CHAPTER XIII

PUBLIC FINANCE

I. Evolution of Indian Public Finance

The finances during the East India Company's regime were characterized by excessive centralization which resulted in provincial extravagance and negligence of local officers. The Provincial Government resented the interference of the Central authority, whose control could not be effective due to the absence of modern methods of accounting and auditing and of rapid means of communication made worse, in the earlier years, by the separation of the Company's territorial areas by independent territories. During the Company's regime, the condition of Indian finance was one of "chronic deficits". Since 1813, when the commercial accounts of the Company were separated from its territorial revenue and expenditure, and until the end of its rule in 1858, there was a surplus of £8.9 million in 13 years of surplus as against deficit in 33 years amounting to £72.2 million. The Company was ceaselessly engaged in aggressive wars which continuously swelled its military expenditure. The expenditure on civil administration was high owing to the exclusion of Indians from higher appointments and it increased with the expansion of the Company's territory. Till 1813, there was also the strain of expenditure on the Company's investment estimated at nearly £1.2 million annually. A certain proportion of the revenue of Bengal had been for many years set apart in the purchase of goods for export to England, and this was called the investment. The Company's expenditure rose from £6.9 million in 1792-93 to £41.1 million in the last year of its rule. The entire revenues were raised in India but a substantial proportion of them were spent in England — this duality of spending authority was not conducive to efficient expenditure control. No attempt was made to check the growth of expenditure, except the notable decrease from £24.2 million in 1828 to £16.7 million in 1835 as a result of the efforts of Lord Bentinck.

The most important source of income was land revenue. The other sources of revenue, in order of importance, being the opium monoply, salt revenues, customs (the duties never exceeded 10 per cent), *abkari* or excise and stamps. The Company never cared to develop the resources of the country or to provide nation-building, social and development services, though a beginning was made in these directions.

II. Indian Finance Under The Crown

At the outset, the entire revenues of the country were pooled into a single Central fund, from which the Government of India met its own expenditure as also that of the provincial Governments. Most of the revenue was collected by the provinces, which were also responsible for disbursing a large proportion of it. As increased revenues or economy in expenditure brought no local advantage, the system was not conducive to efficient management of finances. This extreme centralization led to constant disputes as the provinces had to obtain the approval of the Central Government even for minor items of expenditure. They were more impressed by their own needs and could not appreciate the financial difficulties of the Central Government, which was also not familiar with local problems and was unable to stop provincial extravagance. To remove these defects Lord Mayo, by his Resolution of December 14, 1870, introduced the system of making fixed grants to the provinces for meeting the cost of provincial services, and any extra expenditure on these was to be met by effecting economy or imposing local taxes. A lump sum grant of £4.7 million a year, in addition to the departmental receipts from these services, was made for the provincial services on jails, registration, police, education, medical, printing, roads, civil buildings and miscellaneous public improvements. In the Central accounts, these were replaced by the single item, "Provincial Services". The provinces were given some freedom to appropriate this grant within the several heads and any unspent grant could be carried forward. However, as the need for a strong Central Government was paramount, a number of restrictions were continued to enable the Government of India to retain its controlling and supervisory powers.

The next step forward was taken in 1877, under Lord Lytton, when all the remaining services (along with the connected receipts) except those directly administered by the Government of India, were transferred to the provinces. To meet the extra expenditure, the provinces were given a share of revenue (from excise, stamps and some other items that varied from province to province), which suffered from neglect due to absence of any provincial interest in their collection. If the actual revenue from these heads differed from the estimated realization, the provinces were to share the excess or deficit with the Government of India in equal proportion. Thus, for the first itme, the provinces were given a direct interest in the collection of revenue. These contracts were different for different provinces and were subject to revision after five years. When they were revised in 1882, Lord Mayo's lump sum grants were abolished and the provinces were assigned, besides the departmental receipts, a specified share from the revenue heads already transferred to them and a fixed share of land revenue to make up the deficit in their

budgets. When these quinquennial settlements were revised in 1904, an attempt was made to give the same share of the chief sources of revenue to the provinces so as to achieve equality of treatment and the revenue from excise, stamps, income tax, registration, forests, larger irrigation works and land revenue was shared generally in equal proportion between the two Governments. The shares of the "divided heads" were not always the same for all provinces. For example, while the United Provinces received three-eights of land revenue, Bengal's share was one-half. This resulted in deficits or surpluses in provincial budgets which were adjusted through fixed cash assignments from the central or provincial share of land revenue to the other Government. The provinces also received the departmental receipts, registration fees and minor irrigation receipts and were responsible for expenditure on these heads. The charges on the "divided heads" were shared equally between the two Governments except that expenditure in connection with land revenue, including district administration, was a provincial liability.

The periodical revision of the contracts caused resentment amongst the provinces as the Government of India would try to appropriate to itself most of the improvement in provincial finances. It was not conducive to continuity of financial policy and encouraged hasty and extravagant expenditure by the provinces in the last year of the contracts. The expenditure on Home Charges, incurred in England, caused uncertainty due to a falling exchange rate since the process of decentralization began and imposed a heavy strain on Central finances. By now, the Central budget was no longer a gamble in foreign exchange. Accordingly, the settlements made in 1904 were declared quasi-permanent. After a few changes (such as a larger share of excise revenue to the provinces by reducing the fixed cash assignments from land revenue) the settlements made after 1911 were declared permanent. However, the Government of India was to assist a province in case of widespread famine and call for aid from the provinces in case of war or serious financial crisis.

The history of financial decentralization shows that this process evolved and progressed on considerations of administrative convenience rather than any regard to the principles of finance appropriate to a vast country having wide regional disparities. The arrangemens involved gross inequalities between the provinces *inter se* as no regard was paid to the wealth, population, per capita income or need of the provinces in allocating funds to them. Against this must be said that the Government of India was not proceeding on a clean slate and the satisactory available basis was the actual level of expenditure attained in each province though, to achieve a semblance of equity, subsequent revisions always favoured the weaker provinces. The aim of these steps towards

decentralization was to achieve economy in expenditure and efficiency in revenue collection and they were justified by these tests. The arrangements were occasionally disturbed in emergencies when the provinces were asked to make special contributions, which were remitted later. The Government of India gave special grants in surplus years and this had a distorting influence on provincial finance. It never relinquished its supremacy and throughout retained its overall control over the financial administration, including creation of posts and revision of salary scales, of the provinces. It felt that responsibility for provincial solvency must rest with itself under an administration that was not responsible to the people. For this reason, the provinces could not budget for a deficit and were not given the right to raise loans or impose fresh taxation. In their zeal for improvement of local services, they might impose heavy burdens on the people which might be resented and add to the unpopularity of foreign rule.

III. Montagu-Chelmsford Reforms

The Reforms of 1919 saw the beginnings of the new objective of provincial autonomy. The "divided heads" were abolished. Land revenue, excise, stamps, forests, registration and irrigation works, were wholly provincialized, while opium, salt, customs, income tax*, railways, posts and telegraphs and military receipts were wholly Central. The provinces were also made responsible for the expenditure on irrigation and famine. These changes left the Government of India with a deficit. The Meston Committee** estimated that, as a result of the constitutional changes, the provinces had an extra spending power of Rs. 18.50 crores at the cost of the Government of India. Accordingly, it fixed the provincial countributions to cover the Central deficit, extimated at Rs. 9.83 crores, as a proportion of the addition to the spending power of the different provinces. The Meston Settlement (1920) resulted in great inequalities, for example, the contribution of Tamil Nadu was Rs. 348 lakhs and of the United Provinces Rs. 240 lakhs, as against that of Maharashtra Rs. 56 lakhs and of Bengal Rs. 63 lakhs. This was strongly resented. Against the expectations of the Meston Committee,

* As a result of agitation by the provinces, ultimately the provinces were given a share equal to 3 pies in each rupee on the excess of assessed income over that assessed in 1920-21. The provincial share was small, for example, Rs. 0.04 crore in 1936-37. This was, however, an important departure from the academic instance of the *Report on Constitutional Reforms* to the principle of complete bifurcation of revenue resources.

** The committee was to advise on: (i) the contributions to be paid by the various provinces to the Central Government for the financial year 1921-22; (ii) the modifications to be made in the provincial contributions thereafter with a view to their equitable distribution until there ceases to be an all-India deficit; (iii) the future finance of the Provincial Loan Account; (iv) whether the Government of Bombay should retain any share of the revenue derived from income tax.

the provinces faced budgetary deficits. The contribution of Bengal had to be remitted successively from 1922-23. Further, as a result of improvement in Central finance, the contributions were partly remitted (Rs. 2.50 crores) in 1925-26 and (a further Rs. 1.25 crores) in 1926-27. They were wholly remitted in 1927-28 and were finally abolished in 1928-29. The provinces were given powers of taxation* and borrowing subject to the control of the Government of India. The provinces had the system of dyarchy, wherby the provincial subjects were divided into "Reserved" and "Transferred". The "Transferred" subjects**., consisting of social and nation-building services, were under the charge of Minister responsible to the provincial legislatures. The provincial Governors had powers of restoring any cuts by the legislature in the "Reserved" subjects but were bound by its resolution on the "Transferred" subjects. The provincial resources were to be used in the following order: first, contribution to the Government of In ia; secondly, needs of the reserved subjects; and thirdly, the requirements of the transferred heads. Thus, additional taxation would seem to be necessitated by the needs of the transferred subjects. Though the Central Legislative Assembly had an elected majority and possessed some control over a small proportion of the Central budget, this concession was nullified by giving to the Viceroy the power of certifying the budget if it was not passed by the Assembly.

Provincial Autonomy was inaugurated on April 1, 1937 by the Government of India Act, 1936, which abolished dyarchy. Provincial powers of taxation and borrowing were enlarged and normally the provinces enjoyed budgetary freedom from the Government of India. The provincial list of taxes was expanded and they took advantage of it by levying sales tax, agricultural income tax, etc. The Central taxes were also enumerated and the residuary powers were vested in the Central Government. Income tax, except tax on agricultural incomes, was to be administered by the Centre, but a part of the net proceeds was to be distributed among the provinces. Further, if the Central legislature so provided, export duties, salt duty and Central excise duties could be assigned, wholly or in part, to the provinces. In additon, Section 142 made provision for grants to the provinces. Sir Otto Niemeyer was asked to make specific recommendations*** on these balancing factors.

* In the case of some taxes, such as, those on non-agricultural land, succession, betting and gambling, advertisements, etc. the provincial powers were not subject to the control of the Government of India.

** These were excise, registration, education, medical, public health, local self-Government, agriculture, industires, scientific and miscellaneous departments, forests (in Bombay only) and civil works. The expenditure on transferred subjects was less than 49 per cent of the total provincial expenditure.

*** *Indian Financial Inquiry Report* by Sir Otto Niemeyer (1936). His recommendations were accepted by the British Government.

On his recommendation, 50 per cent of the net proceeds from income tax was assigned to the provinces*, though the Centre retained a part of the provincial share till 1950-51. The share of the jute growing provinces in the export duty on jute was realized from 50 to 62.5 per cent. The entire debt of Assam, Bengal, Bihar, North West Frontier Province and Orissa to the Central Government was cancelled, so also part of the debt of the Central provinces. After taking account all these benefits, Sir Otto recommended tapering annual grants to the five provinces mentioned above, to ensure budgetary equilibrium and to enable them to start on an even keel. The total transfers to the provinces increased from Rs. 7.02 crores in 1937-38 to Rs. 51.61 crores in 1946-47 (of which the share of income tax was Rs. 1.25 crores and Rs. 29.87 crores, respectively) forming 7.8 per cent and 21.6 per cent, respectively of their total revenue. This indicates their increasing dependence on the Centre.

IV. Allocation of Financial Resources Between the Centre and the States

The Indian Constitution, which was inaugurated on January 26, 1950, allocates functions of common interest, belonging to the national or international sphere, to the Central Government, while those of local and regional interest are assigned to the States. This is a necessity in a country, with wide differences of language, religion, economic development and natural resources. The division of functions, as also of resources, is based broadly on the criteria of efficiency so that what belongs naturally to one Government has been placed in its sphere. Thus the Union Government is responsible for defence and foreign affairs, inter-State and international trade and commerce, navigation, aviation and national highways, posts, telegraphs, telephones, broadcasting, wireless currency, coinage, banking and insurance, etc. The States have been assigned police, public order, medical and public health, education, roads and bridges, agriculture and irrigation, forests, inter-State trade and commerce, etc. There is also a concurrent list to which belongs criminal law, economic and social planning, labour welfare, industrial disputes, social security, etc. The division of resources also follows the principle of efficiency**. There is a clear bifurcation of tax jurisdic-

* This was distributed among the provinces on the basis of residence and population, "Paying to neither factor a rigidly pedantic deference". However, little weightage was given to population.

