nation and they should be applied at points where they are most needed." However, it has been noticed that the devolution of resources through the Finance Commission, the Planning Commission and discretionary grants, has tended to benefit the advanced States rather than the poor. The question as to how to make the distribution of resources in such a manner as to be helpful in ironing out regional disparities and imbalances has so far eluded the successive Finance Commissions and the achievement of balanced growth of all the parts of the nation still remain a mirage.

Though the successive Finance Commissions have accepted in theory the objective of equalisation, they have not been able to put it in practice. Assigned the task of determining the basis of and to work out actually the distribution of resources among the States, they have laid down different criteria for the distribution of the proceeds of income tax and Union excise duties among the States inter se.

In determining the share of each State in income tax, the successive Finance Commissions have emphasised on the factor of population, and have assigned a modest weightage to the corrective factor of contribution/collection/assessment. The First Finance Commission recommended 80 per cent weightage to the factor of

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Centre to the States which does not provide for sharing of Union Excise duties". Report, 63, 1978. See also Report, Sixth Finance Commission, 14, 1973.

State-wise population. State-wise collection of income tax revenue was adopted as an index, admittedly inadequate, of their respective contributions and was assigned 20 per cent weightage. The Third and the Fourth Commissions also recommended the same relative weightage for these two factors. The Second, Fifth, Sixth and the Seventh Commissions, on the other hand, increased the weightage given to the population factor to 90 per cent. While the Second Commission took collection as indicator of contribution to income tax revenue from each State, the last three Commissions adopted the State-wise proportions of net assessments of income tax as determinant of the States contribution to the tax revenue. With the result that the successive Finance Commissions have not been able to devise any other criteria except the weightage to the population, and only exercise that they have made is to decrease or increase the weightage that is to be given to this factor.

Neither of these factors - population and collection/contribution/assessment, achieve the desired objective. While 'collection' as a basis adversely affects the thickly populated States as well as relatively backward States which have large population but have small amount of tax proceeds, the 'population' factor fails, for some of the relatively developed States are also more thickly populated than others.

It is submitted that a uniform formula of distribution of revenue inter se may be devised and the same may be made applicable to income tax also. This aspect of the matter is being considered alongwith the distribution of the proceeds of Union duties of excise.

As far the distribution of the proceeds of Union duties of excise, it may be noticed that the successive Finance Commissions have made a modest contribution to the process of elimination of existing disparities. Not only the divisible pool has been augmented by including all Union excise duties (excepting the cess under special statutes), but also a progressive policy of tax devolution has been laid down. To rectify the regional imbalances, the successive Commissions have given weightage to the criterion of "relative economic backwardness" of the States. In this respect, the approach of the Sixth Commission was more precise and direct. Among the numerous
indicators put forward before them, the Commission took per capita income as the sole criterion in assessing the relative economic position of the States. According to the Commission, "the inter se distribution of this portion of Union excise duties should be in relation to the distance of a State per capita income from that of the State with the highest per capita income multiplied by the population of the State concerned according to 1971 census". The merit of this approach lies in its simplicity and straightforwardness. However, the Seventh Commission's formula has yielded better results. Besides the neutral factor of population, the Seventh Commission took progressive factors such as the inverse of SDP (State Domestic Product), poverty ratio and revenue equalization, i.e., equal weightage (25 per cent) is given to the factors of (a) population, (b) inverse of SDP (c) poverty line, and (d) revenue collection. To calculate "poverty ratio", the Commission has taken the percentage of poor in each State as measured by a formula evolved by the Commission. The Seventh Finance Commission recognised that "the States which are less favourably placed in regard to their resource potential should be specially helped in order to place them in a position where they can also take steps more readily for the betterment of the people living in those States". But the Commission could not achieve the desired objective to the full. For instance, under the scheme of the Commission, Haryana, Punjab and Maharashtra, the rich States, got per capita surplus of more than Rs. 600 while poor States like Rajasthan, Orissa and Assam got a marginal surplus of less than Rs. 100 per cent. In his dissenting note, Prof. Raj Krishan suggested another formula, viz., poverty-population formula. This formula is derived, as a product of population, inverse ratio of SDP and poverty ratio, for each State. The poverty ratio is the cumulative percentage of the individuals whose consumption expenditure in 1970-71, at 1970-71 prices, was below an augmented poverty line, which is derived, for each State, as the amount, equivalent to Dandekar-Rath norm, i.e., minimum monthly per capita

