CHAPTER IV.

FINANCIAL RELATIONS.

Finance is an important aspect of government in general and of federal government in particular. Federalism implies the division of legislative, executive and financial powers between the general and the regional governments in such a way that the two are coordinate and independent. Financial autonomy of the Centre and the Units is vital to the preservation of the federal principle. In the words of the Federalist: "It is, therefore, as necessary that the State governments should be able to command the means of supplying their wants, as that the national government should possess the like faculty in respect to the wants of the Union." The two canons of federal finance are independence and adequacy. The first means the power of either government - general or regional - to determine for itself the amount of revenue it needs, the method of raising it and the manner of expending it. The second involves the ability of each government to raise in full the fund that it requires to perform all its functions. That system of federal finance which gives effect to both these principles is undoubtedly an ideal one. Such a system is yet to be evolved. It is the one most difficult to translate into operation. The problem of allocation of functions is a hard problem. Harder still is that of dividing the sources of revenues between the Centre

and the constituent units in such a wise as to satisfy the ends of independence and adequacy.

Distribution of revenues between the Centre and the Units.

The problem of the division of the sources of revenue between the Centre and the Units in a federation is one of the most complex problems and bristles with many difficulties. In the solution of this all vital problem no less than five methods of division are suggested. In the first place, we may adopt the simplest method of separating the sources of revenue of each government from those of the other. This method in addition to its being simple, possesses the characteristics of intelligibility and convenience. It also obviates the difficulties inherent in a system of double or multiple taxation. The one grave defect of this system, however, is that it is rigid and certain to breakdown in times of stress or emergency like a war. Secondly, both the Centre and the Units may possess independent sources of revenue and both may exercise concurrent powers of taxation in certain fields like income-tax and excise. This system obtains in the United States and Australia. But the concurrent sphere creates a sort of 'twilight zone' which leads surely to conflict of jurisdictions. Thirdly, a sharing of revenues in accordance with some equitable principle between the two governments is also possible. The revenue may be collected by one government say, the Centre and a percentage of it handed over to the Units. While this arrangement is simple and economical, its adoption depends upon the evolution of a suitable basis of allocation which is most difficult. Fourthly, there may be subventions from the Centre to the Units and vice versa. Subventions from the Centre or vice versa.
grants-in-aid have come to play a prominent role in the financial relations between the Centre and the Units in all federations. They are also popular. Their main purpose is to enable the Units to effect a certain national minimum in certain social services. Subventions to the Centre from the Units existed in Imperial Germany and in India under the Meston Award between 1921-22 and 1926-27. This practice is not at all favoured by economists and statesmen. It reduces the Centre to a position of dependence upon the Units and incompetence and helplessness. As Professor Seligman has pointed out, "to have the Federal Government depend entirely upon largesses from the States is to render it more or less impotent and certainly to make it subordinate to the States." A fifth system which has been developed in U.S.A. in recent times is called the system of credits. With regard to certain taxes like death duties, pay roll taxes, the Federal Government in the U.S.A. credits the States with a percentage of the amount collected. In the U.S.A., the estate tax is levied by both the Federal and State Governments. The Federal Government grants a credit equivalent to 80 per cent of the tax collected to the States which levy a similar estate tax either as a substitute for an inheritance tax or as a supplement to it. Under the Security Act of 1935, pay roll taxes were introduced. They are meant for old age pensions and unemployment benefits. States levying pay roll taxes are credited with 90 per cent of the tax levied by the Federal Government. The system of credits no doubt avoids the difficulties of double taxation and compensates the States for the federal collection of the tax, but it encourages extravagance and irresponsibility on the part of the States receiving the benefits since

1. Essays in Taxation, P. 666.
they are not responsible for the levy.

It must be emphasized that no single method can be adequate and that a clear-cut solution of financial relations is impossible in a federation. The financial history of the existing federations confirms the truth of this statement. As Findlay Shirras observes, "Separation of sources, sharing of revenues, grants-in-aid, credits, supplements, joint administration and re-allocation of functions will not individually achieve the desired results under all conditions and each method will have to be tried out. Each country has its own problems and no clear-cut solution is possible. Each problem has to be considered on its own merits, and this demands inter-governmental co-operation in no ordinary degree." K.C. Wheare puts the problem of federal finance in a nutshell when he says: "Conditions in a variety of communities joined together in a federation differ too much from time to time and from place to place for a fixed division of financial resources to be laid down finally in a constitution. There is and can be no final solution to the allocation of financial resources in a federal system. There can only be adjustments and re-allocations in the light of changing conditions."

Federal finance to-day is in a state of flux. The two world wars have imposed a heavy strain on the financial resources of both the general and regional governments in all the federations. The steady development in and practice of the concept of the Welfare State has added to the functions and responsibilities of all governments. Federal finance stands in need of a fresh examination in

1. Federal Finance in Peace and War, P.229.
2. Op., Cit., P.123.
the light of recent developments. It would be appropriate if an analysis is here made of the developments that have taken place in inter-governmental finance in recent times.

The first thing that strikes even a casual observer of government is the vast expansion of the scale of governmental activity. The functions of both the general and regional governments have tremendously increased. There has also been a marked tendency towards federal Centralisation. Similar has been the experience in the field of finance. Centralization of finance has become markedly manifest in all federations. In 1848, the Federal Government in Switzerland could raise only customs duties. All other powers of indirect taxation and the whole field of direct taxation were exploited by the Cantons. Even a nonbelligerent Country like Switzerland could not escape the effects of World War I. As a result of the war there was a marked decline in her revenues and a rise in her expenditure. In order to enable the Federal Government to meet the increased expenditure recourse was had to constitutional amendments. The amendments of 1915 and 1919 authorised the Federal Government to enter the field of direct taxation and impose a tax on incomes, property and profits. The tax on securities, insurance premiums and the like. In 1938 a further amendment of the Constitution gave the Federal Government power to levy taxes on war profits, income and Capital and a tax on beer.

In other federations, too, the general government has entered into the field of direct taxation which was being exploited

1. The Swiss Constitution, Art. 28.
by the regions. The Commonwealth Government in Australia, under the stress of war, imposed for the first time in 1914, an estate duty and in 1915, an income-tax. The result was the Commonwealth and the States were brought into competition in the field of direct taxation. The evils of double taxation became manifest. Increased and unexpected war expenditure forced the Commonwealth Government in 1942 to introduce an uniform income-tax in Australia. Prior to 1942, there were in Australia no less than 26 different taxes on income. In 1942, the Commonwealth Government proposed to the States that they should withdraw from the field of income-tax in lieu of grants from the Commonwealth. The States refused. The Commonwealth passed a series of four Acts. The first of them imposed a uniform Commonwealth income-tax at rates high enough to bring in as much revenue as the former Commonwealth and States taxes combined. The second Act provided for payment to any State, which did not collect income-tax, of a grant equal to the average amount of its own income-tax collections during the first two financial years of the war. The third Act gave priority to the Commonwealth over payments due to the States by way of income-tax. The fourth Act authorised the Commonwealth to take over the State income-tax organisation. These acts were held valid unanimously by the High Court of Australia.

The Dominion Government in Canada entered the field of income-tax in 1917 but had to compete with the Provinces which

also levied income-tax. On the recommendations of the Royal Commission on Dominion-Provincial Relations (1940), the Provinces vacated the field of income-tax, tax on corporations and succession duty for the duration of the war and twelve months thereafter, in return for the Dominion Government taking over all provincial net debts and making national adjustment grants to the Provinces for maintaining 'an average Canadian standard of essential services.'

Before its entry into the war in 1917, the United States relied mainly on customs and excise for its revenues. In 1913, the Sixteenth Amendment authorised the levy of a tax on incomes. In 1917 the entry of U.S.A. into war led to increased income taxes, war profits taxes and excess profits taxes. The participation in the Second World War in 1941 raised the level of taxation to unprecedented heights. Personal and Corporation income taxes were raised. Personal income tax was made subject to a surtax and to a special victory tax. Corporation income taxes were subject to a surtax and an excess profits tax. A Committee of Inter-Governmental Fiscal Relations appointed in 1943 recommended the developing in consultation with the States, rules of uniform income-tax procedure with a view to the adoption ultimately of a single administration of a relatively uniform State and Federal income-tax.

Thus the general government in all the federations has established its powers over direct taxation which was purely regional. The encroachment of the regional domain by the federal government is steadily going on. Centralization of finance has
been the inevitable result. The effect of these developments is, as pointed out by Wheare, that the federal government in all four federations "have become incomparably the most powerful financial authorities in their federal systems, and the regional governments have been reduced to a restricted, if not subordinate position."

Distribution of Revenues between the Union and the States.

The distribution of revenues between the Union and States is, in essentials, the same as the distribution under the Act of 1935. The recommendations of the Expert Committee on Financial provisions of Union Constitution (The Sarkar Committee) appointed by the Constituent Assembly were not accepted and it was decided by the Assembly that it was best to retain the Status quo in view of the unstable conditions which were then prevailing. The Finance Commission for which provision has been made in the constitution will go into the question of financial relations and make its recommendations to the President.