** The scheme of division follows broadly the pattern of the Government of India Act, 1935. The important changes are: (1) export duties are not shared with the States. This is necessary to ensure complete federal control over foreign trade. However, fixed grants were given for ten years to the jute growing States to compensate them and to enable them to adjust their finances, (2) some restrictions are

tion and a comprehensive enumeration of taxes so that competitive exploitation of the same tax and duplication of tax administration is avoided. The taxes under the legislative jurisdiction of the Union can be grouped under four categories: First, taxes whose entire proceeds are retained by the Union. These are corporation tax, import and export duties, taxes on capital other than agricultural land and surcharge on taxes under categories (2) and (3). Secondly, taxes whose proceeds are shared with the States. These are taxes on income (other than agricultural income) and excise duties except those assigned to the States. Thirdly, taxes whose entire net proceeds are assigned to the States. These are succession and estate duties on property other than agricultural land, terminal taxes on goods and passengers carried by rail, sea or air, taxes on railway fares and freights, taxes other than stamp duties on transactions in stock exchanges and future markets and taxes on the sale or purchase of newspapers and on advertisements published in them. Lastly, taxes to be collected and retained by the States. These are stamp duties mentioned in the Union List, taxes on inter-State sales and duties of excise on medicinal and toilet preparations containing alcohol, opium or such drugs. The jurisdiction of the States extended to land revenue, taxes on agricultural land and income, excise duties on alcoholic liquors, opium, Indian hemp, and other narcotic drugs, taxes on the sale and purchase of goods other than newspapers, taxes on lands and buildings and mineral rights, capitation taxes, tolls, stamp duties and registration fees. Taxes on the following are also assigned to the States: entry of goods into a local area, consumption and sale of electricity, advertisements other than those published in newspapers, goods or passengers carried by road or inland waterways, vehicles, animals or boats, professions, trades,callings and employments, luxuries including entertainments, amusements, betting and gambling. There is a provision that if a State or local authority was levying a tax (now in the Union List) before the commencement of the Constitution, then it can continue to do so until prohibited by Parliament. The residuary powers of taxation belong to the Union Government.

V. The Problem of Financial Adjustment

The scheme of allocation assigns elastic and productive sources of revenue to the Centre while expanding social and development services are assigned to the States. The balancing factors are, therefore, of great

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placed on the powers of the States to levy taxes on the sale and purchase of goods, (3) the limit to the total amount of taxes on professions, trades, callings and employments payable by any person is raised from Rs. 50 to Rs. 250 per annum, and (4) the Union Government has legislative jurisdiction over taxes on the sale and purchase of newspapers and advertisements published therein.

importance. The States derive substantial revenue from them and to give them fiscal independence, Constitution provides for a Finance Commission*, to be appointed by the President, after every five years or earlier, to recommend the share of taxes and grants-in-aid to be paid to the States. Before the inauguration of the Constitution, the balancing factors were based on the recommendations of Sir Otto Niemeyer. With the partition of the country, the alloation of the provincial share of income tax was revised by the Government of India. This caused discontentment amongst some provinces and accordingly C. D. Deshmukh was asked to give a binding award to be applicable from 1950-51. He reallocated the released percentage comprising 14½ units relating to the areas/provinces that had formed part of Pakistan to the Indian provinces largely on the basis of population with some weightage in favour of the more needy provinces.

The Government of India also reduced the provincial share of the jute export duty to 20 per cent as about 70 per cent of the jute growing area of undivided India became part of Pakistan. The four affected provinces strongly protested against it. In view of the constitutional provinces, Deshmukh fixed the compensation to be paid to these provinces in lieu of the share of export duty on jute at Rs. 1.85 crores. The First Finance Commission increased it to Rs. 3.15 crores which was endorsed by the Second Commission. These grants lapsed after 1959-60.

The First Finance Commission raised the States' share of income tax to 55 per cent of the divisible pool**. This was increased to 60 per cent by the Second Finance Commission, to 66⅔ per cent by the Third Commission and to 75 per cent by the Fourth Commission. The Fifth

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* The recommendations of the Finance Commissions so far appointed were almost wholly accepted. This convention should ensure fiscal independence to the States. The recommendations of the First Commission were for five years ending 1956-57, of the Second for the period ending 1961-62, and of the Third for the fours years ending 1965-66, so that in future the period covered by the recommendations of the Finance Commission could synchronise with the five year period of the Plans. The Fourth Commission made recommendations for the five years ending March 31, 1971. However, the Commission's recommendations were applied only during the three years 1966-67 to 1968-69; when there were annual Plans. The recommendations of the Fifth Commission were for the five years ending March 31, 1974, to synchronize with the period of the Fourth Plan.

** Divisible pool of income tax-total revenue from taxes on income other than corporation tax excluding Central surcharge, *minus* cost of collection and the portion attributable to Union emoluments and Union Territories. The advance tax collections were taken into account in determining the net proceeds of income tax only on the completion of regular assessments. Some State Governments represented to the Fifth Commission that the advance tax collections should form part of the divisible pool. The Commission took up this question with the Comptroller and Auditor-General and the Government of India, who agreed that the advance tax collections should form part of the net proceeds of income tax for that year. In accordance with the recommendations of the Fifth Commission, the State share of the unadjusted amount of advance tax for earlier years, amounting to Rs. 371 crores, was to be paid to them in three equal instalments in each of the years 1971-72, 1973-73 and 1973-74.

Commission did not change the share of the States. The First Commission distributed 20 per cent of the States' share on the basis of collection and the rest on the basis of population. The former percentage was reduced to 10 by the Second Commission but the Third Commission, to help the industrial States, restored the formula of the First Commission. This was endorsed by the Fourth Commission. The Fifth Commission recommended that 90 per cent of the States' share of the divisible pool should be distributed among them on the basis of population and "the remaining 10 per cent on the basis of figures of assessments after allowing for reductions on account of appellate orders, references, revisions, rectifications, etc."*. Thus, the Fifth Commission restored the formula of the Second Commission.

The States were given, on the recommendation of the First Finance Commission, 40 per cent of the net proceeds of Union excise duties on tobacco (including manufactured tobacco), matches and vegetable products to be distributed among them on the basis of population. The Second Commission reduced the States' share to 25 per cent but added the excises on sugar, tea, coffee, paper, and vegetable non-essential oils to the divisible pool, so that the States' share was actually larger. It distributed 90 per cent of it on the basis of population and used the balance for adjustments. The Third Commission, impressed by State's needs and the shrinkage of the divisible pool of income tax following the reform in company taxation, increased the number of excisable commodities in the divisible pool from 8 to 35 by including all commodities (except motor spirit) on which the duty yielded more than Rs. 50

* *Report of the (Fifth) Finance Commission, p.* 28. On the basis of the formula recommended by the Commission, it fixed the share of each State in respect of the financial years 1969-70 to 1973-74, as under (figures indicate the percentage share of each State):—

Andhra Pradesh	8.01
Assam**	2.67
Bihar	9.99
Gujarat	5.13
Haryana	1.73
Jammu and Kashmir	0.79
Kerala	3.83
Madhya Pradesh	7.09
Maharashtra	11.34
Karnataka	5.40
Nagaland	0.08
Orissa	3.75
Punjab	2.55
Rajasthan	4.34
Tamil Nadu	8.18
Uttar Pradesh	16.01
West Bengal	9.11
Total	100.00

**The share of divisible taxes (received from the Union Government) is to be apportioned between Assam and Meghalaya in accordance with section 56(1) of the Assam Reorganisation (Meghalaya) Act, 1969.

lakhs. The States' share was fixed at 20 per cent to be distributed mainly on the basis of population, but the Commission gave some weightage to the backward States. The Fourth Commission recommended that 20 per cent of the net proceeds of all Union excise duties, including the duties which might be taken up for levy in the coming quinquennium, except regulatory duties, special excises and duties and cesses earmarked for special purposes, should be distributed among the States. They recommended that 80 per cent of the State share be distributed on the basis of population and 20 per cent on the basis of economic backwardness. The Fifth Commission did not agree to increase the State share but recommended that the revenue from special excise duties should be included in the divisible proceeds from the year 1972-73 in case such duties were continued. It recommended that 80 per cent of the States' share be distributed on the basis of population and out of the remaining 20 per cent "two-third should be distributed among States whose per capita income was below the average per capita income of all States in proportion to the shortfall of the States' per capita income from all States' average, multiplied by the population of the State and remaining one-third on the basis of an integrated index of backwardness.*

As against special grants of Rs. 70 lakhs paid to Orissa and Assam in 1950-51, the First Finance Commission gave special grants of Rs. 5.05 crores per annum to seven States** besides specific grants for the spread

* On the basis of the formula recommended by them, the Commission worked out the share of each State as under (figures indicate percentage share of each State):

State	Share
Andhra Pradesh	7.15
Assam	2.15
Bihar	13.81
Gujarat	4.17
Haryana	1.49
Jammu and Kashmir	1.12
Kerala	4.28
Madhya Pradesh	8.48
Maharashtra	7.93
Karnataka	4.65
Nagaland	0.08
Orissa	4.72
Punjab	2.17
Rajasthan	5.28
Tamil Nadu	6.50
Uttar Pradesh	18.82
West Bengal	6.84
Total	10.000

** Assam, Mysore (Karnataka), Orissa, Punjab, Saurashtra, Travancore, Cochin and West Bengal.

of primary education to eight backward States[1] rising from Rs. 150 crores in 1953-54 to Rs. 300 crores in 1956-57. The Second Commission gave special grants to eleven States[2] rising from Rs. 36.25 crores in 1957-58 to Rs. 39.50 crores in 1961-62. These were increased following the recommendation of the Third Commission[3], to Rs. 110.25 crores per annum payable to all the States except Maharashtra, besides a grant of Rs. 9 crores per annum (approximately equal to 20 per cent of the proceeds from the excise duty on motor spirit) to ten States[4] for improvement of communications. The Fourth Commission recommended annual grants of Rs. 121.89 crores to ten States[5]. The Fifth Commission recommended grants to ten States[6]. gradually declining from Rs. 152.73 crores in 1969-70 to Rs. 102.41 crores in 1973-74.

In addition, the following revenues are also distributed amongst the States on the recommendation of the Finance Commissions appointed from time to time: (1) additional duties of excise (in lieu of sales tax levied by the States) imposed in 1957-58 on mill-made textiles (excluding silk fabrics), sugar and tobacco (including manufactured tobacco) and in 1961-62 on silk fabrics; (2) estate duty (exlcuding that on agricultural land, which accrues to the States that have authorized the Centre to impose it and in which such land is situated), and (3) tax on railway passenger fares imposed on September 15, 1957, and abolished from April 1, 1961, when it was merged in passenger fares. The railways thereafter provided Rs. 12.5 crores annually in lieu of the tax. On representations made by the State in view of the increase in traffic, the Railway Convention Committee (1965) agreed that this grant be increased to an amount equal to one per cent of the capital at charge on March 31, 1964, out of which Rs. 16.25 crores may be paid as grant to States in lieu of the repealed tax and the balance of about Rs. 1.50 crores may be utilized to assist the States to provide their share of the cost of Railway safety works.

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1. Bihar, Hyderabad, Madhya Bharat, Madhya Pradesh, Orissa, P.E.P.S.U., Punjab and Rajasthan.

2. Andhra Pradesh, Assam, Bihar, Kerala, Madhya Pradesh, Karnataka, Orissa, Punjab, Rajasthan, West Bengal and Jammu and Kashmir.

3. The Government of India did not agree that 75 per cent of the revenue component of the State Plans be included in the scheme of devolution. This was not a unanimous recommendation and its non-acceptance did not affect the total amount of Central assistance to the States. If the Commission's recommendation was accepted these would be statutory grants and would lack flexibility.

4. Andhra Pradesh, Assam, Bihar, Gujarat, Jammu and Kashmir, Kerala, Madhya Pradesh, Karnataka, Orissa and Rajasthan.

5. Andhra Pradesh, Assam, Jammu and Kashmir, Kerala, Madhya Pradesh Tamil Nadu, Karnataka, Nagaland, Orissa and Rajasthan.