26. Id. at 17.
28. Id. at 67.
consumption expenditure of Rs. 15 for rural area and Rs. 22.5 for urban area at 1960-61 prices. The amounts are worked out by using the price indices relevant for each State. To the estimated private consumption expenditure norms at 1970-71 prices, the desired benefit of public expenditure has been added to come to a more inclusive measure of welfare or deprivation. To the poverty consumption of each State the maximum per capita monthly expenditure for any State in India in 1970-71 was added to derive the augmented poverty line. It is evident that as regards the inter se distribution of States' share in Union duties of excise, a progressive approach is adopted by the successive Finance Commissions. The approach of the Seventh Finance Commission has been so far the best in the direction of equalization. Prof. Raj Krishan's formula would have given still better results.

It is submitted that there is no legal or economic basis for allocating shareable income-tax revenue and excise revenue according to different criteria as has been the practice with the successive Finance Commissions. The reason for this might be found in the wording of Article 270 and Article 272. Where under the former provision, the Commission is to lay down the 'manner of distribution', in the latter provision, the Commission is to formulate the 'principles of distribution'. But the two expressions can validly be interpreted to have the same meaning, particularly when every Finance Commission has felt free to define "manner" in varying ways and "principles" too, in varying ways. Had the constitution-makers intended to limit the freedom of the Finance Commission in the matter, they would have laid down the method in a separate provision of the Constitution. What is important is that the total transfer to the State should be adequate and the inter-State distribution of the whole transfer should be progressive. It matters little for the States whether the total transfer comes out of income tax revenue or out of the excise revenue. It is, therefore, suggested that allocation of the shareable income tax revenue as well as the shareable excise revenue, should be

29. Ibid.
distributed among the States inter se, according to one and the same formula. It is further submitted that the formula propounded by Prof. Raj Krishan may be given a fair trial as it appears to be, by far, the best formula for the elimination of regional imbalances. That it requires complicated calculations, should not deter us from adopting it.

III

POOR TAX AND FISCAL MANAGEMENT

It is a notorious fact that the States are heavily indebted so much so that they do not have the resources to service their debts. The total outstanding debt of all the States at the end of 1978-79 was Rs. 18,785 crores. It rose to Rs. 19,565 crores by the end of 1982. The major cause of this indebtedness of the States is their poor mobilisation of their resources and poor fiscal management. It is evident in the budgets presented so far that no State has really taken up resource mobilisation seriously and have brazenly enlarged their deficits. It is true that most of the States are administratively very weak to plug the loopholes in tax collection but they are also reluctant politically to raise the level of their taxation. For instance, our agricultural sector is patently under-taxed, especially the rich farmers. In 1977-78 budget of Punjab sales tax accounted for 45 per cent and land revenue to 1 per cent in its total tax revenue collections. Similar has been the case with the State of Haryana, where the respective figures were 47 per cent for sales tax and 4 per cent for land revenue. This is despite the fact that Punjab and Haryana are the greeneries of India and they contain a very large population of rich farmers. The per capita income of Punjab is Rs. 1586 and that of Haryana is Rs. 1399. Yet the farm sector has been taxed only marginally in these States.

For this state of the States, partly it is the Finance Commission itself, which has been responsible. By creating the impression that all that a State is to achieve, is a budgetary
deficit, the present approach of the Finance Commissions puts a premium on financial imprudence and poor tax mobilisation by the States.