As the distribution of revenues between the Union and the States under the Constitution is after the manner adopted in the Government of India Act, 1935, it would be useful and relevant to note briefly the position under the Act.

The taxing jurisdictions of the Central and Provincial Legislatures were entirely separate. While the Provinces retained the whole of the net proceeds of all taxes levied by them the

Central Government had to give away either in part or in whole the net proceeds of some of the taxes levied by it. The net proceeds of (1) Federal estate and succession duties, (2) Federal Stamp duties, (3) Terminal taxes on goods and passengers carried by Railway or Air, and (4) Taxes on Railway fares and freights, had to be handed over wholly to the Provinces. The Centre could levy a sur-charge on these taxes entirely for its own purpose. None of these was levied except the Federal Stamp duties which are collected and retained by the Provinces.

Certain federal taxes had to be shared with the Provinces. The sharing of the net proceeds of income-tax and jute export duty was made obligatory, while the sharing of the proceeds of Central excises including duty on salt was made to depend on Legislation by the Central Legislature which made no such provision.

The Act also provided for fixed grants-in-aid to some provinces. There was also a general provision for giving grants to Provinces at the discretion of the Central Government either for general or specific purposes.

The Government of India Act, 1935 was unique in that the powers of the Central and Provincial governments were completely enumerated. The Constitution of India does not possess this distinctive demarcation. It confers on the Parliament the exclusive power to make any law with respect to any matter not enumerated in the Concurrent or State List and such power includes the power of imposing a tax not mentioned in either of those Lists.

1. Art. 248.
While the powers of the State Government are limited by complete enumeration, the residuary powers are vested in the Union. Subject to this change in the pattern and subject also to certain variations in detail, the taxing powers of the Union and the State Governments are very similar to those under the Act.

The taxing power of the Union and the State is no doubt well defined but the exclusive tax jurisdiction has been subjected to two newly introduced limitations. In the first place, Parliament is empowered with the approval of the Council of States to legislate with respect to any matter in the State List in the national interest for a period of one year at a time. The currency of such legislation may be extended with fresh annual resolutions. Secondly, Parliament has power to make any law for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body.

Sources of Revenue collected and appropriated by the Union and the States respectively.

The exclusive sources of revenue of the Union are: Corporation tax; Customs duties including export duties but excluding the grants to the States of Assam, Bihar, Orissa and West Bengal in lieu of the assignment of any share of the net proceeds of the export duty on jute products to those States; taxes

1. Art. 249.
2. Entry 85, List I.
3. Entry 83, List I.
on the Capital Value of the assets, exclusive of agricultural land, of individuals and companies, taxes on the Capital of Companies; and rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.

The sources of revenue exclusive to the States are: land revenue; taxes on agricultural incomes; duties in respect of succession to agricultural land; estate duty in respect of agricultural land; taxes on lands and buildings; taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development; duties of excise on the following goods manufactured and produced in the State, viz., alcoholic liquors, opium, Indian hemp and other narcotic drugs and narcotics; taxes on the entry of goods into a local area for consumption, use or sale therein; taxes on the consumption or sale of electricity, except electricity consumed by the Government of India or sold to the Government of India and electricity consumed in the construction, maintenance or operation of any railway by the Government of India or a railway company operating that railway or sold

1. Entry 86, List I
2. Entry 91, List I
3. Entry 45, List II
4. Entry 46, List II
5. Entry 47, List II
6. Entry 48, List II
7. Entry 49, List II
8. Entry 50, List II
9. Entry 51, List II
10. Entry 52, List II
to that Government or Company; taxes on the sale or purchase of goods other than newspapers; taxes on advertisements other than advertisements published in the newspapers; taxes on goods and passengers carried by road or on inland waterways; taxes on vehicles, suitable for use on roads, including tram cars subject to the provisions of entry 33 of List III; taxes on animals and boats; tolls; taxes on professions, trades, callings and employments; Capitation taxes; taxes on Luxuries, including taxes on entertainments, amusements, betting and gambling; rates of stamp duty in respect of documents other than those specified in List I.

With regard to the imposition of 'taxes on professions, trades, callings and employments,' the maximum amount payable in respect of any one person has been increased from rupees fifty to two hundred and fifty.

The power of the State to levy a tax on the sale or purchase of goods is subjected to certain limitations. The sales tax has become one of the major sources of revenue of the States. It was felt by the Government of India that it was making serious inroads into the Central sources of revenue like customs and export duties. Besides, there were also public complaints that the necessaries of life were becoming dearer by inconsiderate

1. Entry 53, List II
2. Art. 54, Art. II
3. " 55, " II
4. " 56, " II
5. " 57, " II
6. " 58, " II
7. " 59, " II
8. " 60, " II
9. " 61, " II
10. " 62, " II
11. " 63, " II
levy of the sales tax. Three kinds of restrictions are imposed on the levy of sales tax. In the first place, no State can impose a sale or purchase tax on goods which takes place outside the State or in the course of import into or export from India. By itself, this restriction is devoid of meaning as no State can tax sales outside its jurisdiction. The explanation of this is that if a sale outside the State results in the delivery of goods inside a State for consumption in that State, then the sale or purchase is deemed to have been made within that State and becomes liable to the Sales tax. Secondly, no State can impose a sales tax on any goods if the sale takes place in the course of inter-State trade or commerce. The third limitation covers the essential goods. No state can impose sales tax on goods declared by Parliament to be essential for the life of the Community unless the State obtains assent from the President.

Duties and Taxes, the proceeds of which are assigned wholly to the States.

Under the Constitution the right to levy a tax and the right to retain its yield do not go together. Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List are to be levied by the Union Government. They are collected and appropriated by the States in which they are levied except in Part C States where such duties

1. Art. 186.
are levied and the proceeds thereof are appropriated by the Union Government itself.

The following duties and taxes are to be levied and collected by Government of India but shall be assigned to the States and shall be distributed among them in accordance with such principles of distribution as may be formulated by Parliament by Law:-

(a) duties in respect of property other than agricultural land;
(b) estate duty in respect of property other than agricultural land;
(c) terminal taxes on goods or passengers carried by railway, sea or air;
(d) taxes on railway fares and freights;
(e) taxes other than stamp duties on transactions in stock exchanges and futures markets;
(f) taxes on the sale or purchase of newspapers and on advertisements published therein.

The Union may levy a surcharge on any of these taxes or duties and appropriate to itself the proceeds of such surcharge.

None of these taxes has so far been levied by the Centre. Terminal taxes on goods and passengers carried by railway or air are not suitable except for purely local purposes, i.e., for the

1. Art. 268.
2. Art. 269.
3. Art. 271
benefit of municipalities, pilgrim funds etc. They can however be conveniently levied by the Centre. Taxes on railway fares and freights will be objected to on the ground that the railways are making a substantial contribution to the general budget. They will also be resented by the public as they will put up the railway rates. Taxes on sale or purchase of newspapers and advertisements published therein will invite formidable opposition from the newspapers. The only tax which may be levied in the future is the Estate Duty. An Estate Duty Bill was introduced twice in 1946 and again in 1947, but legislation has been postponed. Fiscal considerations and considerations of equality demand the levy of the Estate Duty. As to the basis of the distribution of the proceeds of the duty among the States, the Finance Commission may be requested to lay down the principles of distribution. The Sarkar Committee suggested that the net proceeds of such a duty may be distributed among the States as follows:

"The net proceeds attributable to real property on the basis of the location of the property. Of the balance —

75 per cent on the basis of the residence of the deceased;
25 per cent on the basis of the population of the Province." 1

Sharing of Revenues.

The net proceeds of certain taxes are to be shared between the Union and the States. Included in this category are the taxes on income other than agricultural income and Union duties of

1. Report, Par. 58.
2. Art. 270.
excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List. The sharing of the net proceeds of income-tax is obligatory, while the sharing of Union duties of excise depends upon legislation by Parliament. The Union can levy entirely for its own purposes a surcharge on income-tax.

Taxes on income are to be levied and collected by the Union Government and distributed between the Union and the States. Only a certain percentage of the net proceeds will be distributed in a financial year. In determining the fund to be distributed between the Union and the States in Part A and B, two items are to be excluded from the net proceeds of the income-tax: (a) proceeds of the tax attributable to States in Part C and other territories, and (b) proceeds of the tax, payable in respect of 'Union emoluments' which includes all emoluments and pensions payable out of the Consolidated Fund of India in respect of which income-tax is chargeable. 'Taxes on income' will not include a corporation tax. Until a Finance Commission is constituted the manner of distribution will be prescribed by the President by order. After the Finance Commission has been constituted the manner of distribution shall be prescribed by the President after considering the recommendations of the Commission.