6. Andhra Pradesh, Assam, Jammu and Kashmir, Kerala, Karnataka, Nagaland, Orissa, Rajasthan, Tamil Nadu and West Bengal.

Table 1* shows the increasing dependence of the States on the devolution of funds from the Centre,** which (excluding loans) formed 24.1 per cent of their total revenue expenditure during the First Plan and 35.8 per cent during the Second Plan. This percentage declined to 34.4 during the Third Plan but rose to 37.3 during the three Annual Plans (1966-69) and to 45.2 in 1971-72 (Budget). While it solves the problem of financial disequilibrium, it violates the principle of Financial Responsibility. There is divorce of revenue raising and spending powers. There is, however, a preponderance of unconditional grants and share of taxes which the States are free to utilize as they like. This gives fiscal independence to the States and has neither encouraged extravagance in expenditure nor laxity in tax collection. In the case of specific or conditional grants, the Union Government provides the funds while the States are responsible for the execution of the projects. This divided responsibility results in delay and inefficiency in the execution of the schemes. The problem bristles with difficulties and on its solution will depend the future of federalism in India. Though the dependence of the States on the Centre has been increasing, they have not become mere departments of the Government of India and have asserted their rights whenever they have found it necessary to do.

VI. Financial Integration of Princely States

At the time of independence, there were about 555 Princely States. The genius of Sardar Vallabh Bhai Patel brought them into an integral relationship with the Indian Union. The process began on January 1, 1948, and was completed within two years. "This bloodless revolution has been brought about, on the one hand, by the operation of democratic forces unleashed by freedom and, on the other, by the patriotic attitude of the Rulers who have been quick to appreciate the change." The smaller States were merged in the provinces of India or into Unions of States known as Part B States.*** Though Part B States were politically integrated, many of them had their own army, coinage system, railways and post offices. The Union Government had no right to levy federal taxes in their territories. These States were financially integrated with the Union of India on April 1, 1950****. on the basis of the

*See Appendix.

**The percentage of shared taxes, grants and net loans made available by the Centre to the States formed 36.0 per cent of their total expenditure on capital and revenue account during the First Plan. This percentage rose to 41.9 during the Second Plan, and to 43.4 during the Third Plan. It, however, declined to 41.7 during the annual Plans, and to 40.4 in 1971-72 (Budget).

***These were Hyderabad, Madhya Bharat, Karnataka, P.E.P.S.U., Rajasthan, Saurashtra and Travancore-Cochin. The former British Indian Provinces were known as Part A States, while the Centrally administered areas were known as Part C States.

****Except P.E.P.S.U. which was integrated on April 13, the beginning of its financial year.

recommendations of the Indian States Finances Enquiry Committee (1948-49). Thereafter, the Union Government acquired the same functions and fiscal powers in these States as in the rest of India, though some time-lag was permitted to raise the rates of federal taxes on income to the all-India level and to abolish the internal customs duties levied in some of these States. In the case of States whose revenue gap (the difference between revenue and expenditure taken over by the Union Government) was positive, which measured their financial loss as a result of integration, the Union Government gave, to prevent any dislocation in their finances, tapering revenue gap grants for ten years. The revenue gap of Madhya Bharat, P.E.P.S.U., and Rajasthan was negative and they were not to compensate the Union Government. Part B States became entitled to a share of divisible federal taxes, which was set off against the revenue gap grants,if any. If their share of federal taxes exceeded their revenue gap, they were entitled to the former. A similar principle was applied to Part A States with respect to Princely States merged in them. Jammu and Kashmir was financially integrated on May 14, 1954. In this case, the power of Parliament to make laws is regulated by Article 370 of the Constitution. The distinction between Part A and B States was abolished on the reorganization of the States in 1956. Thus, independent India, though truncated in size due to partition, has achieved fiscal and economic unity.

VII. Union and State-Budgets : Growth of Revenue and Expenditure

During the last three decades, momentous events took place in India, which produced a marked impact on Government finances. Burma was separated on April 1, 1937, and this caused a net loss of Rs. 2.33 crores to the Central exchequer. The inauguration of Provincial Autonomy imposed an additional burden of about Rs. 5.80 crores in the first year. The Second World War increased the expenditure on defence, which rose from Rs. 46.18 crores in 1938-39 to Rs. 395.49 crores in 1944-45, the last full year of war. Nationalist opinion rightly felt that a part of it was unjustly debited to the Indian exchequer. There was also a considerable increase in the expenditure on civilian services connected with the war, so that the Central expenditure increased from Rs. 85.11 crores in 1938-39 to Rs. 496.25 crores in 1944-45 or by 484 per cent. To meet the increased expenditure, the rates of existing taxes were increased and some new taxes, such as the Excess Profits Tax and new excise duties, were imposed. Railway fares and freights and postal and telegraph charges were also increased. These measures, along with the increased activity generated by the war, helped to boost up revenue, which increased from Rs. 84.47 crores in 1938-39 to Rs. 335.70 crores in 1944-45 or by 300 per cent. Since expenditure increased more rapidly, the Government of India resorted to a large borrowing pro-

gramme and introduced a scheme of compulsory savings in the case of excess profits. Despite this, the Government failed to bridge the inflationary gap and there was a steep rise in prices, which had its impact on the Government's expenditure and revenue.

The provinces were able to build up Revenue Reserve Funds, which exceeded Rs. 60 crores at the end of the war. Their expenditure also increased, but relatively less rapidly due to rise in prices, increase in the police budget and civil defence measures and the prevalence of scarcity conditons, which necessitated the Grow More Food Scheme and measures for the control and distribution of food and other commodities. Their revenues increased due to war activity and the increase in taxation to mop up surplus purchasing power. New taxes, such as, the sales tax, agricultural income tax and urban immovable property tax, were also imposed.

As a result of developments that followed the termination of the war, India achieved independence on August 15, 1947, though it was accompanied by the partition of the country. The wisdom of British diplomacy and the sagacity of Mahatma Gandhi enabled India to achieve independence through peaceful means. However, the pangs of partittion were painful. The serious communal disturbances resulted in the mass evacuation of Hindus from West and East Pakistan. This imposed a heavy burden on the Government for their relief and rehabilitation. The expenditure on foreign affairs also increased. The progress in the reduction of defence expenditure was halted. There is a large land frontier, with no natural barriers, with Pakistan with whom relations have not been satisfactory. The paramountcy of the Government of India over the princely States lapsed with the grant of independence and some of them threatened to remain independent and increased their armed forces. The Kashmir operations also emphasized the need for a strong army. After the political and financial integration of the princely States, their armed forces were merged with Indian defence forces, which increased the defence bill. Relations with Pakistan deteriorated as a result of its attitude towards the Chinese aggression on India in 1962. There have been frequent border raids and though the cease-fire is operative in Kashmir, provocative speeches by responsible leaders of Pakistan and threats to use force to solve the Kashmir issue, which culminated in the Pakistan aggression of 1965, necessitate vigilance on the part of our defence forces. On account of our faith in the philosophy of peace, and the need to accelerate economic development, our defence expenditure has been very modest. In 1959, it was 1.9 per cent of our gross national product while this percentage was 10.0 for Burma, 8.7 for Viet Nam, 7.7 for Korea, 4.6 for Indonesia, 4.0 for Pakistan and 9.6 for the U.S.A. In 1959, the percentage of our defence expenditure to the total expenditure of the Union and State Govern-

ments was 15.4, whereas this percentage in the case of other countries was as follows: Pakistan 30.9, Korea 35.3, Burma 37.8, Viet Nam 39.0, Indonesia 39.8, and the U.S.A. 41.6. Pakistan, Korea and Viet Nam receive substantial U.S. military assistance and to that extent their defence expenditure is under-stated. The arms assistance from the U.S.A., U.K. and other friendly countries was received by us only after the Chinese aggression in October 1962, which has brought about an important historical change. For thousands of years, the Himalayan frontier has been peaceful and unguarded. It has now become a live and dangerous frontier. The effect of deteriorating relations with Pakistan and the Chinese aggression is reflected in the rapid growth of defence expenditure.

The attainment of freedom raised new hopes and aspirations amongst the masses. A popular Government had to justify the trust reposed in it and had to undertake a large social and development programme to fulfil the promises it had made to the people. The Planning Commission was set up in March 1950 to accelerate economic development. A large development programme compelled the Government to resort to deficit financing* which led to a rise in prices. This forced the Government to increase the salary and allowances of its employees and has also increased other expenditure. The financial integration of Part B States involved the taking over of federal services by the Government of India. They also became eligible for federal grants and other financial and technical assistance like Part A States. Both these factors increased the Central expenditure. The State Governments are responsible for social and developmental services, but they do not have the resources to finance them. Consequently, grants-in-aid to the States have increased. The increase in social and developmental expenditure has also increased the expenditure on administration. A large capital expenditure has increased the interest bill. The cumulative effect of all these factors has been that in almost each post-indepencence year, the Union Government's expenditure achieved a peace-time record.

The expenditure of the State Governments also increased rapidly. Every year it attained a peace-time record. The causes are rise in prices,

* In the Indian context, this implies borrowing funds from the Reserve Bank of India resulting in an expansion of currency. The extent of deficit financing was Rs. 420 crores in the First Plan and Rs. 948 crores in the Second Plan. On account of an increase in the money supply, the index number of wholesale prices (1952-53=100) declined from 111.8 in 1950-51 (average of weeks) to 98.1 in March 1956, but increased to 128.4 in March 1961. The quantum of deficit financing during the Third Plan was Rs. 1,133 crores. It was Rs. 723 crores during the Annual Plans 1966-69. In the Fourth Plan the provision for deficit financing was Rs. 850 crores, forming 5 per cent of the total resources as against 13 per cent in the Third Plan. The dependence on deficit financing had to be reduced on account of continuous rise in prices. The index number of wholesale prices (1961-62=100) rose to 131.6 (average of weeks) in 1965-66 and to 165.4 in 1968-69 (average of weeks). It continued to rise thereafter and was 181.2 (average of weeks) in 1970-71. The index had risen to 189.1 in the last week of July, 1971.

increased pay scales and allowances of employees, expansion of social and development services, increase in expenditure on civil administration and debt services. Since 1950-51, development expenditure was increased by 1,047 per cent as against an increase of 708 per cent in non-Government expenditure. Education has rightly received the highest priority. The future progress of the country depends on increasing opportunities for technical and general education. Under adult franchize, the importance of removing illiteracy cannot be over-emphasized. The percentage of literacy has increased from 16.6 in 1951 to 24.0 in 1961 and to 29.0 in 1971. The increased expenditure on medical and public health has paid rich dividends and the average expectation of life increased from 32.4 years during 1941-50 to 41.9 years during 1951-60. The large increase in the expenditure on agriculture and rural development is fully justifiable since agriculture accounts for 48 per cent of the national income and 82 per cent of the population lives in rural areas.

The increase in expenditure has emphasized the need for economy and efficiency. There is a strong feeling that more men are employed in Government departments than are necessary to do the work efficiently. The reports of the Estimates Committee and the Public Accounts Committee emphasize instances of waste,inefficiency and bad planning. There are also numerous complaints of corruption, bribery and nepotaism. It is necessary to reduce the cost of Government and to impose severe penalties in proved cases of corruption and nepotism. The Government is aware of the need for economy and the recommendations of Economy Committees in the States have reduced unnecessary expenditure. The Union Government also has machinery to secure economies in expenditure. The Organization and Methods Division in the Cabinet Secretariat, tries to improve the efficiency of administration. The Department of Expenditure in the Ministry of Finance has an Economy Division which examines all proposals, requiring the sanction of the Ministry, with the object of securing utmost economy. It has a Special Reorganization Unit, which explores improvements in the methods of work, so that it can be done with lesser staff. It works out suitable standards to measure the work that can be done, and is actually done, by each employee. The Internal Economy Committee in the different Ministries and departments constantly examine ways and means of quicker disposal and try to reduce expenditure on staff and contingencies. The Central Economy Board examines cases of disagreement between the Special Reorganization Unit and the Ministry concerned and the extent to which the proposals of the former should be enforced. The National Development Council has set up a committee on Plan Projects, which scrutinizes the projects and appoints teams to visit selected projects to examine their working thoroughly with the object

of avoiding waste and ensuring economy and efficiency in their execution.