The problem facing the States today is, therefore, not one of mere distribution of resources between them inter se, it is rather one of mobilisation of larger resources through greater efficiency in tax assessment and tax collection and better returns on investments in public enterprises, including irrigation schemes and power projects.

This brings us to the most important aspect, i.e., "fiscal management" and economy combined with efficiency in expenditure at the State level. The Sixth Finance Commission stated "Fiscal management is multi-dimensional concept. In the application of this concept to concrete situation, both qualitative and quantitative aspects deserve attention. Briefly stated, in assessing sound fiscal management one should have regard both to the manner in which the State has endeavoured to raise the resources needed for meeting its commitments and also the manner in which it has deployed the resources so raised so as to get the best possible results for the expenditure incurred." But most of the States have failed in doing so. Neither they have exerted themselves to a reasonable extent in raising their resources nor have they properly deployed their resources. Their tax efforts being poor, they have also not cared to see that at least minimum rates of return of the investment are secured. With the result, most of the State enterprises are in a poor state of affair.

Huge capital investment has been made by the States for the developmental plans from their own resources and from the resources they obtained from the Finance Commission, the Planning Commission and by way of discretionary grants from the Central Government. Most of these investments have been in electricity generation, irrigation projects and road transport undertakings. By the end of 1973-74, the total investment in all States in electricity generation was over Rs. 5000 crores; in major and medium irrigation projects Rs. 3486.91 crores; in road transport undertakings

Rs. 380 crores and in other enterprises Rs. 832.23 crores. It would be noticed that with a few exceptions, such as road transport undertakings (that too in some of the States only), these undertakings are running into losses.

The Sixth and the Seventh Finance Commissions examined the state of some of the State undertakings, such as electricity generation, irrigation works and road transport. In their estimation, for the period 1979-84, nineteen States would be in deficit to the tune of Rs. 2,800 crores, after providing for working expenses and interest on investments at the rate prescribed by the State Governments concerned. This is indeed a serious situation and any complacency would be harmful and unjustified. The fact of the matter is that such deficits are subsidised by the general taxpayer to those who benefit from irrigation and other public sector undertakings. Each Finance Commission devoted serious thought to this problem and this has been noted as "a very disturbing feature of the revenue position of the States". They have asserted that there was no reason why public sources of irrigation should not be so managed as to avoid at least losses, particularly, when very large number of agriculturists were incurring higher costs in obtaining water from private sources. The Sixth Finance Commission emphasised that "an improvement in working results of irrigation projects can be secured not through any economy in expenditure on maintenance, but only through enhancement of present level of receipts." The Seventh Finance Commission was more categorical in saying that "steps like better utilization of the available potential, efficient and economic maintenance and management of the irrigation system, raising of water rates correctly and collect them fully and in time should contribute to desired results."

31. Id. at 53-62.
33. The matter was, for the first time considered by the Second Finance Commission in 1957.
The performance of the State Electricity boards is in no way better. As already noticed, the investments in power projects as at the end of 1973-74 were estimated to be well over Rs. 5000 crores. The loans advanced by the State Governments to Electricity Boards were estimated to about Rs. 3225 crores. The arrears due for collection increased from Rs. 166 crores at the end of 1973-74 to Rs. 266 crores at the end of 1975-76. According to the estimate of the Planning Commission, total losses of the Electricity Boards including interest payments due to the States were to go up from the Annual Plan estimate of Rs. 388 crores to Rs. 542 crores in 1980-81. Even after the revision in tariff value of Rs. 102 crores, as recommended by the Seventh Finance Commission, is taken into account, the losses would still be at Rs. 440 crores. The reasons adduced for this sorry plight of Electricity Boards are not merely poor fiscal management but many others such as, increase in cost of raw material, fuel and replacements. The increase in the capital costs of new projects has also been substantial. The transmission losses range from 20 to 27 per cent as against the normal loss of 15 per cent. Besides, the spread of rural electrification, though a wholly desirable feature, had added to the plight of Electricity Boards. There is a very wide gap between the cost of power at the point of delivery to agricultural consumers and the actual rate charged to the consumer. The Sixth Finance Commission observed "Agricultural tariff in most States are palpably low and the losses currently being incurred on rural electrification are thus in the nature of concealed subsidies. Even granting for the sake of argument that rural electrification can never be fully remunerative and should, therefore, be given subsidies, it is only fair that the burden of this subsidy should be borne by the general tax payer of the State concerned and not shifted to the national exchequer." The Venkataraman Committee had recommended that the return from the investment in electricity generation should be 9 ½ per cent exclusive of electricity duty on the average capital base. But the return for the Electricity Boards in 1976-77 varied from 5.8 per cent in U.P.