The division of the proceeds of income-tax was one of the

1. Art. 272.
2. Art. 271.
most difficult problems under the Government of India Act, 1935. The issue was left to be decided by the Governor-General after necessary enquiries. After an inquiry by Sir Otto Niemeyer, the provincial shares in the divided heads of Central revenue and subventions to some of the Provinces were fixed by and Order-in-Council, which subject to a modification during the war continued till 15th August, 1947. Consequent on Partition, the Government of India revised the basis of allocation of income-tax revenues among the States which had been fixed by Sir Otto Niemeyer. Sind, N.W.F. Province and parts of Bengal, Punjab and Assam became parts of Pakistan. Hence the shares of Sind and N.W.F. Province and part of the shares of these provinces had to be taken away and redistributed among the States of the Indian Union. By the Government of India (Distribution of Revenues) Order, 1948, the net proceeds of the taxes on income were distributed among the Provinces. Some of the Provinces like East Punjab and West Bengal expressed dissatisfaction with the interim distribution. In November, 1949, the Government of India invited Sir Chintaman Deshmukh to give an award regarding the share of the States of the proceeds of income-tax and its distribution among the States. The Award given at the close of January 1950 was accepted and implemented. It will remain in force till the Finance Commission makes its recommendations in this behalf. The Deshmukh Award was given effect to by the Constitution (Distribution of Revenues) Order, 1950.
The Award is as follows:

"(a) Each Part B State shall be entitled to receive out of the said sums a sum equivalent to fifty per cent of the net proceeds of the taxes on income other than agricultural income levied and collected by the Government of India in that State in the said financial year:

Provided that if any such State is entitled to receive in the said financial year any grant of financial assistance from the Government of India by virtue of an agreement under Cl.(1) of Article 278, then the sum payable to that State under this sub-paragraph shall be reduced by the amount of the said grant;

(b) each Part A State shall be entitled to receive out of the said sums a sum equivalent to fifty per cent of the net proceeds of the taxes on income other than agricultural income levied and collected by the Government of India in the merged territories within that State in the said financial year; and

(c) after deducting the sums referred to in the sub-paragraphs (a) and (b) from the said sums, the balance shall be distributed as follows:

<table>
<thead>
<tr>
<th>State</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assam</td>
<td>3</td>
</tr>
<tr>
<td>Bihar</td>
<td>12.5</td>
</tr>
<tr>
<td>Bombay</td>
<td>21</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>6</td>
</tr>
<tr>
<td>Madras</td>
<td>17.5</td>
</tr>
<tr>
<td>Orissa</td>
<td>3</td>
</tr>
<tr>
<td>Punjab</td>
<td>5.5</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>18</td>
</tr>
<tr>
<td>West Bengal</td>
<td>13.5</td>
</tr>
</tbody>
</table>

The Finance Commission will have a hard job in determining not only the percentage of the divisible pool of income-tax revenue to be distributed among the States but also in laying down the principles of such distribution. On this important question the various Provinces submitted their viewpoints to the Sarkar Committee. The Provinces (Part A States) differ widely in their view both with regard to the percentage to be distributed and also with regard to the basis of distribution. Bombay, Madhya Pradesh and Assam claim 75\%, West Bengal 60\%, Madras, Uttar Pradesh and Orissa 50\% of the divisible pool of income-tax revenue. "On the question of apportionment of income-tax also the Provinces differ widely in their views. Bombay and West Bengal support the basis of collection or residence, the United Provinces that of population, and Bihar a combined basis of population and origin (place of accrual); Orissa and Assam want weightage for backwardness. East Punjab, while suggesting no basis wants her deficit of Rs. 3 crores somehow to be met." The same viewpoints are likely to be placed by the States before the Finance Commission.

The Sarkar Committee recommended that the percentage of income proceeds to be allocated to the States should be raised to 60 per cent and that this should be distributed among the States on the following basis:

- 20\% on the basis of population;
- 35\% on the basis of collection; and
- 5\% to be utilized "as a balancing

2. Ibid Par. 24.
3. Ibid Paras 55-56.
factor in order to mitigate any hardship that may arise in the
1 case of particular provinces as a result of the application of
the other two criteria."

The principles of distribution generally recognised are:
the origin or locus of income, the residence of the tax-payer,
the place of collection and population.

'The origin of income' is doubtless relevant but "in the
complex industrial and commercial structure of modern times,
where a single point of control often regulates a vast net work
of transactions, where the raw materials come from one place,
are processed in another, manufactured in a third, marketed whole-
sale in a fourth and ultimately sold in retail over a large area,
contracts are made at places different from where they are per-
formed, money is paid in at one place and goods delivered at ano-
ther and more than one of these stages relate to the same tax-payer
the assignment of a share of profits to each stage can only be
empirical or arbitrary." 2

The place of residence of the tax-payer, although an
important factor, has little or no relation to the source from
which the income is earned, especially in the case of Joint-Stock
Companies. Bihar for instance, has contended legitimately, that
the source from which an income is earned is more important than
the place at which an assessee is taxed. The reason is that most

1. Ibid Paras 55-56.
2. The Sarkar Committee Report, Par. 50.
of the companies which exploit the mineral resources of Bihar have their head offices in Calcutta. The criterion of residence becomes a difficult factor to apply in practice in distributing the proceeds of the tax for the simple reason residence could be changed at the will of the tax-payer.

Another basis of distribution is the place of collection. The chief objection to this principle is that "it is unfair to the areas of origin and sale which it completely ignores, while it gives far too much weight to the place of control of a business, which is usually, though not necessarily, the place of collection. Moreover, even more than in the case of residence, the place of collection can easily be altered at the will of the tax-payer."

The basis of population has an element of equity. The population of a State can be taken as a rough measure of its needs. The acceptance of this principle would mean that the shares would be regulated somewhat like grants-in-aid. The objection to this criterion is that a share, is something to which a State is entitled because its citizens or things have in some measure contributed to the Fund, while a grant is something given to it without regard to its contribution to the Centre or to any common pool.

There is a fundamental divergence of interest between the more advanced and less advanced States, between the States with large populations and the smaller States. Bombay and West Bengal which are industrially the most advanced States will benefit if the

1. Report of the Sarkar Committee, Par. 52.
principle of origin of income-tax is adopted as the basis of allocation. On the other hand, Madras, Uttar Pradesh and Bihar will benefit if the principle of population is accepted. The smaller states put their claims on the basis of their backwardness. On the basis of place of collection, Bombay and West Bengal will get a major share while the rest will have very meagre shares.

Thus the problem of finding an adequate basis of distribution of the income-tax revenue among the States bristles with difficulties. No single criterion would lead to equitable result. The solution appears to lie in a judicious combination of two or more of the above principles. Whatever basis is decided upon by the Finance Commission, it is evident that greater weight will have to be attached to the factor of population than did the Sarkar Committee and also to the claims on the backward states.

The Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List are levied and collected by the Union. The net proceeds of these duties may be shared between the Union and the States if Parliament provides by law for such sharing. The Government of India Act, 1935 provided for the distribution of the duties on salt, federal duties of excise and export duties. Duties on salt have been abolished. Export duties are excluded from this group on the ground that import and export duties are sources of income common to the whole country. The States are unanimous in demanding

1. Section 14C.
50 to 75 per cent of the proceeds of Central excise duties. The Sarkar Committee was not in favour of giving the States a share in too many Central excises as that would bring about a divorce between benefit and responsibility. The Committee was of the opinion that excise duties on commodities subject to a protective tariff or even a high revenue tariff could not be conveniently shared. It suggested that 50 per cent of the excise duty on tobacco might be handed over to the States. As to the method of distribution of this duty the Committee were of the view that the most equitable method is on the basis of estimated consumption.

Federal Financial Integration.

Prior to the commencement of the Constitution, the financial relations between the Government of India and the Indian States were different from those between the Centre and the Provinces. They were governed by treaties, engagements and sanads. The main features of the relations were: First, the Indian States were paying various tributes and contributions to the Crown which formed part of the Central revenue. These contributions were divided by the Indian States Enquiry Committee (Financial) 1932 (also known as the Davidson Committee) under seven heads, viz., (1) Contributions in acknowledgment of suzerainty, (2) contributions in commutation of obligations to provide military assistance to the Crown; (3) contributions for the maintenance of a British 'Subsidiary force'; (4) contributions fixed on the creation or restoration

1. Report, Par. 40.
2. Ibid, Par. 57.
of a State or on a regrant or increase of territory; (5) contributions for special or local purposes such as the maintenance of local crops, police etc; (6) contributions acquired by the consequent or lapse of the original recipient State and (7) contributions acquired by treaty.

Secondly, while the Centre had a number of sources of revenue reserved to itself so far as the provinces were concerned it had no power over these sources so far as the Indian States were concerned without specific agreements. The States could pursue their own policies freely in such matters as customs, income-tax, railways, posts and telegraphs etc., which had incidence of British India too. On the one hand the States were free to impose their own internal customs duties, which could not but obstruct the flow of trade with the rest of India; on the other, the tariff policy of India which affected all parts of India like was determined by the Executive and the legislature of British India, in which the States had no voice.