The large increase in expenditure necessitated adequate expansion in revenues. Since 1950-51, Central and State revenues have increased by 806 per cent and 876 per cent respectively. Central revenues have increased as a result of financial integration of princely States, increase in the rates of existing taxes, imposition of new taxes and expansion of administrative receipts and the net contribution of public undertakings. Since 1950-51, tax revenues collected by the Union and State Governments have increased by 741 per cent and 624 per cent respectively. This reflects the comparative inelasticity of State taxes and explains the dependence of the States on the balancing factors. State revenues have increased on account of large transfers from the Union Government, increases in the rates of existing taxes, imposition of new taxes and an increase in the contribution of public enterprises and administrative receipts. While increased revenues have enabled the Union and State Governments to expand social and development services, they have also sacrificed revenue on sentimental and ideological grounds — the abolition of the salt duty and the policy of prohibition.

An important development in the post-independence period is that the Union Government has deliberately planned large revenue surpluses, which have helped to reduce the extent of deficit financing. Since independence, the revenue surplus amounted to Rs. 386 crores (of which Rs. 250 crores was during the First Plan) till the end of the First Plan. During the Second Plan, it was Rs. 220 crores and rose to Rs. 1,019 crores during the Third Plan. It was Rs. 414 crores during the three Annual Plans and was Rs. 125 crores in 1969-70, Rs. 198 crores in 1970-71 (Revised) and Rs. 153 crores in 1971-72 (Budget). Thus, the total revenue surplus till the end of March 1972 (Budget) amounted to Rs. 2,515 crores. The technique of financing capital expenditure out of revenue surpluses has helped in the fight against inflation.

As a result of continuous increases in taxation, the percentage of national income raised in taxation by the Union and State Governments increased from 6.6 in 1950-51 to 7.6 in 1955-56 and to 9.5 in 1960-61. It has since increased to 13.2 in 1968-69 and to about 14 per cent in 1970-71.

VIII. Capital Expenditure

Since independence, there has been a large increase in capital expenditure, to make up for the neglect of the past. Under British rule, the Government followed a conservative policy with respect to development expenditure. The total capital outlay of the Central Government was Rs. 1,239 crores and of Part A states (including the undivided provinces of the Punjab and Bengal) Rs. 208 crores till the end of March 1947.

Since independence, the capital outlay of the Government of India was Rs. 473 crores and of Part A States Rs. 173 crores till the end of 1950-51. Since then, it has considerably increased. In the post-independence period, capital expenditure has been restricted by the ability of the Government to raise funds through non-inflationary methods of finance. It is, therefore, necessary that public enterprises should follow a price policy that helps rapid economic development. Their surpluses should be enlarged to finance new projects. So far, the net contribution of public enterprises has been too small as compared to the large capital outlay on them.

There is great misunderstanding, especially abroad, about our objective of establishing a socialistic pattern of society. It is due to the use of the word 'socialistic' and the large capital outlay of the Government. It is, therefore, necesssary to emphasize — and the Government has repeatedly clarified it — that the 'socialistic pattern' does not mean that the State intends to own, now or ultimately, all the means of production or that it will nationalize all existing and new private industries. Our objective implies that the country's existing and potential resources should be fully exploited so that the standard of living of the masses, which is pitiably low, may rise quickly. This necessitates that the fruits of economic development should be equitabley shared by all, so that existing inequalities are reduced and there is no concentration of economic power. In an under-developed country like India, there are vast investment opportunities, but enterprise is shy and capital is lacking. Private enterprise wants to invest in tried and safe channels, where the gestation period is short and returns are resonably quick. The people are unfamiliar with the investment habit so that private industrialist cannot take up projects which require a high amount of capital and take several years to complete and another few years to be profitable. The construction of railways, irrigation works, multiple purpose river valley projects and even modern steel plants, are beyond the resources available to private enterprise. Even under the British rule, these projects, except steel plants, had to be State-owned. Lord Canning, in the fifties of the last century, tried the experiment of entrusting the investment on irrigation works to private enterprise. Two companies took up the Tungabhadra and Orissa canal projects and both of them failed. The Government alone has the patience and resources to finance such projects in under-developed countries as the utlay is large and the profits accrue after several years. The construction of railways began under the Company's rule, but till the end of the 19th century they were a financial loss to the Government. There is really no conflict between private and public enterprise in India. There are vast opportunities for both and these will continue to expand. In spite of investment by the Government, there is no shortage of investment opportunities for private enterprise.

IX. Revenue and Expenditure of Local Bodies

Lord Mayo (1869-72) encouraged local bodies to rouse local interest and supervision in the management of funds devoted to local welfare. Lord Ripon (1880-84) regarded them as good training ground for popular and political education and accordingly shifted the emphasis to 'Local Self-Government.' The next important landmark is the Government of India Act 1919, which made it a "transferred" subject and the Scheduled Taxes Rules framed under it reserved eleven taxes for local authorities. The self-Government aspect developed further on the inauguration of Provincial Autonomy and the attainment of independence. The constitutional directive that the State shall take steps to organize village panchayats as units of self-Government visualizes "development from below" and emphasizes the importance of local Government as an effective instrument for the democratic decentralization of political and economic power.

The Government of India Act 1935, bifurcated financial resources between the Central and State Governments and abolished the reservation of taxes for local bodies. This position continues under the Constitution. The result is that State Governments, burdened with large development outlays, coupled with the sacrifice of revenue due to prohibition, have encroached on local taxes, such as, profession tax, urban immovable property tax, entertainment tax, etc. The State Governments have also invaded the field of public enterprise which works more efficiently under local control. Instances are city transport, electric supply, etc. The consequence is that local bodies are starved of funds and are unable to play their proper role in providing civic amenities. In 1950-51, the share of Union and State Governments was 42 per cent and 49 per cent respectively in total governmental ependiture while that of local bodies was 9 per cent. In the U.S.A., the States and local authorities incurred 18 per cent and 19 per cent respectively of total governmental expenditure in 1950-51 and nearly the same percentages in 1962-63. The State Governments are relatively more important in our federal system.

Local bodies are eminently suited to provide certain social services, such as, primary education, sanitation, drainage, water supply, lighting, parks, local and feeder roads, public health, medical relief, regulation of offensive or dangerous trades, improvement of slums, etc. These functions can be performed efficiently if adequate resources are available. Impressed by the divergence in the functions and resources of local bodies, the Local Finance Enquiry Committee (1949-50) rightly held that, "wholesale transfer of functions from local bodies to State Governments is a retrograde step and should be avoided." It has, against a constitutional amendment, to reserve specified taxes for local bodies and recommended that a convention should be developed to that effect. The

Taxation Enquiry Commission (1953-54) was also against amending the Constitution and recommended that some taxes should be reserved for local bodies and panchayats and rural boards should be given at least 15 per cent of the yield from land revenue and municipalities and district boards at least 25 per cent of the revenue from motor vehicles taxes. The State Governments have not accepted these recommendations on account of financial stringency. It would be better if the Government of India, which gives substantial assistance to the States, uses its influence with them to increase the resources of local bodies.

The Taxation Enquiry Commission reported that there were 12 municipal corporations, 1,426 municipalities, 379 small town and notified area committees, 56 cantonment boards, 196 district boards, 96 rural boards and 87,018 village panchayats, whose number increased to 193,527 on March 31, 1961. There are some port trusts also. In recent years several big cities have set up improvement trusts and town planning bodies, which do not exercise powers of taxation. There is a great dearth of statistics of the revenue and expenditure of this large body of local authorities and it is necessary to fill this gap. The Local Financial Enquiry Committee estimated that in 1946-47 the total income of municipalities and corporations, covering a population of 2.7 crores, was Rs. 27.5 crores, of which about 70 per cent was from taxation. The total income of district boards, covering a population of 20.5 crores, was Rs. 15.6 crores — of which about 34 per cent was from taxation. The Taxation Enquiry Commission estimated that the income of municipalities was Rs. 35.55 crores, of which Rs. 4.31 crores or 12 per cent was from grants-in-aid and Rs. 22.77 crores or 63 per cent from taxation. The important tax sources were (all in crores) octroi Rs. 6.32, terminal tax Rs. 1.83, property tax Rs. 5.23, services tax Rs. 5.08, tolls Rs. 0.85, theatre tax Rs. 0.83, taxes on vehicles, animals and boats Rs. 0.48, profession tax Rs. 0.41, and taxes on passengers and goods Rs. 0·34. Octroi is the most important tax source. It is, however, a vexations tax, involving maintenance of road barriers and delegation of wide powers to petty officials. It should be replaced by terminal taxes and preferably by a local surcharge on State sales tax, which will introduce elasticity in local tax structures. The total expenditure of municipalities was Rs. 33.15 crores, of which Rs. 13.35 crores, or 40 per cent, was on drainage, conservancy, etc., Rs. 4.52 crores on roads and buildings, Rs. 3.56 crores on medical and health and Rs. 3.55 crores on administration. The total income of corporations which have wider functions and ampler powers of taxation, was Rs. 24.06 crores — of which Rs. 18.45 crores or 77 per cent was tax revenue. The chief tax sources were (all in crores): property tax Rs. 9.61, service taxes Rs. 4.46, octroi and terminal taxes Rs. 2.39, taxes on vehicles, animals and boats Rs. 0.74, profession tax Rs. 0.43 and theatre tax Rs. 0.27.

The Reserve Bank of India conducted surveys on the finances of city corporations, port trusts and municipalities in towns with a population exceeding 1,00,000. The following data covers 63 local authorities (4 port trusts, 17 corporations and 42 municipalities) which furnished returns as against 83 that were addressed. Their total receipts (revenue and capital account) increased from Rs. 92.7 crores in 1955-56 to Rs. 181.9 crores in 1960-61 (Revised). During this period, the revenue from rates and taxes increased from Rs. 29.4 crores to Rs. 73.8 crores or by 151 per cent, while grants from the Government increased from Rs. 4.1 crores to Rs. 9.3 crores, and loan receipts increased from Rs. 17.7 crores to Rs. 23.4 crores. During the same period, the expenditure on general administration increased from Rs. 10.4 crores to Rs. 16.8 crores or by 62 per cent, while that on public health and conveniences increased from Rs. 3.8 crores to Rs. 36.9 crores or by 871 per cent and on public works from Rs. 5.3 crores to Rs. 36.8 crores or by 594 per cent; yet civic amenities have not increased proportionately due to rise in prices and large influx of population. Their outstanding debt increased from Rs. 125.4 crores at the end of March 1956 to Rs. 201.9 crores at the end of March 1961, of which Rs. 77.1 crores and Rs. 107.1 crores respectively were market loans and Rs. 48.2 crores and Rs. 87.1 crores respectively were loans from the Union and State Governments. Gross capital formation in 1960-61 amounted to Rs. 30 crores or 15 per cent of their total disbursements.

The Reserve Bank survey on the finances of port trusts, municipal corporations and municipalites in towns with a population exceeding 1,00,000 (on the basis of the 1961 Census) for the years 1962-63 to 1965-66 covers 5 port trusts, 14 corporations and 63 municipalities which replied to their questionnaire as against 108 that were addressed. The total number of urban local bodies in 1961 was 1,860 with a population of 692 lakhs. The population covered by the local reporting authorities was 241 lakhs or 35 per cent of the total urban population covered by all local authorities. Their total receipts (revenue and capital account) increased from Rs. 214.05 crores in 1962-63 to Rs. 282.43 crores in 1965-66 (Budget) or by 32.0 per cent. During this period, the revenue from rates and taxes increased from Rs. 83.57 crores to Rs. 108.23 crores or by 23.0 per cent, while receipts from remunerative enterprises increased from Rs. 9.08 crores to Rs. 26.38 crores or by 192.2 per cent, grants from Government increased from Rs. 10.40 crores to Rs. 12.66 crores or by 21.7 per cent, and loan receipts increased from Rs. 23.59 crores to Rs. 40.01 crores or by 69.6 per cent. During the same period, the expenditure on general administration increased from Rs. 18.58 crores to Rs. 22.50 crores or by 21.1 per cent, while that on public health and conveniences increased from Rs. 30.97 crores to Rs. 50.97 crores or by 64.5, per cent, that on public works from Rs. 17.88 crores to Rs.