to 15.8 per cent in Karnataka. Thus the financial working of the Electricity Boards of the States are genuine cause of concern.

Road transport, particularly passenger transport, is another sector in which State Governments have made large investments. During 1973-74, the investment in all State road transport undertakings was estimated to be Rs. 380 crores out of which the contribution of the State Governments in the form of equity and loans amounted to about Rs. 205 crores. In most States the road transport undertakings have, by and large, proved financially remunerative and have been making reasonable contribution to State revenue in the form of investment payments and dividends. But in some of the States financial position of road transport undertakings even, has been a cause of serious concern. For instance, the Calcutta State Transport Corporation, does not meet even its working expenses in full. The Sixth Finance Commission observed "in the light of the experience of most of the road transport undertakings, it is clear that given proper management and economic fare structure State Governments should be able to secure reasonable return on their investments in this sector."38

It is submitted that sizeable investments are made in public sectors. If the Indian economy is to show up, rightly says Dr. Diwan, "it must prove an important source of capital formation and this cannot happen if these donot show up profits."39 Rightly states the Sixth Finance Commission that "a satisfactory and enduring solution to the problem of Centre-State relations cannot be found except through a vigorous and concentrated drive against tax evasion, tax avoidance and waste and extravagance in public expenditure."40 It is,therefore, submitted that a massive effort on the part of the State Governments to raise resources and to economise on wasteful expenditure is needed. Then and then only the States and the Union will have enough to build the nation

39. Dr. Diwan, 255.
and make people happy, prosperous and contended.

If we work out the return on the investment on electricity generation, irrigation projects and road transport undertakings alone\(^1\) at the rate of 4 per cent, the net revenue to the States on this account will be around Rs. 354.68 crores. This implies that the States will not incur any losses and that it will amount to the augmentation of the States' revenue not merely to the tune of Rs. 354.68 crores, but also the additional revenue that will accrue by eliminating the losses.

IV

FINANCE AND PLANNING COMMISSION

Any discussion on Centre-State financial relations would be incomplete without a reference to the roles of the Finance Commission and the Planning Commission. The Finance Commission is a statutory body constituted with the task of distribution of shared taxes between the Union and the States and between the States \textit{inter se}, and grants-in-aid of revenue to the States. For this purpose the Finance Commission makes an assessment of the non-plan needs of the States periodically. The Planning Commission is a body constituted by an executive decision and is entrusted with the responsibility for providing leadership, direction and guidance in the formulation of plans and for canalisation of Central assistance to the States for the implementation of the plans.

It has been seen that the relationship between these two Commissions has not been a happy one. The assessment of non-Plan needs of the States by the Finance Commission and of requirements of the Plan by the Planning Commission has proved unsatisfactory. It has been seriously urged that there should be some mechanism whereby the dichotomy which has arisen between the estimates made by the Finance Commission and the Planning Commission should be properly coordinated.

