Chapter - I

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INTRODUCTION

1.1 INTRODUCTION

In order to understand the state functions, we must know about the form of government adopted in India. We have adopted a federal set-up in which there is a government at the national level and state governments at the regional level. Federal form of government is necessary owing to (a) vastness of the country, and (b) multi-lingual and multi-cultural social order.

Federation is a form of government in which the essential principle is that there is union of two or more states under the central body for certain objects. R. L. Watts defines federation "as a form of political association in which two or more states constitute a political unity with a common government, but in which these member states retain a measure of internal authority."[1] Federal set-up provides a thread by which various regions having diverse characteristics can be knitted together into a beautiful and well defined fabric of a federal nation. Thus federation is a bouquet of entities, all diverse, but brought together and tied by a string of constitution.[2]

In a federal system, there is distribution of functions and powers between the central government and regional governments. Such distribution of power is generally laid down in the constitution and cannot be changed by the ordinary process of central legislation. The distribution of legislative powers between central and regional governments under the constitution is the corner stone of a federation.

1.2 CONCEPT OF FEDERAL FINANCE

Modern concept of federalism was evolved in U. S. A. in the year 1776. Naturally federation is often considered as an American innovation. The founding fathers of U. S. constitution drew their ideas from ancient Greece.

The word 'Federation; suggests a union of two or more states. Federal form of government implies co-existence and simultaneous functioning of two or more layers of governments.

According to Encyclopedia Britannica,

"Federation is a form of government in which essential principle is that there is union of two or more states under the central body for central objects." [3]

Dr. B. R. Ambedkar explained birth of Indian federal structure as follows –

"Under the federal plan the consolidated imperial budget with its formal division between imperial and provincial was sought to be replaced by the creation of distinctly separate budgets, central and provincial based on a genuine division of services and allocation of revenues."[4]

In a federal form of government the principle of decentralisation of political power plays a major role in the formation of local level government bodies in the form of urban local bodies and rural local bodies. The process of political decentralisation and devolution of resources from the higher layer of government to the lower layer of government is a basic characteristic of the federal system.

1.3 EVOLUTION OF FEDERAL FINANCE IN INDIA

India has a long history of federal finance spreading over 100 years. The history can be divided into eight periods as under :

1.3.1 Centralisation – 1833-1871

Before 1833, there were separate British Presidencies in Bengal, Bombay and Madras. Till 1833, these presidencies were autonomous and independent. Thus, there was complete centralisation after the war of independence or the so called mutiny of 1857.[5]

1.3.2 Decentralisation – Initial changes – 1871-1882

It was in 1871 that some decentralisation of finances was granted by Lord Mayo, the then Governor General of India. Financial powers of certain heads, such as police, jails, registration, roads, education and medical services, etc. were devolved on the provinces. This system is known as "Provincial Settlement".[6]

1.3.3 Five Yearly Settlement and Share in Central Proceeds (1882-1904)

Realising the financial strains on the provinces, Lord Ripon, the then Governor General, introduced a new financial scheme known as "Five Yearly Settlement" in 1882. With the introduction of this system, fixed grant system was abolished, and the sources of revenue were classified into three categories, viz.

1. Imperial Heads;
2. Provincial Heads, and
3. Divided Heads.

Under the "Imperial Heads", following items were included, (i) Customs, (ii) Salt, (iii) Opium, (iv) Land Revenue, and (v) Profits from commercial departments. These powers remained with the central government. The provincial Heads comprised (i) the receipts from law and justice and (ii) public works. The third category of Divided Heads, included (i) excise duties, (ii) stamps, (iii) forests and (iv) registration. [7]

1.3.4 Quasi Permanent Settlement (1904-1912)

Lord Curzon, the Governor General of India made this scheme quasi-permanent in the year 1904. The new Quasi permanent settlements were better than the earlier Five Yearly settlements and according to Dr. Ambedkar the reins of ultimate financial control still continued to be held by the Central government.[8]