Thirdly, some of the states had the right to mint their own currency and coinage.

Fourthly, certain States enjoyed some privileges such as the right to receive free service stamps from the Government of India, for their official correspondence; immunity in respect of sea customs; the privilege of importing sea-borne goods in bond etc.

1. Report, Paras 41-43.
The Government of India Act, 1935 envisaged that the States would enter the scheme of federation by giving up by their Instruments of Accession the right to and control over the sources of revenue mentioned in the Federal List such as customs, income-tax etc. It also provided that the Crown in signifying acceptance of an Instrument of Accession might agree to remit over a period of 20 years, the cash contributions payable by the State in excess of the value of the immunities and privileges enjoyed by the States.

The federal scheme envisaged in the Act did not mature. The whole position changed completely with the coming of independence. Under the Indian Independence Act Paramountcy over the Indian States lapsed and with it the relationships between the Paramount Power and the States except for "provisions of any agreement which may relate to customs, transit and communications, post and telegraphs or other like matters." The States acceded to the Dominion of India and closed the void that had been created by the lapse of paramountcy. A policy of integration of the States was pursued with great success. Some of the States were merged in the neighbouring Provinces, some were taken over by the Centre to be administered directly by it and others were constituted into Unions of States. With the completion of the process of integration it became necessary to redetermine the financial relationship of the States with the Union Centre. Accordingly, the Indian States Finance Enquiry Committee (The Krishnamachari Committee) was appointed in October 1948 to examine and report on the desirability and feasibility of integrating federal finance in Indian States and Unions of States with that of the rest of India so as to establish a uniform system of federal finance, the manner...
in which it should be brought about and the results of such a policy upon the finances of Indian States and Unions and the consequential financial adjustments that may be necessary between the Union and the States.

The Committee came to the conclusion that 'an integrated system is an essential part of the new relationship between States and the rest of India resulting from the attainment of independence by India' and that it is feasible and desirable. The new relationship in its view should rest on the following principles:

"(1) The Union Government should have authority in States over the same range of subjects as in Provinces.

(ii) The Union Government should exercise its functions in States through its own administrative agency as in Provinces.

(iii) The States should contribute to the finances of the Union on exactly the same basis as the Provinces and receive grants and other forms of financial assistance on the same basis."

The Committee also formulated schemes of federal financial integration in consultation with the States. The general principles adopted by the Committee are as follows: The Centre should take over all 'federal revenues with the States and also the 'federal' services maintained by the States. The federal revenues comprise duties of customs including export duties; income-tax and corporation tax (excluding agricultural income-tax); Central excises; railways; posts, telegraphs and telephones; opium; taxes

other than stamp duties upon transactions in stock exchanges and "futures" markets, taxes on the Capital Value of assets of individuals and Companies and on the Capital of Companies; and salt.

The 'federal' services are: defence ("I.S.F." Units only); aviation, broadcasting; meteorology; archaeology; geological survey; patents; copyrights, trade marks; registration of Joint Stock Companies, national highways; Currency Coinage and mints; accounts and audit. The Committee thus adopted the concept of "functional division as the basis for the integration of 'federal' revenues, expenditure and Service Departments of the States with the Centre. According to the Committee 'federal integration' means a functional bifurcation of the State Governments and upon such bifurcation the "federal" portions of the State Governments are to become integrated with the Government of the Union of India leaving behind 'Provincial' State Governments with purely 'Provincial' functions. The same principle of 'functional' bifurcation is to be adopted in the allocation of assets and liabilities of a State between the Union and that State. All assets and liabilities connected with federal revenues, expenditure and service Departments should be taken over by the Centre, the rest being associated with 'Provincial' functions should remain with the States. All internal customs barriers are to be abolished. The integration is to take effect from 1st April 1950 (in the case of Travancore-Cochin the date is to be 17th August, 1949) subject to a measure of gradualness in certain directions. The abolition of internal customs duties in some States

1. Ibid. Para 19.
2. Ibid Para 30.
3. Ibid. Para 25.
may be spread over three to five years. The rates of income-tax in States are to be raised to the level of Indian rates in two or three stages. The administrative transfer of certain federal functions and services to the Centre may be effected gradually. In order that there may be no sudden dislocation of the finances of the States by the introduction of the financial integration, the Union Government should guarantee to the States the whole amount of the loss or the share from the divisible pool of federal revenues allotted to the State, whichever is higher, for an initial period of five years and thereafter guarantee annually the amount of the loss diminishing by certain amounts every year until it is reduced to 60 per cent of the initial over-all net loss in the tenth year, or the States' share from the divisible pool of federal revenues, whichever is higher. The States are to be eligible for all grants, subsidies and other forms of financial assistance from the Central Government on the same basis as the Provinces from the date of integration.

In the calculation of the overall net loss of revenue to the States resulting from financial integration, the Committee took into account the loss from the abolition of internal customs duties, together with the 'federal' revenues which would accrue to the Centre minus the federal expenditure to be borne by the Centre. The overall net loss is referred to as the net 'revenue gap' resulting from integration.
## The Net 'Revenue Gap'  
(Amount in lakhs of rupees)

<table>
<thead>
<tr>
<th>State.</th>
<th>Internal Customs &amp; Salt.</th>
<th>'Federal' revenue Collected in the State.</th>
<th>'Federal' expenditure in the state.</th>
<th>Net 'revenue gap' - or gain.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mysore (1946-47)</td>
<td>-</td>
<td>321.59</td>
<td>51.04</td>
<td>-269.95</td>
</tr>
<tr>
<td>Saurashtra (1949-50)</td>
<td>79.99</td>
<td>294.82</td>
<td>62.31</td>
<td>-311.50</td>
</tr>
<tr>
<td>Pepsu (1949-50)</td>
<td>-</td>
<td>111.77</td>
<td>147.80</td>
<td>30.93</td>
</tr>
<tr>
<td>Rajasthan (1948-49)</td>
<td>301.89</td>
<td>225.32</td>
<td>247.99</td>
<td>-279.22</td>
</tr>
<tr>
<td>Madhya Bharat (1949-50)</td>
<td>150.55</td>
<td>133.07</td>
<td>151.32</td>
<td>-132.41</td>
</tr>
<tr>
<td>Travancore-Cochin (1947-48)</td>
<td>100.08</td>
<td>304.28</td>
<td>74.06</td>
<td>-330.30</td>
</tr>
<tr>
<td>Hyderabad (Year ending 30th Sept. 49)</td>
<td>364.94</td>
<td>557.40</td>
<td>336.01</td>
<td>-586.33</td>
</tr>
</tbody>
</table>

The Committee opined that no compensation for the abolition of internal customs duties should be paid as they were obstacles to the freedom of trade, commerce and intercourse.

In order to fill the 'revenue gap' the Centre should guarantee to reimburse the State Government the full net revenue gap for the first five years after which the amount would be gradually reduced to 60 per cent in the tenth year. Wherever the Centre suffered a loss as in the case of PEPSU the Centre should waive its claims. No compensation should be paid for the federal assets such as railways, passing to the Centre. With
a view to avoiding sudden financial dislocation, the excess of current assets over liabilities should be allocated between the Centre and the States on some equitable basis with reference to the relative needs for reconstruction and development expenditure upon 'federal' and 'provincial' fields in the State. An adhoc arrangement suggested is that the share to be apportioned to the Centre should be fixed at 10 per cent of the residual net surplus.

With a view to giving effect to the recommendations of the Indian States Finance Enquiry Committee, the Government of India have entered into agreements with each of the Part B States except Jammu and Kashmir. Provision has been made in the Constitution for such separate arrangements with the States in Part B. The Government of India can enter into agreement with the Government of any State in Part B with respect to (a) the levy and collection of any tax or duty leviable by the Government of India in such State and for the distribution of the proceeds thereof otherwise than in accordance with the provisions of the Constitution; (b) the grant of any financial assistance by the Government of India to such State in consequence of the loss of any revenue which that State used to derive from any tax or duty leviable by the Government of India or from any other sources; and (c) the contribution by such State in respect of any payment by the Government of India in respect of the Privy Purse of the Rulers. Such agreements are to continue in force for ten years but the President may at the end of five years modify any such agreement in consideration of the recommendations of the Finance Commission.