30.78 crores or by 72.1 per cent, that on public instruction from Rs. 13.93 crores to Rs. 30.87 crores or by 121.9 per cent and on remunerative enterprises from Rs. 10.47 crores to Rs. 15.15 crores or by 44.6 per cent. Their outstanding debt increased from Rs. 246.35 crores at the end of March 1963 to Rs. 283.04 crores at the end of March 1965 (or by 14.9 per cent), of which Rs. 111.61 crores and Rs. 119.01 crores respectively were market loans and Rs. 120.51 crores and Rs. 143.96 crores respectively were loan from Government. Gross capital formation increased from Rs. 19.82 crores in 1962-63 to Rs. 36.73 crores in 1965-66 or by 85.4 per cent.

The most important source of tax revenue of district and local boards is the land cess, which generally varies from $6\frac{1}{4}$ per cent to $12\frac{1}{2}$ per cent of land revenue. The Taxation Enquiry Commission reported that the total income of district boards was Rs. 27.63 crores, of which Rs. 11.99 crores, or 43 per cent, was from grants-in-aid. Their tax revenue was Rs. 10.19 crores, the main sources being (all in crores), land cess Rs. 7.31, duty on transfer of immovable property Rs. 1.06, local rates Rs. 0.79, tolls Rs. 0.46, property tax Rs. 0.20, profession tax Rs. 0.16, octroi and terminal tax Rs. 0.07, and taxes on animals and vehicles Rs. 0.05. The per capita incidence of their taxation was about one-twelfth of municipal taxation. Their position is becoming untenable as some of their functions have been taken over by panchayats and some others, such as, roads, medical and public health, etc., by the States.

The village panchayats derive most of their revenue from grants and taxes. Their establishment has curtailed the resources of local boards. They can levy property tax, profession tax, service taxes, taxes on animals and vehicles, octroi, cess on land revenue, tolls, theatre tax, etc. The exercise of their tax powers is subject to the approval of the State Governments. They are authorized to require all adult able-bodied male residents to give free labour for some days in a year (or its money equivalent) for building community assets. In 1951-52, the total revenue of 54,263 panchayats in Bihar, Kerala, Karnataka, Punjab and Uttar Pradesh was Rs. 1.26 crores, of which Rs. 0.60 crores, or 48 per cent, was from taxes, Rs. 0.17 crore from grants and Rs. 0.14 crore from fees and fines.

XI. Tax Structure

During the East India Company's regime, the taxes which it inherited from the local rulers were continued. Except for land revenue, the system of direct taxation was almost unknown. The *moturpha* was a direct tax levied on artisans, traders, etc. It was universally detested and yielded a small revenue. Accordingly, it was abolished in Bengal in 1793 and in other provinces (except Madras, where it was abolished at the end of the Company's rule) by 1844. The Company never cared to evolve

a coherent system of taxation and depended mostly on land revenue. This dependence continued under the Crown, though, with the development of other taxes, the percentage contribution of land revenue to total tax revenue declined from 43.9 in 1870-71 to 38.6 in 1900-01* when it yielded Rs. 26.2 crores. The concept of a tax structure based on equity was unknown to the 19th century unrepresentative Government. Land revenue has been an inelastic source of revenue: its yield increased to Rs. 31.1 crores in 1911-12 and to Rs. 34.7 crores in 1921-22. During the same period, the increase in revenue from the other principal taxes was (all in crores);customs Rs. 9.6 to Rs. 34.4, income tax** Rs. 2.4 to Rs. 22.1, excise Rs. 11.4 to Rs. 17.2 and salt Rs. 5.1 to Rs. 6.3, while the opium revenue declined from Rs. 8.8 to Rs. 3.1. With doses of representative Government, there was an increase in tax revenue combined with an expansion of social and development services. Provincial revenues increased from Rs. 70.4 crores in 1921-22 to Rs. 92.3 crores in 1935-36 or by 31 per cent, whereas the revenues of the Central Government, where little progress was made towards popular control, increased during the same period from Rs. 115.2 crores to Rs. 117.8 crores or by 2 per cent only. The grant of Provincial Autonomy and the strains of the Second World War led to a search of fresh sources of revenue and new taxes, like the excess profits tax, new excise duties, sales tax, agricultural income tax, etc., were imposed to make the tax structure more equitable and broad based. Since independence, taxation has assumed a new role as it is an important source of financing the development programme. It is, therefore, necessary to have a scientific structure of taxation which is geared to the needs of development finance.

Taxation is the most important source of Government revenue. It formed 77 per cent of the total revenue of the Union and State Governments in 1970-71 (Budget). The tax system must transfer adequate resources to the Government. Income tax assesses form about 0.5 per cent of the population in India as against about 35 per cent in the U.K. and 26.7 per cent in the U.S.A. In 1968-69, the revenue form income tax on the non-corporate sector formed 1.26 per cent of the national income in India as against 11.34 per cent in the U.S.A. Accordingly, the Government has to rely more on indirect taxes in India. To achieve equity, heavier taxes are levied on luxuries and commodities mostly consumed by the well-to-do sections of the community.*** Commodity taxes are also useful to restrict the consumption of harmful commodities, like liquors and intoxicating drugs. They also help to economize

* In 1970-71 (Budget) land revenue yielded Rs. 110 crores forming 2.46 per cent of the total tax revenue of the Union and State Governments.

** The income tax was first levied temporarily in 1860 in the form of a licence tax and finally reimposed by the Act of 1886.

*** Recent budgets of the Union Government have kept these objectives in view.

the consumption of commodities that are required for export or for the development programme. Import duties can be used to encourage import substitution and to mop up excessive profits of importers, which inevitably accrue under conditions of import control.

XI. Growth of Revenues

Estate duty was levied with effect from October 15, 1963. It is imposed on agricultural land also in those States that have authorized Parliament to do so. The present exemption limit is Rs. 50,000. The rate of tax rises from 4 per cent on the next slab of Rs. 50,000 to 85 per cent in the case of slabs exceeding Rs. 20 lakhs. Taxes on gifts and expenditure (which were imposed under the residuary powers of the Union Government and do not, therefore, apply to Jammu and Kashmir) were imposed from April 1, 1959. The Gift Tax exempts annual gifts upto Rs. 5,000. It is levied at 5 per cent on the first taxable slab of Rs. 5,000 rising to 75 per cent on slabs exceeding Rs. 20 lakhs. The Expenditure Tax, which yielded a small revenue was suspended from April 1, 1962. It was revised from the assessment year 1964-65 (that is, with respect to the expenditure incurred during the financial year 1963-64). The tax was abolished with effect from April 1, 1966. Annual expenditure upto Rs. 30,000 was exempt from tax. In the case of Hindu undivided families, the exemption limit depended upon the number of coparceners in the family, subject to a maximum of Rs. 60,000. In addition there were liberal exemptions and deductions in computing taxable expenditure. The tax was levied at 10 per cent on the first Rs. 10,000 of taxable expenditure, rising to 100 per cent on taxable expenditure exceeding Rs. 50,000. Realized capital gains, arising on or after April 1, 1956, are taxed. The first Rs. 5,000 of all capital gains plus 36 per cent of capital gains on land and buildings and 50 per cent of the capital gains on other assets are exempt from tax and the balance is added to the assessee's income. The taxpayer has the option of adopting, instead of the actual cost of the capital asset, its fair market value as on January 1, 1954. In he case of non-company assessees, capital gains are not taxed if they do not exceed Rs. 5,000 or the total income including them does not exceed Rs. 10,000. Realized capital gains of the corporate sector are taxed at the rate of 45 per cent if they accrue on lands or buildings and at 35 per cent if they accure on other assets. The Wealth Tax was imposed from April 1, 1967. The first slab* of Rs. 2 lakhs of net wealth in the case of individuals and Rs. 4 lakhs in the case of Hindu undivided families is exempt from tax, while agricultural land was not included in

*The entire capital gains on assets held for less than two years is treated as income for tax purpose.

net wealth till 1970, thereafter any excess over 1.5 lakhs is added to net wealth. The tax rates have been increased since 1957. The present rate of tax (1971-72) rises from 1 per cent on the first slab of wealth of Rs. 1 lakh (Rs. 2 lakhs in the case of Hindu undivided families) to 8 per cent on slabs of wealth exceeding Rs. 20 lakhs. There is an additional wealth tax on urban property exceeding Rs. 5 lakhs in value. The first taxable slab of Rs. 5 lakhs is taxed at 5 per cent and the balance at 7 per cent. The revenue from wealth tax has increased from R 8.15 crores in 1960-61 to Rs. 30 crores in 1971-72 (Budget).

Prior to the reform in company taxation, corporate incomes were subject to an income tax and a corporation tax (known as super tax on companies) and neither was allowed as a deduction in computing the other tax. In the case of profits distributed as dividends each share-holder was given in his assessment a credit for the amount of income tax (but not the super tax on companies) paid by the company that was attributable to the dividend received by him. This process of increasing the dividend income of a share-holder by the amount of income tax paid by the company on that part of its income, was known as 'grossing'. Thus, on profits distributed as dividends, the company was supposed to have paid the income tax on behalf of its share-holders. The 'grossing' process involved several complications. The share-holder was given credit at the average rate of income tax paid by the company and it was, therefore, necessary to find out how much of the dividend came out of taxed profits and how much, if any, out of profits exempt from income tax, and whether any part of it was paid out of profits of earlier years, which may have been taxed at different rates. These calculations involved delay in the assessment of share-holders, specially if they received dividends from several companies. The budget for 1959-60 abolished this 'grossing' process. As a part of the scheme of a simplification of company taxation, the wealth tax on companies and the excess dividends tax were abolished, though the tax on bonus shares was retained. It was levied at the rate of 30 per cent. The rate of the tax was reduced to 12½ per cent from April 1, 1961. The Finance Act, 1966 abolished the tax with a view to encourage the ploughing back of profits which may later be capitalized. Bonus shares were not taxable in the hands of the share-holders*.

Under the new scheme, companies deduct income tax, which is deposited by them with the Government, at a flat rate (at present 23 per cent) from dividends paid by them and credit for this is given to share-holders in their assessments. Thereafter, corporate profits were, strictly speaking, subject to a single non-refundable tax. No part of it was

*The concession was withdrawn from April 1, 1964, except in the case of bonus shares issued wholly out of share premium account.

paid on behalf of the share-holders of a company. The annual Finance Act, however, continued till 1964 the fiction of an income tax and a super tax on companies. Both were really a corporation tax and were so treated by the Government. From 1965, the annual Finance Act speaks of an income tax on companies. The terminology is misleading as under the Constitution, taxes on income (other than agricultural income) are shared with the States, while the corporation tax is assigned exclusively to the Union Government. While the Government of India treats the income tax on companies as a corporation tax,it is desirable (perhaps necessary) that the annual Finance Act should use the term corporation tax instead of income-tax on companies. An important effect of the new scheme has been the shrinkage of the divisible pool of income tax, which is not shared with the States. The reform in the scheme of company taxation was intended to simplify the taxation of corporate profits, but the Government of India used it to increase revenue also. The yield from the corporation tax has increased more rapidly than from the income tax. The corporation tax is levied at the rate of 55 per cent* on the profits of Indian companies. The rate of tax is 70 per cent** in the case of foreign companies as their share-holders are not assessed to taxes on income.

In 1963, an additional Super Profit Tax was imposed on the corporate sector at 50 per cent on residual income (that is, after payment of corporation tax) that exceeded 6 per cent of the paid up capital and reserves. The rate of tax was 60 per cent on that part of residual income which exceeded 10 per cent of the paid up capital and reserves. Subject to certain conditions, 10 per cent of residual income was exempt from tax.

The Super Profit Tax proved unpopular because, among other things, of the uneven nature of its effect on industry as a whole. To some extent, it affected industrial growth. Accordingly, the Super Profit Tax Act was suspended forom April 1, 1964, and in its place a surtax was levied. The Act was repealed with effect from April 1, 1966.

The Company (Profits) Surtax Act, 1964 imposed a new tax in place of the Super Profit Tax. The new Act provided for lower tax rates, a larger standard deduction and a wider capital base. The surtax is applicable on corporate income from all sources, after deducting income and super tax payable on it that exceeds 10 per cent of the capital base or Rs. 2 lakhs, whichever is more. It was levied at a uniform rate of 40 per cent on the entire profits subject to surtax. The Act also provides for a rebate of 20 per cent of the surtax on profits derived from certain basic and

*If the income does not exceed Rs. 50,000, the rate of tax is 45 per cent. The rate of tax in the case of private limited companies is 65 per cent, but in the case of industrial companies the tax is levied at 55 per cent on the first Rs. 10 lakhs of income and at 60 per cent on the excess.