1.3.5 Permanent Settlement (1912-1919)

The Decentralisation Committee recommended permanent settlement in 1912. Lord Hardinge the then Governor General, accepted these recommendations and introduced the permanent settlements. Moreover certain heads under "Divided Heads" like forest were given exclusively to the provinces. Certain "Imperial Heads": like excise duties, registration etc. were put in the "Divided Heads".[9]

1.3.6 Montagu-Chelmsford Reforms (1919-1935)

The Report of Montagu-Chelmsford Committee on Indian Constitutional Reforms was a landmark in the history of federal finances in India. The Report said:

"The existing provincial relations between the central and provincial governments must be changed if the pioneer principle is to be a fair play in the provinces. This system necessarily involves control and interference by the Indian Government in provincial matters."[10]

The important recommendations of the Montagu-Chelmsford Committee were :

1. Abolition of "Divided Heads" and
2. Complete separation of resources between the centre and the provinces.

As a sequel to the Montagu-Chelmsford recommendations, the Government of India Act, 1919, was passed to include these recommendations. The Act came into force in 1921. For the first time in the history of India, financial powers were meticulously divided between the centre and provinces by the Act.[11]

1.3.7 Provincial Autonomy (1935-1950)

The provisions of the Government of India Act (1935) were similar to those of the Act of 1919. There was complete division of sources of finance between the Central Government and the provinces under British control. The Princely States, however, remained outside the federal finances.[12]

1.3.7 (A) Provisions of the 1935 Act

1. The provinces were given the following resources exclusively : Land revenue, alcoholic excise duties, narcotic drugs, medical and toilet preparations, irrigation charge, taxes on agricultural income, sales tax and registration and stamp duties.

2. The Federal Government was given the following sources exclusively : Corporation tax, customs duties, posts and telegraph, telephone, broadcasting, railways, currency and coinage and military receipts.

3. Certain taxes were to be levied and collected by the Central government, but their proceeds were to be shared between the centre and the states, e. g. income taxes and jute export duty.

4. Certain taxes, such as taxes on succession to non-agricultural properties were to be imposed and collected by the central government but were to be fully assigned to the provices.[13]

1.3.8 Deshmukh Award (Period after 1950 onwards)

After independence the Government of the new independent India appointed C. D. Deshmukh, a great scholar and eminent economist, to examine the situation and make recommendations regarding the distribution of income tax proceeds between the centre and the provinces.

C. D. Deshmukh submitted his report, popularly known as the Deshmukh Award, in January 1950.[14]

The following were his recommendations :

1. Net proceeds of income tax were to be equally divided between the central government and state governments.

2. The shares of each state in new India were divided as shown in the following table.

Table 1.1

The Deshmukh Award

Share of States in Income Tax Revenue

States	Percentage share of states	
	Adhoc Arrangement	Deshmukh Award
Bombay	21.0	21.0
Uttar Pradesh	19.0	18.0
Madras	18.0	17.5
West Bengal	12.0	13.5
Punjab	5.0	5.5
Bihar	13.0	12.5
Madhya Pradesh	6.0	6.0
Assam	3.0	3.0
Orissa	3.0	3.0
	100.0	100.0

3. The Deshmukh Award made recommendations regarding the distribution of Jute export duties as under :

West Bengal	:	Rs. 105 lakhs per annum
Assam	:	Rs. 40 lakhs per annum
Bihar	:	Rs. 35 lakhs per annum
Orissa	:	Rs. 5 lakhs per annum

The government accepted the recommendations of the Deshmukh Award, which were to be continued for 2 years pending the appointment of the First Finance Commission of India as stipulated under Article 280 of the Indian constitution which was adopted by the Indian Constituent Assembly in November, 1949.[16]

1.4 TYPES OF FEDERAL FINANCE

Federations come into existence either by 'aggregation' or by 'devolution'. Federation formed by aggregation comes into being "through an agreement between a number of states, hitherto separate, transferring some of their functions and services to a new federal government".[17] such federations are formed by a 'Forward Process' as authority flows from lower level of governments to a higher level of government.