1. Art. 278.
The manner in which the Union Government have implemented as the scheme of federal financial integration recommended by the Krishnamachari Committee is as follows:— The Union Government have taken over on a 'functional' basis the 'federal' revenues and 'federal' expenditure of States. On the same basis the assets and liabilities are also apportioned. The 'net revenue gap' arising out of the transfer of 'federal' items of revenue and expenditure to the Centre will be made good by the Union in full for five years and thereafter at a diminishing rate for another five years and at the end of the tenth year Central assistance will be stopped altogether. The loss of revenue resulting from the abolition of customs duties must be borne wholly by the States. However, Rajasthan, Madhya Bharat and Hyderabad are allowed to continue to collect internal customs for a brief period. Rajasthan and Madhya Bharat must abolish it in five years and Hyderabad in four years. Within that period these States have to develop alternative sources of revenue. Income-tax will be imposed at Indian rates in PEPSU and Travancore-Cochin and in Madhya Bharat and Rajasthan the rates prevailing in Saurashtra will be imposed. All States' rates will, however, be raised gradually to the Indian level over a period of two to six years. No State can participate in the All-India Divisible Pool of income-tax until two years after the full rates of Indian taxation have been reached. In the meanwhile under an adhoc arrangement half the income-tax collected within a State will be allotted to it. The share of a State of income-tax and other divisible sources of revenue will be set off against the revenue gap-payment. The State will be entitled either to the amount
of the 'revenue gap' or to its share of the divisible pool whichever is higher. In Mysore, Hyderabad, Saurashtra and Travancore-Cochin the revenue gap is higher than the share of the divisible sources. They will, therefore, receive the amount of the revenue gap. The 'revenue gap' in the case of PTPSU, Madhya Bharat and Rajasthan is smaller than the share of income-tax and they will receive the latter.

The guaranteed annual recoupment for the States with reference to 'revenue gap' is fixed as follows:

<table>
<thead>
<tr>
<th>State</th>
<th>(lakhs of rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyderabad</td>
<td>135</td>
</tr>
<tr>
<td>Mysore</td>
<td>345</td>
</tr>
<tr>
<td>Saurashtra</td>
<td>275</td>
</tr>
<tr>
<td>Travancore-Cochin</td>
<td>280</td>
</tr>
</tbody>
</table>

The States will also be entitled to food subsidies, developmental and other grants-in-aid and loans in the same way as Part A States. The Privy Purse of the Rulers is to be borne by the continuing States and States Unions or the Part A States into which some of the States have been merged. But under the scheme of integration, the liability on account of the Privy Purse has been taken over the Centre but included in the revenue gap which for the transitional period will be reimbursed to the States, where a state has a surplus and no revenue gap the arrangements provide for the recovery of the Privy Purse to the extent of the actual amount of surplus. A similar arrangement has been agreed upon with respect to the States merged in the former Provinces.

The responsibility for the administration of the Centrally merged States is on the Union Government. The effects of the merger of States in Provinces on the finances of the latter have been rather adverse as revenue collections in merged areas are less than expenditure commitments. On the recommendations of the Krishnamachari Committee the Union Government have agreed to allot to the States in Part A the excess of 'federal revenue' over 'federal expenditure' in merged areas or half the net income-tax collections in the merged areas whichever is higher.

The benefits of federal financial integration are many and momentous. From the point of view of the Union of India the benefits are: (1) Both Part A and Part B States have become equal partners and the Union will exercise the same rights and obligations throughout India. (2) An uniform integrated financial system has been evolved. The abolition of customs duties will make inter-state trade free and unfettered. The levy, assessment and collection of federal taxes will be uniform throughout the country. The evils of double-taxation and tax evasion can be checked effectively. (3) An uniform system of transport and communications has become possible. (4) National Planning, on an all-India basis will become possible. Finally, (5) it has become possible to present a consolidated picture of the finances of the Union as well as of States.

The States themselves will derive substantial benefits: "Firstly their people and Governments will take their place in the polity of India alongside the people and Governments in the rest of India and share in its wider life with equal rights and obligations. Secondly, administrative standards and efficiency will increase by closer contacts with the administration
of the Central Government and especially by the uniform account-
ing and audit system which will result from the supervision of
the Auditor-General of India, recruitment to the higher services
on an all-India basis, a unified judicial system and access to
technical advice and assistance furnished by the Central Govern-
ment. Thirdly, States will have their share of such federal
revenues as may be made divisible from time to time and of the
grants, loans and other forms of financial assistance given
by the Centre on the same basis as Provinces; an impetus will
thus be given to development programme in these areas."

Grants-in-Aid.

As a result of the two World Wars there has been a
tightening of the federal grip on the economic life. There
has been a steady movement towards centralization of finance.
The federal governments have invaded the sphere of direct taxa-
tion which belonged to the Units. While the financial resources
of the Units are contracting, their functions are increasing.
There has thus been a maladjustment between the functions and
sources of revenue so far as the federal units are concerned.
Moreover, the Units in a federation are generally diverse in
financial strength. Some Units are unable to maintain the
essential services at the necessary minimum level. They are
compelled to seek federal aid. The coordination of the elemen-
tary principles of federal finance viz., independence and res-
ponsibility, adequacy and elasticity has been of the utmost

1. The Indian State Finances Enquiry Committee, Para 15.
importance. Various means are adopted to achieve this aim and one such device is 'grants-in-aid'.

According to Finer, a grant-in-aid is "a sum of money assigned from a superior to an inferior government either from the exchequer of the former or from the sources of revenue specially designated." The general purpose of a grant-in-aid is to improve the quality of quantity of governmental service in backward areas by transferring public funds from the more wealthy to the less wealthy regions through the medium of the Central treasury."

Grants-in-aid are of two types: conditional and unconditional. The former are developed in the U.S.A., and the latter in Australia and the Dominion of Canada. In the United States grants are made subject to conditions and is followed by the regulatory authority of the Federal Government. The Congress had no power to compel a State to accept federal aid. But a State which accepts such aid must accept it subject to the conditions imposed by Congress and to that extent surrender its powers to manage its affairs in its own way. Conditional grants thus impair the autonomy of the recipient Units. The government which makes the grant will assert its control both by specifying the purposes for which it will give assistance and by satisfying itself that the money is properly spent. Conditional grants will lead to the extension of the federal authority and inevitably involve some amount of centralization. But conditional grants

1. Encyclopaedia of Social Sciences.
2. White, Public Administration, P. 155.
guarantee that there is no waste in expenditure and that the
grant will be spent for the purpose for which it is made.

Unconditional grants, on the other hand, are given as
block grants without any 'strings' attached. They are grants
which can be spent as State government prefers. These are
based upon complete severance between responsibility and control.
The chances of waste are greater because the spending government
owes no responsibility to the government from which the grants
have come and its responsibility to the electors is tenuous
because it has not raised the money from them by revenue measures
of its own. Experience has shown that as between the two con­
ditional grants are preferable although they involve the limita­
tion of the autonomy of the States. Conditional grants have
many accomplishments to their credit. Their object is invariably
realised. Unconditional grants lead to lack of responsibility
and waste. Yet each has its own place in a federation and
there should be provision for both types so that the needs of
efficiency and flexibility might be adequately answered.

Sometimes special grants are also made to the Units.
According to the Commonwealth Grants Commission of Australia
they are made "When a State through financial stress from any
cause is unable efficiently to discharge its functions as member
of the Federation and should be determined by the amount of help
found necessary to make it possible for that State by reasonable
effort to function at a standard not appreciably below that of
other States." It is better to provide for special grants to
the Units in a federation.

A major problem connected with grants-in-aid is to arrive at a satisfactory basis of allocation. It is usual to take into account the factor of population. "Population serves as a reasonably satisfactory basis of appointment, since it is uniform, easily determined and not subject to political manipulations."

Of course, population is a rough and ready measure, but under certain circumstances a rich State having a larger population than a poor State might receive larger amount of grants. Thus the whole purpose of grants-in-aid might be distorted. But population is undoubtedly an important factor in as much as it gives an index to the needs of a State.

The Commonwealth Grants Commission in Australia have adopted the basis of 'fiscal needs' of a State for making special grants. They take the 'normal' standard of expenditure and taxation of the States. A detailed comparison of the expenditures of the claimant States with this normal is made. The scale of social expenditure, costs of administration are analysed and the revenue systems of claimant States are related to the normal by careful comparison of severity of taxation and of the scales of charges levied by State enterprises. A study is made of how each of the claimant states stands in relation to the 'normal' in expenditure and taxation. The special grants will not be equal to the amount of deficiency. Extra effort through curtailment of expenditure and severity of taxation is demanded of the States so that they might try to improve their financial position by their own efforts.

1. A.F. Macdonald, Federal Aid, P. 266.
In Canada 'the national adjustment grants' are determined on the basis of (1) the expenditure needed to finance developmental projects and to provide social services according to the 'normal Canadian Standard,' and (2) the yield of Provincial taxation of normal severity.

In the words of Mr. R.K. Nehru and B.P. Adarkar, "The purpose of financial assistance in a federation is not mere avoidance of Central or Provincial deficits, no financial settlement can achieve that purpose. Hence if any Province in a Federation attempts to make out a case by mere "window-dressing" and a show of "deficit" such case must necessarily be ignored. Moreover, in the allocation of grants whether for current budgetary purposes or for long term developmental plans, the fullest consideration will have to be given to all relevant factors, including the size of the population, the wealth of natural resources, the existing backwardness of the areas concerned, the geographical density of population, the per capita income and the wealth of the peoples of the Provinces and their basic needs."

Grants-in-Aid in India.