\(^1\) By the end of 1973-74, the total investment in these three State undertakings, as estimated by the Sixth Finance Commission was around Rs. 8867 crores.
Two suggestions have been put forward in order to overcome this dualism. One view is that the emergence of Planning Commission has undermined the importance of the Finance Commission as envisaged in the Constitution. It has, therefore, been argued that the Finance Commission should itself be vested with the responsibility of assessing the requirements of the States for the Plan also. The other suggestion is that the Planning Commission should take on the functions of the Finance Commission. Both these are extreme suggestions, and, therefore, it is submitted that they will not work. In our submission it is not desirable that the Finance Commission should be entrusted with the role of the Planning Commission or the Planning Commission be entrusted with the role of Finance Commission. What is needed is a mechanism through which an integrated view of the flow of resources, both for plan and non-Plan purposes becomes possible. The plan and non-plan expenditure should not be considered in isolation, rather the approach should be total.

At present, the planning has almost become totalitarian and in a developing economy, unless we have an integrated approach, things are not likely to show up. Why, after all the work that is being done in one Commission should be different from the work that is done in another Commission? It is, therefore, submitted that we should have one Commission which may be named as "Finance and Planning Commission", which should look after the finance both of the States and the Union, including the devolutionary process and which should also do the planning and determine the principles for canalisation of Central assistance to the States for the implementation of the plans. The Commission should be constantly at work on the subject of the scope for better fiscal management as also for economy consistent with efficiency which could be effected by the States and the Centre in their administrative, maintenance, development and other expenditures. The Commission should also keep under constant review the financial performance and revenue returns from all capital investment financed by loans which are made either by the Centre or State Governments. To achieve this end, the following suggestion is made:
Article 280 should be amended so as to provide for the establishment of a "Finance and Planning Commission". The Commission should be constituted of one Chairman, two Deputy Chairmen and six other members. The Prime Minister should be the ex officio Chairman of the Commission. The qualifications of the two Deputy Chairmen and other members of the Commission should be laid down by the Parliament by law. The Commission should be a permanent body. The Deputy Chairmen and other members of the Commission should be appointed by the President after consulting the leader of the opposition in the Lok Sabha and the States. They should hold office at the pleasure of the President.

The Commission should have a strong secretariat of its own, whose function should be the collection and monitoring of all the relevant data pertaining to a full-fledged and detailed discussion on the subject of Centre-State financial relations and the progress in planning.

When the exercise of the devolution of resources is made under Articles 269, 270, 270A (when the suggestion made above in this respect is adopted) and 272, the President may entrust the task to one of the Deputy Chairmen along with some of the members of the Commission nominated by him. The President may, if he so feels necessary, nominate one or two members from outside the Commission.

V

INTER-STATE COUNCIL

Indian Constitution is essentially a cooperative federation. Its federal structure is to be looked at in the light of the economic goals that India has set before itself. In the achievement of these goals planning plays a vital role and planning is essentially totalitarian. Yet, the State autonomy has to be maintained and plans have to be executed with a view to further the cooperative character of Indian federation.

The units of a federation are not water-tight compartments. They are inter-dependent in many ways. This emphasises the need for cooperation and coordination between the units. There must, therefore,
be an effective machinery to ensure that there is frequent consultation and exchange of views between the Union and the States and between the States inter se. Though the National Development Council is a forum for such considerations, but it meets at long intervals and confines itself to laying down the guidelines for planning only. Conferences of Ministers at the Union and the State levels are being held, but they are only ad hoc meetings, usually convened by the Union Minister concerned to discuss problems that may be urgent and important with little coordination in regard to follow-up action.

Till 1967, in the era of one-party dominance, harmony in Union-State and inter-State relations was maintained by the fact that the same political party was in power at the Centre as well as in the States. Union-State, as well as inter-State disputes, could be settled through the party's political organisation. With the emergence of different political parties coming to power in a number of States, this is no longer so possible. With the result Centre-State as well as inter-State relations have faced serious stresses and strains. The Chief Ministers of the States usually complain of the indifferent attitude of the Centre towards the States. Inter-State disputes have arisen in many fields. Instances of water disputes are a normal feature now. Inter-State frictions have occurred in the past, in the field of taxation. The operation of sales tax laws enacted by different States created difficulties and controversies reached the Supreme Court. Different sales tax laws in the States are also a hindrance in the free flow of trade throughout the country. All this requires cordial relationship between the Centre and the States and between the States inter se.