**This is the rate at which most taxable corporate profits are taxed.

capital inensive industries that have relatively low profitability and longer gestation period. These are given in the Third Schedule to the Act and include, amongst others, iron and steel, aluminium, copper, coal, cement, paper and pulp, tea, coffee and rubber, generation and distribution of electricity, etc. The finance Act, 1966 reduced the rate of surtax to 35 per cent. In view of the fact that the Finance Act, 1966 provided for a deduction of 8 per cent of the profits derived by a company from priority industries in the computation of their total income, the provision of 20 per cent rebate of surtax to these industries was deleted. The Finance Act, 1968 reduced the rate of surtax to 25 per cent with effect from the assessment year 1969-70. The rate of surtax was increased to 30 per cent on chargeable profits for the corporate sector that are in excess of 15 per cent of capital with effect from the assessment year 1972-73 (that is, with respect to the financial year 1971-72).

The income of the non-corporate sector was subject to two taxes, income tax and the super taxes,* and neither was allowed as a rebate computing the tax liability under the other. In accordance with the constitutional provision, agricultural income** is exempt from these taxes and this introduces great inequity in the tax systemy. In order to simplify tax calculation, the super tax was merged with the income tax in 1965 when a new rate schedule was prescribed. The tax rates have since been increased and are at present as under (the assessment year 1971-72):

1.	Where the total income does not exceed Rs. 5,000	Nil
2.	Where the total income exceeds Rs. 5,000 but does not exceed Rs. 10,000	10 per cent of the amount by which the total income exceeds Rs. 5,000.
3.	Where the toal income exceeds Rs. 10,000 but does not exceed Rs. 15,000	Rs. 500 plus 17 per cent of the amount by which the total income exceeds Rs. 100,00.
4.	Where the total income exceeds Rs. 15,000 but does not exceed Rs. 20,000	Rs. 1,350 plus 23 per cent of the amount by which the total income exceeds Rs. 15,000.
5.	Where the total income exceeds Rs. 20,000 but does not exceed Rs. 25,000	Rs. 2,500 plus 30 per cent of the amount by which the total income exceeds Rs. 20,000.
6.	Where the total income exceeds Rs. 25,000 but does not exceed Rs. 30,000	Rs. 4,000 plus 40 per cent of the amount by which the total income exceeds Rs. 25,000.

*The rate structure of both these taxes for all slabs of income has been revised upwards several times in recent years. The 1939, the combined maximum rate of both these taxes was 9½ annas in the rupee (that is, 59.37 per cent) on slabs of income exceeding Rs. 5 lakhs. In 1947, the combined maximum rate of both these taxes was raised to 15½ annas per rupee (that is, 96.875 per cent) on slabs of income exceeding Rs. 1.2 lakhs of unearned incomes and Rs. 1.5 lakhs of earned incomes.

**Agricultural income can be taxed by the States and is subject to a separate tax in several States. The tax rates are relatively less severe. Further, it is a great advantage, under a progressive rate schedule, to have income split into two different categories subject to two different taxes.

7.	Where the total income exceeds Rs. 30,000 but does not exceed Rs. 40,000	Rs. 6,000 plus 50 per cent of the amount by which the total income exceeds Rs. 30,000.
8.	Where the total income exceeds Rs. 40,000 but does not exceed Rs. 60,000	Rs. 11,000 plus 60 per cent of the amount by which the total income exceeds Rs. 40.000
9.	Where the total income exceeds Rs. 60,000 but does not exceed Rs. 80,000	Rs. 23,000 plus 70 per cent of the amount by which the total income exceeds Rs. 60,000.
10.	Where the total income exceeds Rs. 80,000 but does not exceed Rs. 1,00,000	Rs. 37,000 plus 75 per cent of the amount by which the total income exceeds Rs. 80,000.
11.	Where the total income exceeds Rs. 1,00,000 but does not exceed Rs. 2,00,000	Rs. 52,000 plus 80 per cent of the amount by which the total income exceeds Rs. 1,00,000.
12.	Where the total income exceeds Rs. 2,00,000	Rs. 1,32,000 plus 85 per cent of the amount by which the total income exceeds Rs. 2,00,000.

The rates of tax are different for co-operative societies, registered firms (that is, those firms which are registered with the Income Tax Department), business carried on by local authorities and companies. The income of charitable, religious and approved scientific research institutions is exempt from tax. From 1961 the income of approved sports associations that satisfy certain specified conditions is also exempt from tax.

In addition to the above rates of tax, there is a central surcharge of 10 per cent of the total tax. The rate of the surcharge was increased to 15 per cent of the tax with effect from the assessment year 1972-73 in the case of income exceeding Rs. 15,000.

The present income tax exemption limit is Rs. 5,000 (assessment year 1971-72) for individuals and Rs. 7,000 for Hindu undivided families. Earlier, the exemption limit was Rs. 2,000, but it was redued to Rs. 1,000 by emergency budget of September 1931. The budget for 1936-37 again raised the limit to Rs. 2,000. However, the exemption limit was again reduced to Rs. 1,500 in the budget for 1942-43. The exemption limit was raised to Rs. 2,000 in the budget for 1944-45 and to Rs. 2,500 by the Finance Act of 1947. In 1948-49 the exemption limit was further raised to Rs. 3,000. The Finance Act of 1950 raised the exemption limit to Rs. 3,600 for individuals and to Rs. 7,200 for Hindu undivided familis. These limits were raised to Rs. 4,200 and Rs. 8,400 in the budget for 1963-64. However, in 1957, these limits were reduced to Rs. 3,000 and Rs. 6,000 respectively. In 1966, to give relief to low income groups, the limits were increased to Rs. 3,500 and Rs. 6,500 respectively. Subsequently, the Finance Minister announced on April 29, 1966 to further increase these limits to Rs. 4,000 and Rs. 7,000 respectively. The exemption limit for individuals was raised to Rs. 5,000 with effect

from the assessment year 1971-72 (that is, for incomes earned during the financial year 1970-71).

The rates of income tax are not laid down in the IncomeTax Act. They are prescribed every year by the Annual Finance Act. The result is, there are too frequent changes in the rates of tax.

There are certain incentives in the income tax scheme. Since 1948, donations made to approved charitable institutions are allowed a rebate of tax. At present, the maximum qualifying amount is 10 per cent of income or Rs. 2 lakhs, whichever is less. Corporate and non-corporate donors are allowed to deduct 50 per cent and 55 per cent respectively as the qualifying amount of the donations from their total income. After the Second World War, concessions were granted to provide incentives for investment. In 1946, the Finance Member introduced the grant of special initial depreciation allowances. These were replaced in 1955 by a development rebate, whereby a part of the cost of new plant and machinery is allowed as a deduction from income, without a corresponding reduction in its written down value for purposes of the depreciation allowance. The Finance Minister gave notice in May 1971 that the development rebate will not be allowed on new ships purchased or plants and machinery installed after May 31, 1974. He expected this advance notice to accelerate the rate of investment in the remaining years of the Fourth Plan.

In the case of priority industries (numbering 29, curtailed to 23, with effect from the assessment year 1972-73), 8 per cent (reduced to 5 per cent with effect from the assessment year 1973-72) of the profits are exempt from tax. As an incentive to savings and investment, paymnet of Life Insurance premiums and contributions to recognized Provident Funds and to Post-Office 10 and 15 years Cumulative Deposit Scheme are entitled to rebate of tax. However, only individuals are entitled to rebate on these postal deposits and not Hindu undivided families. The monetary limit for such qualified savings is 30 per cent of income subject to a maximum of Rs. 30,000 for Hindu undivided families and Rs. 15,000 in the case of individuals. With effect from the assessment year 1972-73, the qualifying limit for individuals was increased to Rs. 20,000. At present, 60 per cent of the first Rs. 5,000 of the qualifying savings plus 50 per cent of the balance is deducted from taxable income of the assessee. From the assessment year 1972-73, the whole of Rs. 1,000 of the qualifying saving plus 50 per cent of the next Rs. 4,000 plus 40 per cent of the remainder would be deducted from taxable income. Individuals and Hindu undivided families are also allowed to deduct upto Rs. 3,000 from their taxable income provided the income is from investments in Government securities, shares in Indian companies, units in the Unit Trust of India, deposits with banking companies, etc. Salaried persons are also allowed to deduct expenses of travelling to their place of work.

The deduction is Rs. 200 per month for those maintaing a car, Rs. 60 per month for those maintaining a motor-cycle and scooter and Rs. 35* per month for others.

All newly established undertakings enjoy a tax holiday for five years following the year in which they begin production, subject to a limit of 6 per cent of the capital employed. Dividends declared out of such profits are exempt from tax in the hands of share-holders whether individuals or companies. There is a rebate of tax on the excess of production over the past year, so also on exports. Foreign technicians, whose contract of service has been approved by the Government of India before the commencement of their service in India, enjoy tax concessions. To encourage scientific research in the country, expenditure incurred on it is deductable from taxable income. There are incentives for shifting industries from thickly populated areas. To encourage construction of new buildings, a deduction of Rs. 1,200 or the annual value of the building, whichever is less,is deducted from income for a period of three consecutive years from the completion of the building. There are enhanced depreciation allowances to encourage employers to construct housing accommodation for the benefit of their low paid employees. From 1964, the income derived from the business of livestock breeding or dairy farming, is exempt from tax for three years. There are tax concessions to new industrial undertakings mainly employing displaced persons from Pakistan and repatriates from Burma, Sri Lanka, Mozambique or any other foreign country notified by the Government of India. There are tax concessions also for encouraging tourism in the country.

Customs revenue has lost its predominant position. In 1938-39, it was the most important source of revenue, yielding Rs. 38.91 crores and forming 53.7 per cent of the total tax revenue collected by the Government of India. Most of the duties are *ad valorem*, so that the revenue fluctuates with price changes and changes in the value of imports. Since the Second World War, the rates of import duty have been frequently revised upwards to yield larger revenue. When new excise duties are imposed on indigenous commodities, equivalent import duties are levied on similar imported products so that the indigenous producer is not adversely affected. Similarly, every increase in excise duties is accompanied by a corresponding increase in countervailing import duties. Following devaluation of the rupee in September 1949 and again after the Korean War, the Government of India isolated the internal prices from the export markets by imposing new export duties and increasing the existing ones**,. Accordingly, the revenue from export duties shot up to

*Increased to Rs. 75 and Rs. 50 respectively with effect from the assessment year 1972-73.

**A similar policy was followed after the devaluation of the rupee in June 1966 and the revenue from export duties shot up to Rs. 130.42 crores in 1967-68.

Rs. 90.74 crores in 1951-52. The heavy decline in the revenue thereafter reflects the gradual disappearance of the gap between the external and internal prices of our important exports. Owing to the abolition of most of the export duties, the yield from them was Rs. 2.14 crores in 1965-66, which shows that they are not a dependable source of revenue.

The history of protective tariffs begins with the adoption of the policy of discriminating protection in 1923. Their relative contribution to the revenue from import duties fell from 41 per cent in 1926-27 to 15 per cent in 1936-37 and to 0.54 per cent in 1971-72 (Budget). The contribution of customs revenue to the total tax revenue collected by the Government of India has declined to 15.5 per cent in 1971-72 (Budget), which is a reflection of the growth and diversification of the industrial structure of the country and its balance of payments difficulties, which have necessitated a tight import control. In recent years, import duties have been used to encourage import substitution and to mop up excessive profits of importers. As the industrial development of the country progresses, they are likely to be relatively unimportant source of revenue. In the U.S.A., customs revenue formed 53 per cent of the federal tax revenue during 1901-10. This percentage has now declined to 1.

Union excise duties levied at the manufacturing or production stage, have now become the mainstay of federal revenues. Their growth also reflects that the country's industrial structure has grown impressively. They have developed during the last two decades. Due to pressure from Lancashire an excise duty on cotton yarn was imposed in 1894. It was changed into an excise on mill-made cloth in 1896 and was abolished in 1926. Of the present excises, the earliest on motor spirit was imposed in 1917 and on kerosene in 1922. In 1934, new excise duties were imposed on sugar, matches and steel ingots. A few new excises were levied during the Second World War. Their coverage has been extended since independence. The rates of duty have also been increased several times. These duties yielded Rs. 8.66 crores in 1938-39, forming 11.5 per cent of the total tax revenue collected by the Government of India. This percentage increased to 46.5 in 1960-61 and to 60.4 in 1971-72 (Budget). They are now imposed on more than hundred commodities. The recommendations of the Excise Reorganization Committee (1960-63) have helped to simplify the structure and administration of the Union excise duties.