The Constitution makes provision for grants-in-aid from the Union to the States. There are certain obligatory grants which must be made by the Union to certain States. Under the Government of India Act, 1935 the Provinces were entitled to a

share of export duty on jute. Under the Constitution the States will have no right whatever to any such share as all export and import duties belong to the Centre. But it was felt that a sudden withdrawal of this source might hurt Bengal, Bihar, Assam and Orissa and create difficulties in their budgets. It is therefore, provided that for a period of ten years from the commencement of the Constitution, the jute-growing States of West Bengal, Bihar, Assam and Orissa will receive grants-in-aid from the Union in lieu of their share of the jute export duties and to the extent of such sums as the President may by order prescribe.

The grants prescribed by the President is as follows:

<table>
<thead>
<tr>
<th>State</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assam</td>
<td>Rs. 40,00,000</td>
</tr>
<tr>
<td>Bihar</td>
<td>35,00,000</td>
</tr>
<tr>
<td>Orissa</td>
<td>5,00,000</td>
</tr>
<tr>
<td>West Bengal</td>
<td>1,05,00,000</td>
</tr>
</tbody>
</table>

The Union Parliament is also given power to make such grants as it may feel necessary to give financial assistance to any State in need of such assistance. Discrimination in the matter of making grants would not be unconstitutional for grants to financially weaker States will have to be necessarily discriminatory in character. The Union Government should make grants for purposes of promoting the welfare of Scheduled Tribes in a State or for raising the level of administration of the

1. Section 140.
Scheduled Areas, in that State to that of the administration of the rest of the areas in that State. Moreover, grants-in-aid of the revenues of Assam must be paid. The sum, Capital and recurring, must be equivalent to (a) the average excess of expenditure over the revenues during the two years preceding the commencement of the Constitution in respect of administration of tribal areas specified and (b) the costs of such schemes of development as may be undertaken by that State with the approval of the Government of India for the purpose of raising the level of that State. Until Parliament by law fixes the grants payable to the States the President is empowered to prescribe the grants by order.

The following grants are extended to the States of Assam, Orissa and Punjab under the Article 275.

<table>
<thead>
<tr>
<th>State</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assam</td>
<td>Rs. 30,00,000</td>
</tr>
<tr>
<td>Orissa</td>
<td>40,00,000</td>
</tr>
<tr>
<td>Punjab</td>
<td>75,00,000</td>
</tr>
</tbody>
</table>

The Union Government has made from time to time specific grants-in-aid for developmental schemes, for educational schemes and for Grow More Food Scheme. Again following the financial integration of Indian States with the Union, the Union Government has agreed to make good the 'revenue gap' created by the Central assumption of federal sources of revenue and expenditure by means of grants-in-aid.

In India the Units are in unequal stages of economic development. Grants-in-aid will be most needed for bringing

1. Art. 275.
the backward states like Assam and Orissa in line with the more advanced States. Primary consideration should be given to the object of bringing about a balanced development of every part of the country and grants-in-aid should be designed for this supreme objective.

The Finance Commission is charged with the task of evolving a satisfactory basis of allocation of grants. The Commission will have before it the experience of Canada and Australia in this matter. Australia has been working a complicated system of grants-in-aid. The Sarkar Committee was of the opinion that the Australian system may not be suitable to Indian conditions. The number of States in India is larger than in Australia and conditions differ radically from State to State. It observed that the Union Centre when distributing grants must pay attention to the varying circumstances that prevail in the different States. In the search for a suitable formula in the course of their study of Australian Financial System, Messrs. R.N. Mehru and B.P. Adarkar found three outstanding criteria which may be relevant to the distribution of federal aid. These are (a) per capita income indicating the relative economic strength of the Provinces; (b) the total population of each Province; and (c) the total geographical area of each Province. They fixed up the percentage of each of these factors at 50 per cent, 35 per cent and 15 per cent, respectively.

Functions and Financial Resources.

The distribution of revenues under the Constitution does not correspond properly with the allocation of functions. Although the List of subjects allotted to the Union Centre is longer than the State List the states are entrusted with a number of developmental services such as agriculture, industry, irrigation, communications, fisheries and social services like education, public health, relief of the disabled and the unemployed. The scope of these services is very wide and they are very expensive. In an undeveloped country like India these services will be demanded on an extensive scale.

According to a study made by the Reserve Bank of India recently of the budgetary position of Part A and Part B States for the years 1950-51 and 1951-52, income-tax and sales tax form the mainstay of Part A States and excise, the main source of revenue for Part B States. Excise accounts for 33.84 per cent of the total tax revenue of Part B States while the corresponding figure for Part A States is 11 per cent. Income-tax forms 22 per cent and sales tax 20 per cent of the revenues of Part A States; the corresponding figures for Part B States are only 10 per cent and 2.5 per cent respectively.

The total revenue and expenditure of Part A States during 1950-51 was 296.58 and 301.96 crores respectively leaving a deficit

of 5.38 crores. In the budget of 1951-52 the deficit is reduced to 2.80 crores. The total revenue and expenditure of Part B States for 1950-51 is 78.53 lakhs; for 1951-52 (Budget) the revenue is 80.56 lakhs and expenditure is 81.14 lakhs leaving a deficit of 58 lakhs.

Expenditure on social services has risen in Part B States from 23.47 crores in 1950-51 to Rs. 26 crores in 1951-52, an increase of Rs. 2.53 crores, consisting 30 per cent and 32 per cent of the total expenditure of the States in the respective years. For Part A State also expenditure on social services exceeds that on security services at Rs. 96.09 crores and 90.40 crores or 31 per cent and 29 per cent respectively of total expenditure in 1951-52. Education is the most important single item, as for Part A States accounting for Rs. 11.95 crores in 1950-51 and Rs. 13.38 crores in 1951-52. Every State has a larger provision for education. Medical and public health services come next to education.

The States are left to rely mainly on their own resources for financing development expenditures. They obtain loans from the Centre for their Capital outlays.

The outlook for revenue is not bright. Receipts from income-tax and sales tax which have become the mainstay of the States are likely to decline in the coming years. The character of State finance has been greatly altered by changes since 1939. Land revenue and excise have taken a back place, while income-tax and sales tax have become prominent. If prices fall, incomes fall and the yield from the latter will go down. The Constitutional
limitations on the levy of sales tax will further cut into the increases of States. The future of land revenue is in the melting point. The abolition of Zamindaris will not make any appreciable additions to State revenues. On the other hand it may mean further expenditure in the shape of compensation to Zamindars. The pursuit of policies like prohibition has meant substantial loss of revenue and increased outlays.

The scope for fresh taxation is also limited. Agricultural income-tax has been introduced in Bihar, West Bengal, Orissa, Assam and Uttar Pradesh. The other States can follow suit. The States can resort to a betterment levy. In Madras Legislation on this has been postponed. Another source of revenue is Estate and Succession Duty in respect of agricultural land but the Centre must co-operate by imposing estate duty on property other than agricultural land. Some States like Madras have nationalised public utility services but these are not yielding any appreciable income.

There is thus greater need for economy on the part of the States. They must go slow with their Socio-economic policies. The real dilemma that faces the States in the coming years is how to reconcile the need for economy with the natural demand for an extension of social services.

The transfer of funds from the Union to the States in larger quantities has little prospects. The Centre has been working on deficit budgets. Food shortage, relief and rehabilitation of refugees and heavy expenditure on defence have
caused deficits in Central budgets. The expenditure on these will continue as at present. Due to import restriction there might be a fall in customs receipts. The financial needs of the Centre are also growing. The pattern of defence expenditure is not clear. The range of developmental activity undertaken by the Central Government has been steadily widening. The pre-war assumption about the difference in functions between the Centre and the Provinces is no longer valid. However, State sources of revenue have not been as elastic as Central sources. They are hardly sufficient to meet the expenditure involved in the performance of functions assigned to the States under the Constitution. They will have to depend more and more on Central grants and other forms of financial assistance.
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Art. 274 (84, I).

1. Tax Revenues of the States

(c) In so far as in Parts C & D.

2. Tax Revenues of the States

(97, I)

subject to taxation in States II & III. 

4. Any tax not mentioned in

3. Enquiry on taxes paid to the Union:

States A & B:

5. Taxes levied and collected by

States A & B:

6. Taxes on income other

than agriculture.

Art. 270. 87, I

between Union and

dy Union and disbursement.

A. Share of taxes levied
4. Pounds (17' II) (4' II)

The treasure trove, the (Art 296)!
and bona vacant.