The Indian Constitution visualises the institutions of zonal councils and inter-State Council, which are meant for achieving inter-governmental consultation and cooperation mainly in socio-economic fields. Article 263 of the Indian Constitution says for the establishment of an inter-State Council which may be charged with the duty of "(a) inquiring into and advising upon disputes which may have arisen between States; (b) investigating

42. See Article 263.
and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest; or (c) making recommendations upon any subject and, in particular, recommendations for the better coordination of policy and action with respect to that subject". It appears from this that the Council is envisaged to be an advisory body having no authority to give a binding decision. Also, not much use has been made of Article 263 so far and only a few bodies of minor importance, such as the Central Council of Health, have been created under it.

Although five Zonal Councils have been set up as instruments of inter-governmental consultation and cooperation mainly in socio-economic fields and also to arrest the growth of controversies and particularistic tendencies among the States. But the experience shows that neither the Union Government nor the State Governments are much enthusiastic about the working of these Councils. It may be the reason that these Councils have not been able to amicably settle the disputes which have arisen between various States. For instance, the Pong Dam and Thaïn Dam disputes between the States of Punjab, Jammu and Kashmir, Himachal Pradesh, and Haryana have been creating much ill-will amongst these States, who are not coming to any settlement. It is, therefore, submitted that there is need to completely over-hauling the working and functioning of these Zonal Councils. Reference may be made here of the formation of the Southern Council by the Chief Ministers of the States of Andhra Pradesh, Karnataka and Tamil Nadu and the Union Territory of Pondicherry. The objective the framers of this Council have laid before them, is "to work out a common strategy to solve common problems instead of rushing to the Centre for a solution." The whole idea, the promoters of the Council,
said, is that "the States should not burden Centre with their problems" and to "establish a cooperative federalism which was the true spirit of the Constitution." The formation of this Council is encouraging to the extent that these Chief Ministers are inclined to take a collective view of their problems and to find solutions to these among themselves rather looking to Central guidance or intervention. It is yet to be seen how far these Chief Ministers would accomplish their goal of "a regional approach to regional problems." However, the spirit in which the move is being initiated is a welcome sign. It may be submitted that the Central Government should give a fresh look into the function and working of the existing Zonal Councils, in the light of the objectives laid down by the framers of the Southern Council, to be achieved by its formation.

The Central Government it is suggested should take steps to activate the functioning of these Zonal Councils, so as to put life in them. A Zonal Council should discuss any matter in which some States represented in it, or the Union and one or more of such States, have a common interest. The Council should be empowered to decide the disputes or conflicts which may arise between the concerning parties. In order that the Zonal Councils should have teeth, it should be provided that the decisions reached in a Zonal Council should be binding on the respective parties to the dispute. In case the Council is unable to reach a decision, there should be provision for making a reference of the dispute to the Supreme Court and any decision given by the Supreme Court should be binding on all the concerned States.

47. Ibid.
In order to coordinate the working of these Zonal Councils, it is suggested, that an inter-State Council should be set-up, where all the States could meet to discuss problems of inter-State concern and Union-State coordination. The Council may provide a useful forum for detailed discussions on the working of Centre-State and States inter se, financial relations. Further it may also be emphasised that the proposed Council would be able to act as a corrective factor against the erring policies.\[48\]

\[48\] The setting up of such a Council has been suggested in many quarters including the Administrative Reforms Commission. Report, Study Team on Centre-State Relationship, 301, Vol.I, 1969. See also Rajamannar Committee's recommendation in this regard. Such like Council of State Governments was established in United States in 1933 to promote inter-State cooperation and to improve federal-State relations. It has achieved appreciable success there and its scope is enlarged so as to cover the development of terminal and transportation facilities, maintenance of inter-State park, forest, fire production, water supply and so on. Uniform laws and model Acts are promoted by the Council with the assistance of the National Conference of Commissioners on uniform State laws. These laws have been effective instruments of inter-State cooperation.