To check evasion and to simplify the tax procedure, the State Governments agreed in 1957 to withdraw sales tax on mill-made textiles (cotton, rayon, artificial silk and woolen fabrics), sugar and tobacco (including manufactured tobacco) and in lieu of the sales tax the Government of India levied additional duties of excise on these commodities. Their net proceeds are distributed among the States. In view of the success of this measure, the trade has persistently demanded extension of the

scheme. The Union Government has also lent its influence to this demand. The State Governments have refused to proceed further in this direction as they fear loss of fiscal independence. However, they agreed to include silk fabrics in the scheme in 1961-62. The yield from the additional excise duties has increased from Rs. 33.60 crores in 1960-61 to Rs. 78.81 in 1971-72 (Budget).

The sales tax was first levied in 1939 in Tamil Nadu. It is now levied in all the States and is the most elastic and productive source of State taxation, yielding 50.2 per cent of the tax revenue collected by them in 1971-72 (Budget). It is, strictly speaking, not a general sales tax as some commodities are exempt from tax and some are taxed at higher rates. In several States, foodgrains are not taxed, while luxury articles are taxed at about 10 to 16 per cent. The structure of the tax, as also its rates, vary from State to State. Some States levy a single point tax, generally at 5 to 7 per cent, while others levy a multiple point tax at 0.5 to 3 per cent. Motor spirit is taxed separately in all the States*. The Central Provinces was the first State to tax in 1938. West Bengal levies a purchase tax on raw jute, while Andhra Pradesh, Bihar, Maharashtra, Karnataka and Uttar Pradesh levy a cess on sugar-cane purchased by sugar mills. These taxes are levied on purchases as they are organized and are few in number.

Articles 286 of the Constitution imposed certain restrictions on the powers of the States to levy sales or purchase tax. These restrictions relate to sales or purchases made outside the State or in the course of import of the goods into, or export of the goods out of, the Indian Union. The former is intended to ensure freedom of inter-State trade and to prevent a State from taxing consumers in other States. The latter safeguards the power of the Union Government to tax imports and exports. The Article also prevents the States from levying a sales or purchase tax on any article declared by Parliament to be essential for the life of the community, unless such legislation received the assent of the President. The interpretation of Article 286 by the Supreme Court led to several difficulties. Accordingly, the Constitution was amended in 1956. As a result of the amendment, the Union Government acquired legislative powers to levy taxes on the sale or purchase of goods, where such a transaction takes place in the course of inter-State trade. Parliament was also given powers to formulate principles to determine when a sale or purchase takes place outside a State or in the course of import or export. Parliament also acquired authority to impose restrictions on the powers of the States to levy taxes on the sale or purchase of goods declared by it to be of special importance in inter-State trade or com-

* Except Rajasthan, where the selective sales tax on motor spirit was merged with the general sales tax in March 1969.

merce. Following the Constitutional amendment, Parliament passed the Central Sales Tax Act (1957)· It imposed a tax of 1 per cent (increased to 2 per cent with effect from April 1, 1963 and 3 per cent with effect from July 1, 1966) on inter-State sales to registered dealers.

In the case of sales to unregistered dealers or consumers in other States the rate of tax, on goods not on special importance in inter-State trade, is 7 per cent* or the rate on which the sale or purchase of such goods is taxed inside the exporting State, whichever is higher of the two. The Act declares some essential raw materials as goods of special importance for inter-State trade and commerce and imposes some restrictions on the powers of the States to levy taxes on the sale or purchase of such goods. Under the Act, the Government of the exporting States are authorized to assess and collect the tax. The tax proceeds are also retained by them and are included under general sales tax revenue**.

The assessment of the Central Sales tax is done by the same State officials who assess the general sales tax.

Land revenue has lost its earlier importance and now yields only 6.3 per cent of the tax revenue collected by the States. This is chiefly due to the abolition of intermediaries in land.The yield has also increased due to the impositon of betterment levies and surcharges in several States. There is need to reform the structure of the tax. At present, it is levied on agricultural land at a flat rate on its net produce without any exemption limit. The levy varies with grades of land, as it is related to net produce. It has been a very inelastic source of revenue. Its percentage contribution to the total tax revenue of the Central and State Governments was 7.9 in 1950-51 and 2.0 in 1971-72 (Budget) as against 38.6 in 1900-01. Since the Second World War, the price of agricultural produce has greatly increased, but there has been hardly any increase in the land revenue assessment. The assessment is revised after a resettlement which involves a detailed survey of agricultural land and imposes heavy additional work on the district administration. Resettlement has not been possible in most States due to the pressure during Second World War and the growth of the development programme thereafter. Most of the new taxes are also borne by the non-agricultural sector. The agricultural sector has, therefore, greatly improved its relative position. Studies made about the incidence of taxation by the Taxation Enquiry Commission for 1953-54 and the Department of Economic Affairs, Ministry of Finance, for 1958-59 and 1963-64 show that the burden of taxation is relatively less, for all levels of income, on the rural sector of the economy. On the other hand, most of the developmnt expenditure under the Plan is rural/agricultural

*Increased to 10 per cent with effect from April 1, 1963.

**The revenue from the Central Sales Tax was Rs. 150.04 crores in 1971-72 (Budget).

oriented. Thus public finance results in inequity between the agricultural and the non-agricultural sectors.

Prohibition has resulted in the loss of an annual revenue of about Rs. 100 crores from State excise duties. Complete prohibition has not been enforced in all the States due to revenue and administrative considerations. Some States introduced complete prohibition, some others introduced it in selected towns and areas, while some others have not introduced it in any area. Even non-prohibition States have schemes of reducing the consumption of liquor and intoxicating drugs. The free sale of opium, is, however, prohibited in all the States. State excise duties are levied on the production and sale of alcoholic drugs and intoxicating drugs. The rates of excise duties on these commodities vary from State to State. The drink habit is generally confined to industrial workers and members of some backward communities. The incidence of tax, therefore, falls mostly on the poorer classes and prohibition can be viewed as a fiscal reform. These excise duties have always been levied for regulating the consumption of liquor and the aim has been to raise maximum revenue while trying to maintain consumption at as low a level as possible. These duties yielded a revenue of Rs. 208.59 crores in 1971-72 (Budget) as against Rs. 47.34 crores in 1950-51. Prohibition has greatly increased smuggling and illicit distillation*.

Stamp duty includes the revenue from court fees and probate duties on letters of administration and succeession certificates. It also includes the revenue from non-judicial stamps affixed on instruments relating to transfer of property or other commercial transactions. The rate of duty varies from State to State except in the case of documents where the rates are fixed by the Union Government. In the case of some documents, the duty is *ad valorem*, while on others it is, a fixed sum. It is difficult to determine the incidence of stamp duty as also of court fees. Their rates have been increased frequently to raise more revenue. The registration revenue consists of fees levied on the registration of documents, a permanent record of which is maintained by the Government. These fees are different in different States.

Motor vehicles taxes are levied in all the states for registration and transfer of ownership of motor vehicles and for issuing licences for driving such vehicles. These taxes were originally levied for regulatory purposes, but are now a source of revenue. The revenue from them has increased almost thirteen times since 1950-51. The Motor Vehicle Taxation Enquiry Committee (1950) recommended that, "a licence granted in one State should be valid, if an endorsement to travel in another State is granted, without the payment of further taxes." Most States

* Madras (Tamil Nadu), which was the first State to enforce prohibition, repealed the dry law with effect from August 30, 1971. Some other States have also partially retraced their steps.

levy fees or taxes on the entry of passenger and transport buses registered in other States. This creates a barrier to inter-State transport as buses are discouraged to play on inter-State routes.

Electricity duties are recovered from electric supply companies,who collect them from their consumers. Usually industrial consumers are taxed at a lower rate. The tax does not hit the poor people, who usually use kerosene for lighting their houses. Bombay was the first State to levy the tax in 1932. It is now levied in all the States except Assam and Jammu and Kashmir. The entertainment tax is levied in all the States on the value of tickets to places of entertainment. Entertainments of a wholly educational character or for the advancement of agriculture, industry or public health are generally exempt from tax. The tax is also not levied if the entire proceeds are earmarked for charitable or philanthropic purposes.

The urban immovable property tax is levied in Gujarat, Haryana, Jammu and Kashmir, Kerala, Madhya Pradesh, Maharashtra, Karnataka, Punjab, Tamil Nadu and West Bengal.

XII. Public Debt Policies and Programme

The origin of the public debt in India dates from the French wars in the South during the second half of the 18th century. The East India Company continuously financed its increasing military expenditure by borrowing. It raised loans for its commercial activities also. This debt was not kept separate since the Company regarded its Indian conquests as an income-yielding estate. Even after the separation of the Company's commercial and territorial accounts in 1819 certain items of expenditure definitely relating to the former were debited to the latter. Accordingly, the Company's debt increased to Rs. 63·6 crores. This debt, which was incurred to finance the commercial activities of the Company or to annex the territories of India and was thus part of the cost of acquiring the Empire, was treated as India's public debt when the Empire was acquired by the Crown. In addition, £12 million paid to the proprietors of the East India Company stock was also added ot it. Most of the Company's debt was raised in India — only about 5 per cent of it was sterling debt. Originally, even the India debt was owned by the British, but by the end of the Company's rule about a third of it was held by Indians.

The Company hardly borrowed for productive purposes. In 1867-68 the Government of India began to raise loans for irrigation works and in 1870 this policy was extended for constructing railways by the Government itself. The Government of India also financed capital expenditure out of current revenues or budgetary surpluses and from the annual provision for famine insurance. The result was that the net excess of

debt over productive assets had declined to Rs. 33 crores by the end of March 1902 and to Rs. 3 crores by March 31, 1916. Thereafter, the unproductive debt increased on account of deficits on revenue account due to increased military expenditure* and India's war contribution of £100 million.

So far only the Central Government had a right to raise market loans. Under the Government of India Act (1919), the Provincial Governments were allowed to raise loans on the security of their revenues subject to the sanction of the Governor-General in Council in the case of rupee loans and of the Secretary of State for India in the case of foreign loans. They could, however, borrow only for "any work or permanent asset of a material character in connection with a project of lasting public utility" provided the expenditure was too large to be met from current revenue. Loans could also be raised for famine relief and the Provincial Loan Account subject to certain conditions. Till the inauguration of Provincial Autonomy, Bombay, Uttar Pradesh and the Punjab took advantage of these powers to raise rupee loans. The Government of India Act (1935), authorized the provinces to raise foreign loans with the consent of the Central Government. Such consent was also necessary for internal loans in case a province owed any debt to the Government of India or in respect of which it had given a guarantee. The provincial balances were decentralized, though a part of them were adjusted against the loans outstanding to the Government of India. After cancelling, wholly or partly, the debt of some of the provinces, as special financial assistance to them the balance was repayable in semi-annual equated payments of interest and principal in 45 years. In future, the provinces were to meet their short-term requirements from the Reserve Bank of India or through the issue of Treasury Bills — a form of borrowing commenced by them in 1938-39.

Under the Indian Constitution, the States are prohibited from borrowing abroad in order to give complete control of foreign affairs to the Union Government. A State can borrow within India upon the security of its Consolidated Fund. However, it has to obtain the consent of the Government of India if it owes a debt to it or for which it has given guarantee. The Reserve Bank of India manages the debt operations of the Union and State Governments and co-ordinates their borrowing programmes. All the States are indebted to the Union Government and have, therefore, to obtain its consent to raise market loans. This consent may be given subject to such conditions as the Union Government may deem fit to impose. This provision helps in fixing the timing and volume of State loans and avoids competition.

*During the First World War, India had to meet an expeniture of about Rs. 87.5 crores for Imperial purposes.