2. Forests (17' II) (6' II)

In State (25' II) in Post
transport works, lands and

1. Revenue from

(5't. 276, 276)

From Union
Grants

and functions:

Original revenue

Commercial

Taxes of the States

4. Taxes in List II.

5. Directly raised &

6. Appropriated by

3. Teased by Union

States (Art 270)

but may be distri-

4. Teased by Union

States (Art 269)

stated to States: All

2. Sees in Post

that collected and ap-

1. Sees taken in

Post

Proprietated by States.
on transportation, excise, duties of excise

(pathology (67))
in newspapers & advertisements
4. taxes on stocks

(pathology (67))
lied in 94, first 3. taxes on prep.
3. medical prep.
2. excise duties on extra
1. stamp duties on exchange

(pathology (67))

tax (on)
the corporation (except)
cultural (except)
certain other than art, not
taxes on income &
1. excise, duties on
1. succeed to art, 46, 11
2. succeed to art
3. corporation & 8, 55, 11
4. tax, 46, 11

(pathology (67))
to states &
to union &
by state law:
A & B:
1. levied by union
D. 
C. levied by union
B. directly raised
A. levied by union

(pathology (67))

Taxes of excise on the states
Borrowing Powers of the Union and the States.

The Union Government can borrow on the security on the consolidated fund of India anywhere in the world subject to the limits which may be fixed by Parliament by law. The Central governments everywhere are free to borrow anywhere. The Congress in the United States has unlimited power to borrow anywhere on the credit of the United States. In Canada Dominion Government have exclusive powers in regard to "the borrowing of money on the public credit, but the provinces also have the power in regard to "the borrowing of money on the sole credit of the Province." In Australia the Commonwealth Parliament has exclusive powers of "borrowing money on the public credit of the Commonwealth."

As regards borrowing by the State Governments the practice differs from country to country. The United States Constitution leaves borrowing by States on the credit of their own resources to be governed by State Constitutions. In Canada, too, the provinces can borrow on the sole credit of the Province. In India the borrowing powers of the States are subject to a number of limitations. The States can borrow only within the Union. Under the Government of India Act, 1935 the States could borrow outside India with the consent of the Centre. This power is now denied to the States. The States can borrow within India upon the security of their consolidated Funds but subject to the following:

1. Art. 292
2. Art. 1, Sec. 8, Cl. 2.
3. Section 91 (4)
4. Section 92 (3)
5. Section 51 (iv)
6. Art. 293.
limitations: (1) limitations as may be imposed by State Legislatures; (2) if the Union has guaranteed an outstanding loan of the State no fresh loan can be raised by the State without the consent of the Union Government; (3) the Union Government can offer a loan to a State under a law made by Parliament. So long as such a loan or any part thereof remains outstanding, no new loan can be raised without the consent of the Union Government. In the act of giving its consent the Government of India can impose its own terms.

In Australia the independent powers of borrowing of the Commonwealth and the States have been abandoned. Borrowing is now regulated by the Loan Council established in 1927. The creation of this body has eliminated the competition between the two governments in the loan market. The value of freedom of borrowing lies in the sense of responsibility it creates but it is necessary to have some machinery like the Australian Loan Council which would ensure that borrowing governments do not, by their competition, upset the Capital market. This machinery in India is now provided through the Reserve Bank which advises all the Governments regarding the timing of their loans and coordinates the loan operations of both governments. Nevertheless, an expert body devoted solely to this purpose might be set up with great advantages in India. The Australian Loan Council has to its credit an excellent record of achievement. Where says that "The establishment of the Loan Council in Australia, an institution for compulsory co-operation between general and regional governments, super imposed upon the federal system, is a unique event in the history of the financial relations of
general and regional governments in a federation."

**Financial Emergency.**

A special feature of our Constitution is the provision for the declaration of a **Financial Emergency** as distinguished from a **General Emergency**. When a financial emergency is in operation the executive authority of the Union shall extend to the **giving** of directions to any State to observe such canons of financial propriety as may be specified in the directions. Such direction may include (1) the reduction of salaries and allowances of all or any class of persons serving the State; and (2) a provision requiring all Money Bills or financial bills to be reserved for the consideration of the President after they are passed by the Legislature of the State. Further, the President is also competent to issue directions for the reduction of salaries and allowances of all or any class of persons including the Judges of the Supreme Court and High Courts.

This article was introduced having regard to the economic and financial situation in India which is rather serious. In the words of Mr. K. M. Munshi, "This article in the Constitution is the realization of one supreme fact that the economic structure of the country is one and indivisible. If a Province breaks financially, it will affect the finances of the Centre; if the Centre suffers, all the Provinces will break. Therefore, the
interdependence of the Provinces and the Centre is so great that the whole financial integrity of the country is one and a time might arise when unitary control might be absolutely necessary."

According to Dr. E.R. Ambedkar, the article follows the pattern of what is called the National Recovery Act of the United States passed in 1930's, which gave the American President to make similar provisions in order to remove the difficulties, both economic and financial, that had overtaken the people of America as a result of the great depression. Dr. Ambedkar says: "The reason why we have thought it necessary to include such a provision in the Constitution is because we know that under the American Constitution within a very short time the legislation passed by the President was challenged in the Supreme Court and the Supreme Court declared the whole of that legislation to be unconstitutional, with the result that after the declaration of the Supreme Court, the President can hardly do anything which he wanted to do under the provisions of the National Recovery Act. A similar fate might overwhelm our President if he were to grapple with a similar financial and economic emergency. In order to prevent any such difficulty we thought it was much better to make an express provision in the Constitution itself and that is the reason why this article has been brought forth."

The financial effects of a proclamation of general emergency are serious. During the operation of the emergency the

President will have constitutional power to modify the constitutional

provisions relating to the distribution of revenues between the Union and the States by his own order. Such order shall not have any effect beyond the financial year in which the proclamation itself ceases to operate. Further such order shall be subject to the approval of Parliament. This article gives the Government of India power over the entire field of taxation during the existence of an emergency.

Although a provision of this sort is consequential to the proclamation of an emergency, it is fraught with harmful consequences. Under the existing scheme of distribution of revenues, the proceeds of certain Central taxes like income-tax and Central excise duties have to be shared between the Union and the States. As we have already seen the share of the income-tax revenue is one of the main sources of State revenues. The States will have increased their expenditure and framed their budgets having regard to their revenues from all these sources. Supposing an emergency is proclaimed and the President insists that whatever might happen the financial settlement agreed upon must be modified. What will be the fate of the Provinces or States in such a case. If such a thing happens it would be highly iniquitions. Even under the Government of India Act, the position was far better. All that was provided in it was that the transfer of the full provincial share of the 'divisible pool' may be delayed on account of an emergency but no part of the portion of divisible pool assigned to the Provinces could be taken

1. Art. 354.
away from them. It would have been better if similar arrangements had been made under the Constitution. Far from averting an emergency, the proclamation might as well be the cause of another kind of emergency namely, the financial breakdown of the States. The Central Government cannot in justice ask the States to alter their budgets and curtail the services which they are rendering to the people. That would be unfair and even disastrous. The Centre must make it known to the States that it would only delay the transfer of funds assigned to them but not reduce or stop giving it altogether.

The Finance Commission.

The establishment of a Finance Commission within two years from the commencement of the Constitution and thereafter at the end of every five years or at such earlier time as the President considers necessary is a welcome and worthy feature of our constitution. The Commission will consist of a Chairman and four other members to be appointed by the President. Parliament by law will determine the qualifications required of the members of the Commission and the manner of selecting them.

The Commission has been charged with the duty of making recommendations to the President as to -

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

1. Art. 280.
(b) the principles which should govern the grants-in-aid to the States out of the Consolidated Fund of India;
(c) the continuance or modification of the terms of any agreement entered into by the Government of India with the Government of any State specified in Part B of the First Schedule with regard to financial matter; and
(d) any other matter referred to the Commission by the President in the interests of sound finance.

By a Finance Commission (Miscellaneous Provisions) Act Parliament has laid down the following qualifications for the members of the Finance Commission. The Chairman of the Commission is to be selected from among persons having experience in public affairs while four other members shall be selected from among those (a) who are or have been qualified to be appointed as High Court Judges or (b) who have special knowledge of finances and accounts of the Government or (c) have had wide experience in financial matters and in administration or (d) have special knowledge of economics.

The Act confers on the Commission the powers of a civil court in respect of summoning witnesses, requiring production of any document and requisitioning any public record from any Court or Office and calling for any information from any person.

The President has constituted the Finance Commission consisting of Mr. K.C. Neogy, M.P., as Chairman, Messrs. V.P. Menon, Justice R. Kaushalendra Rao and B.K. Madan (Members) and Mr. M.V. Rangachari (Member-Secretary). The Commission will make its

recommendations to the President in about two years.

The work of the Commission is onerous and difficult. Its success will depend to a great deal upon the sense of impartiality and independence its members will bring to bear upon its work. Its approach to the whole question must be scientific and objective.

The President must lay before Parliament the recommendations of the Commission together with a memorandum as to the action taken on them. In this matter there is need for the establishment of a Convention that its recommendations have to be accepted, even though they may be adverse to the Union Government. Coming from such an expert body the recommendations will have unique weight and a Government rejecting any of them will have to defend their decisions before the Parliament. It is only in the case of taxes on income that the President is empowered to act on the recommendations of the Commission. As regards excise duties, estate and succession duties, terminal taxes, taxes on railway fares and freights and grants-in-aid effect can be given to the recommendations only through Parliamentary legislation. Much will depend upon a clear appreciation that the Centre and the States cannot have divergent interests.