In federation by devolution or disaggregation, authority is 'devolved'; by the central government (unitary government) to the governments of the units, this formation is a 'backward or reverse process' as authority flows from higher to lower layers of government. U. S. A., Canada, Australia, Switzerland are the surviving examples of federations formed by 'Aggregation'. India, Nigeria, etc. may be treated as 'federations by devolution'. This distinction however, may not be watertight and federations may come into existence by a complex process of aggregation and devolution.[18]

1.5 MERITS AND DEMERITS OF FEDERAL FINANCE

Division of functions and resources leads to multiplicity of taxing and spending authority in a federation. Fiscal structure being decentralised wheels within wheels operate in the financial system.

The fiscal federalism involves financial arrangement between the federal government and the states which are of crucial importance. Such arrangements govern the effective power of centre and regions in the field of economic affairs indicating the nature of their future development.

1.6 MERITS OF FEDERAL FINANCE

Federal financial structure generally possesses following merits.[19]

1.. Uniformity :

The federal government performs its responsibilities towards the states in such a way that all the states in a federation get uniform treatment. There should not be any discrimination among units or states. Strictly speaking uniformity requires that the system of taxation and pattern of expenditure are as uniform in all the states as possible.

2. Integration and Coordination :

The whole financial system of a federation is well integrated and each layer of financial system of a federation is not taken as completely isolated from other layers of financial system. This coordination is related not only with taxation, but also with current budget, capital outlay, programme and credit operations of various authorities.

3. Autonomy or Independence :

Under federal finance a government should be autonomous and free in its internal financial matters. Each government should have its own adequate sources of revenue and freedom of scope of expenditure. It is clear that the central government should not interfere in those matters which are exclusively left to states. Similarly, the states also should not interfere with areas of activity where central government has the exclusive responsibility.

4. Adequacy :

The distribution of financial powers between the central government and state government, must ensure that necessary resources given to states are adequate for performing their local functions, both in present and future at the appropriate level social requirement.

5. Equity :

For ensuring quality resource division, it is necessary –

A) Distribute the resources among different units in such a fashion that each unit or state receives a fair portion of revenue, and

B) Allocate resources in such a way so as to give equitable treatment to individuals and business firms in different places.

6. **Efficiency and Economy :**

The financial system should be well organised and efficiently administered. There should be no scope for evasion and fraud. For administrative economy and efficiency, the taxes of regional or local character should be administered with full efficiency at the local level by the local government.

1.7 DEMERITS OF FEDERAL FINANCE

Federal finance generally shows following defects.[20]

1. **Historical Perspective**

In ancient India, we had a few strong states which were later broken into small independent states, which were subsequently subjected to annexation by the alien enemies. The conquest of India by the British imperialists is well known.

2. **Backwardness Despite Huge Expenditure**

In spite of 50 years of planned efforts and huge expenditures, states like Uttar Pradesh and Bihar have still remained backward despite the fact that when some of the national leaders and all our Prime Ministers came from these states. Even in some of the Southern States, industrial development has been very slow.

3. No Link between Development and State Autonomy

To connect industrial or economic growth with the autonomy of the State is not a valid argument for extending financial autonomy to the States.

4. Dirty Politics in States

Dirty politics has pervaded almost all the states in India. In order to maintain its vote bank, the leaders of political parties governing the reluctant to impose income tax on agricultural incomes, though they suffer from heavy deficits in their budgets.

5. Already Considerable Autonomy to States

In fact, the states are enjoying a considerable autonomy in the spheres of agriculture, power, irrigation, social welfare, law and order etc. Despite huge expenditures, legislation and financial powers, many states in India have failed to deliver goods. Even functions like law and order are being performed unsatisfactorily in many states.

It is against this theoretical background that we have to identify, classify and critically examine the views of Dr. Babasaheb Ambedkar on federal finance.

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17. Watts, R. L., Op. Cit., p.115

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