Throughout the British regime, the Government followed a conservative public debt policy. It never borrowed to finance non-revenue yielding social and development expenditure. Even productive capital expenditure was at times financed out of current revenue so that at the end of 1938-39 against interest bearing obligations of Rs. 1,205.76 crores the Government of India held interest yielding assets of Rs. 946.38 crores, and 30.30 crores in cash and securities on Treasury account, so that the uncovered part was Rs. 229.08 crores. Even this was due to the heavy expenditure thrust on India by Imperialist wars and the war contribution of £ 100 million. For the first time, a sinking fund was established for the 5 per cent War Loan of 1917. In December 1924, at the initiative of the Finance Member, Sir Basil Blackett, the Central Assembly accepted a definite scheme of sinking fund. Since then, an annual provision is made in the revenue budget for 'reduction or avoidance of debt'. Since 1945-46 this provision has been Rs. 5 crores. This annual provision was discontinued from 1970-71 in consultation with the Comptroller and Auditor-General.

The Government of India financed the Second World War mainly on a 3 per cent basis, although in pursuance of the cheap money policy it progressively improved the terms of borrowing through a reduction in the rate of interest or an increase in the period of maturity or a rise in the issue price of loans. Its public debt policy failed to raise adequate funds to meet its own requirements as also the Allied expenditure, including recoverable war expenditure*. incurred in India. The rupee obligations of the Government of India increased from Rs. 736.64 crores on March 31, 1939 to Rs. 2,245.10 crores on March 31, 1946.** During the same period, its budgetary deficits were Rs. 604.88 crores and capital outlay, outside the revenue account, Rs. 294.36 crores. Since its rupee incomings were far in excess of its own requirements, its cash balance increased from Rs. 13.14 crores to Rs. 529.53 crores. In spite of this, inflationary conditions developed in the country. The Reserve Bank of India provided rupees against sterling to finance Allied expenditure in India and this became a source of weakness to the rupee. The issue of currency depended on the rupee requirements of the Allied Governments. It resulted in an accumulation of blocked sterling balances and an increase in currency circulation that led to a fall in the international purchasing power of the rupee. This amounted to a compulsory loan to the British Government. During the war, this arrangement was anti-inflationary for the British economy. Further, while the Government

*During the period 1939-40 to 1946-47, the total recoverable war expenditure was Rs. 1,791.35 crores.

**During the same period, the intrest bearing obligations in England declined from Rs. 469.12 to Rs. 63.38 crores.

of Inida borrowed at about 3 per cent, the sterling balances earned a meager ½ per cent or so as they were invested in the U.K. Treasury Bills. This was an additional burden imposed on India. However, the Government of India repatriated its sterling debt and made advance payments for its sterling liabilities on account of railway annuities, pensions, provident funds, etc. The Government paid an average of 3.36 per cent on its sterling debt, whereas the sterling balances, used to repatriate this debt, earned much less.

Since independence, there has been no change in the importance of rising internal loans. The Government is committed to a large development programme and its success in raising loans reduces dependence on deficit financing. It has also tried to raise large loans from I.B.R.D. (International Bank for Reconstruction and Development, also known as the World Bank) and friendly foreign countries to finance the foreign exchange component of the development programme. The response to the Government's internal borrowing programme has, however, been poor. There was a net outgo on permanent debt account, the outstanding rupee loans having declined in March 1956 as compared to March, 1948. The response has since been better. During the five years ending March 1963, net realizations from rupee loans were Rs. 859.39 crores and from unfunded debt, which includes provident fund receipts and Postal deposits, Rs. 961.98 crores. During the five years ending 1971-72 (Budget), the net increase in the permanent rupee debit of the Government of India was Rs. 994.58, in the floating debt (including Treasury Bills) was Rs. 817.48 crores, in the unfunded debt (including small savings schemes Rs. 682.36 crores) Rs. 1,125.21 crores and in the reserve funds and deposits Rs. 550.45 crores. Owing to the insufficiency of loans finance, the Government of India had large deficits in its capital budget. Consequently, despite surpluses on revenue account there have been overall deficits. These have been financed through the sale of Treasury Bills to the Reserve Bank of India, resulting in expansion of currency and rise in prices. Since independence, the terms of borrowing have progressively been against the Government, which allowed the dried up springs of loanable funds to revive and did not increase the rate of interest beyond 3 per cent till 1953, though better terms were offered. The effective rate of interest, however, increased due to a fall in the price of Government loans. For instance, the market price of 3 per cent Rupee Paper fell from Rs. 97.88 in March 1948 to Rs. 92.69 in October 1951, yielding a return of 3.24 per cent. The Government of India had to offer 3½ per cent interest on National Plan Bonds, 1961 issued at Rs. 98.25 in June 1953. The terms of borrowing have since become more adverse. In November 1962, a medium-dated loan repayable in 1972 was offered at

4½ per cent, while a long-dated loan repayable in 1985 was isued in July 1962 at 4½ per cent. The Government also increased the rate of interest on Post-Office Savings Bank deposits to 3 per cent in August 1962. The rates of return on other forms of Postal deposits were also increased. The rate of interest was further increased when in July 1964 the Government of India issued a 25 year loan at 5½ per cent. With effect from April 1, 1965 the interest on Post-Office Savings Bank deposits was increased to 4 per cent. Similar increases were affected on other forms of Postal deposits also. The rate of interest on fresh loans was further increased in 1971, when in June 1971, and October 1971 the Government of India issued the short-dated loan 1978 at 4.75 per cent, the medium-dated loan 1986 at 5.25 per cent and the long-dated loan 2001 at 5.75 per cent (all at par)

The rupee and foreign debt liabilities of the Government of India have increased rapidly since independence and this in turn has increased the the Government's interest bill. In this connection, it is relevant to examine the maturity pattern of the Government of India loans. Of the total rupee loans*, 40.8 per cent mature within 5 years and another 14.6 per cent within a further period of 5 years. Only 38.3 per cent mature after 10 years and the remaining 6.3 per cent are undated loans. Most of the debt liabilities are covered by assets. The development grants to the States have also resulted in material assets. The Government owns museums, research laboratories, buildings and other properties as well.

The States are increasingly dependent on the Centre even for loan finance. Their debt has increased rapidly, though most of it is covered by remunerative capital assets.

XIII. Financial Organization and Controls

The Government of India did not have a separate finance department till 1843. The post of a Financial Member of the Governor-General's Council was created in 1859. The origin of the budget system dates from February 19, 1860 when the first Finance Member, Sir James Wilson, presented his budget to the Legislative Council. The Indian Councils Act of 1892 granted to the Legislative Council the right to discuss the budget. From 1871-72, the provinces had separate budgets, which were appended to the Central budget. They were entirely separated under the Reforms of 1919 and from 1921-22 provincial transactions were not included in the Central budget. Popular control, except on expenditure charged on the revenue, was extended under Provincial Autonomy in 1937, when the Provincial Governments became res-

*As at the end of March 1970.

ponsible to their legislatures. The Governor could restore any cut, if in his considered opinion, was essential for the discharge of his special responsibilities. At the Centre, the expenditure on defence, external and ecclesiastical affairs, tribal areas, etc. was non-votable and the Governor-General had powers to restore any cut, if necessary, for the discharge of his special responsibilities, which were much wider than those of the Governors. Since the abolition of the Company's rule in 1858, the Governor-General was under the overall control of the Secretary of State for India, who was responsible to the British Parliament.

Under the Constitution, adopted in 1950, an 'annual financial statement' or the budget has* to be placed before both Houses of Parliament. It has to distinguish transactions relating to the Consolidated Fund from those relating to the Public Account. All revenues, loans etc., received by the Government are credited to the Consolidated Fund, while the Public Account contains transactions of a banking nature and withdrawals therefrom do not require the sanction of Parliament. The statement has also to distinguish expenditure on revenue account from capital expenditure and so, in fact, there is provision for a capital budget distinct from the revenue budget. No money can be withdrawn from the Consolidated Fund except on the sanction of Parliament. However, the following expenditure is charged on the Consolidated Fund: (a) servicing of the public debt, (b) salaries and allowances of the President and the expenditure of his office, (c) salaries and allowances of the Speaker and Deputy Speaker of the Lok Sabha (the Lower House) and of the Chairman and Deputy Chairman of the Rajya Sabha (the Upper House), (d) salaries etc., of the Judges of the Supreme Court and the Comptroller and Auditor-General and the expenses of his office, (e) privy purses** of the former Princely Rulers, etc. There are similar provisions in the Constitution with respect to the States.

The Constitution provides that no tax can be 'levied or collected except by authority of law'. A money bill can only be introduced in the Lower House on the recommendation of the President or the Governor as the case may be. This makes the Ministry solely responsible for taxation and expenditure. The legislature cannot force it to spend more though it can reduce or reject a demand for grant. The budget speech of the Finance Minister contains all the new financial proposals of the Ministry and evokes great public interest, as they will certainly be enacted by the legislature, unless the Ministry agrees to modify them. This is possible as the Ministry enjoys the support of the legislature, otherwise a new

*The Central budget is presented on the last day of February. The Railway budget is presented separately before the general budget, which incorporates these figures in lumpsum.

**The Government of India has since abolished the privy purses and privileges of the former Princely Rulers.

Ministry will be formed. Yet the control of the legislature is supreme as nothing can be raised or spent except through its sanction. For unforseen emergencies, there is a Contingency Fund from which the Government can incur expenditure pending sanction of the legislature. The Contingency Fund is recouped through supplementary demands for grants. Thus the Ministry has not to run to the legislature every time it has to incur expenditure not provided in the original estimates. The device of supplementary grants may, however, encourage careless budgeting. The estimates of expenditure are presented to the Lower House in the form of Demands for Grants, except for such expenditure as is 'charged' on the Consolidated Fund. After the demands have been voted, the money required to meet them as also for 'charged' expenditure is withdrawn on the authority of an Appropriation Act passed annually by the legislature. As this takes time, the legislature appropriates, at the beginning of each financial year, some funds for the interim period through a 'Vote on Account'. A separate Finance Act is passed incorporating the tax proposals of the budget. The Government has authority to meet excess expediture under one sub-head of a demand from savings under another sub-head, provided it is within the total demand except that savings in 'charged' expenditure cannot be utilized for excess expenditure under 'voted' heads.

To ensure that the wishes of the legislature are carried out, there is provision for independent audit. The terms of appointment of the Comptroller and Auditor-General, who is appointed by the President, cannot be varied during his tenure. His emoluments and the expenses of his office are charges on the Consolidted Fund. After he ceases to hold office, he is ineligible to hold any paid office under the Union or State Governments. Thus, his independence is complete and he has to seek no favour from the Government. Audit is a federal responsibility and this ensures uniformity in the maintenance of accounts in accordance with the standard classification laid down in the All India List of Major and Minor Heads of Account, published by the Comptroller and Auditor-General. The Government accounts represent the actual cash receipt and disbursements during the financial year ending March 31, when any unspent grants lapse and fresh sanction is necessary. Before 1867, the financial year ended on April 30, so that the accounts for 1866-67 relate to 11 months only. Prior to financial integration the Princely States had different financial years. Their accounting classifications were also different.

The Union and State legislatures have two committees, composed of their members, who act as watch-dogs over the financial transactions of the executive. The Public Accounts Committee conduct a *post-mortem* examination of the accounts, after they have been audited to ensure that the wishes of the legislature have been carried out. It also detects

frauds or irregularities, malpractices and misappropriations. The Estimates Committee scrutinizes demands to recommend economies in carrying out policies approved by the legislature. It usually studies thoroughly the working of a few Ministries each year and goes into considerable details to scrutinize expenditure. Both the Committees make searching enquiries and have been doing very useful work.

The British in India followed an orthodox budgetary policy. During the depression of the thirties, the Government increased taxes and drastically reduced expenditure to achieve budgetary balance. A welcome change was noticeable during the Second World War. Today, the budget is an important policy instrument and fiscal policy is a tool for achieving the social and economic objectives of the nation. The annual budget is accordingly framed in the light of the existing situation, which is reviewed in the budget speech of the Union Finance Minister. *The Economic Survey*, circulated to Parliament shortly before the Union budget, reviews the economic situation in greater detail. The State Governments also frame their budgets in the light of the prevailing circumstances and the objectives to be achieved. Uniformity in fiscal policy is achieved through the National Development Council, consisting of the Chief Ministers of all the States and presided over by the Prime Minister of India. There are also conferences of Union and State Finance Ministers. The Planning Commission and the Five Year Plans also help to bring about uniformity in policy. Finally, the increasing dependence of the States on the flow of funds from the Union Government ensures a co-ordinated fiscal policy.