The Constitution has laid down a broad scheme of financial relations between the Union and the States. Many details are left to be worked out by the Finance Commission. This imparts an element of flexibility to the Constitution in so far as its

1. Art. 281.
financial provisions are concerned. There will be a regular review of the financial relations every five years by the Commission in the light of past experience and future needs. Experience will show whether the advantages of such a periodic compulsory review will not be largely nullified by the uncertainty which may be caused during the period the Commission is making investigation. The Constitution also permits a diversity of possible financial relations and arrangements between the Union and the States.

Financial Control.

The Union Government exercises real control over the States through its financial operations. Almost all productive taxes are centrally levied and collected. While this may be desirable from the point of view of economy and administrative convenience the rates of levy are determined by the Union itself.

The funds made available to the States under the Constitution from the central revenue depend sometimes on the orders of the President, sometimes on Parliament, sometimes on recommendations of an expert body like the Finance Commission and sometimes on the political decisions of the Union Government. There are certain taxes like taxes on railway fares and freights, estate duty on property other than agricultural land, etc., which may be levied by the Union Government and the proceeds of which must go wholly to the States. Until now not a single tax under this head has been levied by the Union Government. The States have no option in this respect. They have to depend upon the sweet disposition of the Union Government.
Although the recommendations of the Finance Commission are authoritative and embody decisions of an expert character they may be altered by the President. If such a thing is resorted to the States will cease to have all confidence in the Union Government. Nothing prevents the Union Government to modify the recommendations of the Finance Commission. The alterations effected might hit the States hard.

In matters of finance it is the House of the People that is supreme. The Council of State has no authority in financial matters. The States as Units cannot have any hand in financial matters.

In times of emergency the President can suspend the distribution of revenues or modify it in any manner he likes. The finances of the States are thus completely determined and controlled by the Union Government.

As regards borrowing while the Union has powers to borrow anywhere in the world on the security of the Consolidated Fund of India, the States States' powers of borrowing are hedged around with various limitations. The loan policies of the States are controlled indirectly by the Union Government.

The recent trends in inter-governmental relations which we have noticed earlier in this chapter are reflected in the financial relations between the Union and the States in India. There has been almost a complete unification of the finances in India. The Units cannot by themselves raise all the funds they
need for the performance of a wide range of development and social services that is assigned to them. They are dependent upon various forms of assistance from the Union. Such dependence will mean control by the Union. The system of grants-in-aid in particular entails some amount of Central Control. Certain grants are made for specific purposes. For instance grants to Assam and Orissa are given for the promotion of the welfare of tribal areas, scheduled areas and scheduled people. Grants are made to States to promote grow more food campaign, etc. In all such cases the Union will have to satisfy itself that the grants are properly made use of by the recipient States. This means that the Centre will exercise control over the States in financial matters. Grants-in-aid have undoubtedly a centralising effect. Of this Centralising power Griffith writes: "Here is an attack on federalism, so subtle that it is scarcely realised. Control of economic life and of these social services (viz., unemployment, old age, maternity and child-welfare) were the two major functions of State and Local governments. The first has largely passed into national hands; the second seems to be passing. If these both go what we shall have left of State autonomy will be a hollow shell, a symbol."

Financial Co-operation.

It is the field of finance that competition for revenue between the federal government and the Units is the keenest. It

1. The Impasse of Democracy, P. 195.
is this competition that is responsible for the evils of double and multiple taxation. What is most desirable is a system of co-operative devices which will enable both governments without entering into competition which each other to get the revenues they need. In most of the federal Constitutions such co-operative devices already exist although they are few in number. In the U.S.A., a recent device that has been adopted is that of Tax Credit and Tax Deduction. The amount collected by one government is allowed as a Credit against the amount due to the other, if both governments are using the same tax. This will enable the State to share in the tax and will limit the burden on the taxpayer and remove the injurious effects of double or multiple taxation.

Another co-operative device is the surrender by the States of their right to levy and collect certain taxes. The Centre levies and collects the taxes on behalf of the States and makes over the net proceeds of such taxes to the States. Again certain taxes are levied and collected by the Union but both governments share the net proceeds on an agreed basis. In the Union of India certain taxes are imposed by the Union Government but they are collected and appropriated by the Units. Some taxes are levied and collected by the Union but are assigned to the States. Some taxes again are levied and collected by the Union but are distributed between the Union and the States.

1. Art. 268.
2. Art. 269.
3. Art. 270 and 272.
A third co-operative device exists in Australia. The units there have surrendered to the Commonwealth Government their right to certain taxes in return for some special grants.

Another co-operative device which has helped the elimination of competition between the governments in the matter of governmental loans is the creation of a statutory body with power to regulate the loan operations of both governments. In Australia the Loan Council has successfully handled the problem of loans. It has the final voice in determining the amount that should be raised each year by way of loans by the federal and State governments. The Loan Council consists of the Commonwealth Premier and the Premiers of the State Governments. In India this task is being performed by the Reserve Bank but it is essential that a separate statutory body must be set up exclusively for the purpose of controlling the loans raised by the Union and the States. The need for such a body has been felt in Canada. The Royal Commission proposed by it should be charged with the function of examining the soundness of Provincial loans. The Finance Commission in India has jurisdiction over almost all financial matters of an inter-governmental character. Both the United States Congress Committee on Federal, State and Local Government Fiscal Relations (1943) and the United States Treasury Committee have suggested the setting up of a "Federal-State Fiscal Authority" for promoting financial co-operation.

The system of grants-in-aid which has come to stay in almost all federations is an effective co-operative device. It provides relief to the units which are affected adversely by the
policies pursued by the Central Government. Several of the Units in Australia have claimed grants on this ground. Grants also help to reduce the disparity between administrative power and finance power. The idea of a national minimum in essentials of life, of health, education etc., has come to be accepted and it must be guaranteed throughout the area of the federation. Some Units for lack of adequate funds may not be able to ensure even this minimum. It is necessary in the interests of the strength of the Union that the centre should enable such units through a system of grants-in-aid, to maintain such minimum standards. The Union Government in India makes special grants to the States of Assam and Orissa for the upliftment and promotion of the welfare of Scheduled areas and Scheduled tribes. In Canada the Royal Commission recommended the grant of National Adjustment Grants to the Provinces in order to enable them to maintain what is called the 'Average Canadian Standard.'

The principle of "immunity of instrumentalities" generally recognised in all federations has found a place in our Constitution. The principle implies the mutual immunity from taxation of the two governments in a federation. This was laid down in Macculloch V Maryland, by the U.S. Supreme Court. In Canada 'no lands or property belonging to Canada or any Province shall be liable to taxation.' The Constitution of Australia lays down that a State 'shall not impose any tax on property of any kind belonging to the Commonwealth, nor shall the Commonwealth impose any tax on property

of any kind belonging to a State.'

Under the Constitution, the property of the Union Government is exempt from all taxes imposed by a State. But until Parliament by law or otherwise provides, a State can levy tax on any property of the Union to which such property was before the commencement of Constitution liable. Similarly the property and income of a State shall be exempt from Union taxation. But this immunity is of a limited character. The Union can impose any tax to such extent as Parliament may by law provide, in respect of a trade or business of any kind carried on by the Government of a State or any operations connected therewith, or any property used or occupied for purposes of such trade or business or any income accruing or arising in that connexion. However, any trade or business which Parliament by law declares to be incidental to the ordinary functions of government shall be exempt from Union taxation.

State taxes on electricity are not to be imposed on Union Government and the railways. When the imposition of such a tax is permitted by Parliament, the law imposing such tax must secure that the price of electricity consumed by the Government of India or by its railways shall be less than that charged to other customers by the amount of the tax. In other words the incidence of the tax shall be upon the producer of electricity i.e., the State and not upon the Government of India.

1. Section 114.
3. Art. 289.
4. Art. 287.
Subject to any order of the President to the contrary, certain objects of inter-State public utility are exempted from existing State taxation. This provision is in respect of water or electricity generated or consumed or sold by any authority established by Parliament for regulating or developing any inter-State river or river-valley like the Damodar Valley Corporation. The Legislature of a State may impose any such tax, but it shall have effect only after having been reserved for consideration of the President and after having received his assent.

The above two provisions constitute partial application of the principle of immunity of instrumentalities. These ensure immunity of certain functions carried on by the Union, as distinguished from property. The immunity of instrumentalities constitutes undoubtedly one of the co-operative devices in a federation.

In the field of finance there is bound to be a great deal of co-operation between the Union and the States. As rigid allocation of sources of revenue is impossible and as financial relations have to be regulated through a system of adjustments and re-allocations, the Centre and the units have to co-operate in this task. Co-operative relations between the Union and the States are bound to grow in the future and such growth must be ensured in the interests of both the Union and the States.