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JOINT COMMITTEE  
ON INDIAN CONSTITUTIONAL REFORM

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# The Financial Implications of (1) Provincial Autonomy and (2) Federation.

1. The object of this paper is to afford some guide to the points which may arise in discussion of the financial implications of the constitutional changes now under consideration; it does not attempt to supply answers to the problems which arise, nor do any opinions expressed reflect the views of His Majesty's Government. Figures are given in crores of rupees; one crore—i.e. ten million—of rupees is equivalent to £750,000. Sterling equivalents, in millions of pounds to two decimal places, have been indicated in the margin.

2. The problem of the allocation of resources under the new Constitution may be considered under two heads; firstly, the readjustments which are desirable in the financial relations of the Centre and the Provinces if the latter become autonomous; and secondly, the financial implications of the establishment of a Federation. As far as possible, the two points are separately treated as Parts I and II below. A summary of the proposals in the White Paper is given as Part III.

## PART I.

3. At present all the revenues of British India are in theory available to the purposes of the Governor-General in Council, and the Government of India Act of 1919 does not recognise any division between the revenues of the Centre and the Provinces. But Rules under section 45A of the Act assign certain sources of revenue to the Provinces, corresponding in the main to the provincial subjects administered by them, though the Centre retains a final call on all the revenues of the Provinces (see Devolution Rules 14-20). In practice the Provinces budget for the disposal of the revenues accruing to them under these arrangements and the Centre only intervenes to the extent of requiring a Province to re-establish its finances in the event of a deficit. The general result at the present time is shown in the following Table, from which may be gathered the manner in which the total revenues of British India are now divided as between the Centre and the Provinces, the main sources from which revenues are derived, and the relative importance of the various items of revenue and expenditure.

TABLE I.

*Budget Estimates of Revenue and Expenditure of Central and Provincial Governments in 1933-34.*

<i>Central Revenue.</i>			<i>Central Expenditure.</i>		
	Rs. =	£		Rs. =	£
	Crores. millions.			Crores. millions.	
Customs (net) ...	50·27	37·70	Post and Telegraphs (net) ...	·61	·46
Income taxes (net) ...	17·21	12·91	Debt:		
Salt (net) ...	7·60	5·70	Interest (net) ...	8·97	6·78
Other taxes (net) ...	·60	·46	Reduction of Debt... ..	6·89	5·17
Net tax revenue ...	75·68	56·76	Civil Administration (net) ...	8·76	6·57
Opium (net) ...	·63	·47	Pensions (net) ...	3·02	2·26
Railways (net) ...	Nil	Nil	Civil Works (net) ...	1·72	1·29
Currency and Mint (net) ...	1·11	·88	Defence Services (net) ...	46·20	34·65
Payments from States ...	·74	·56	Subvention to N.W.F.P. ...	1·00	·75
Total ...	78·16	58·62	Miscellaneous (net) ...	·74	·55
			Total ...	77·91	58·48
<i>Provincial Revenues.</i>			<i>Provincial Expenditure.</i>		
Land Revenue ...	55·29	26·47	Land Revenue and General		
Excise ...	14·85	11·14	Administration ...	14·86	11·14
Stamps ...	12·40	9·80	Police ...	12·88	9·28
Registration ...	1·14	·85	Jails and Justice ...	7·66	5·75
Scheduled Taxes ...	·48	·82	Debt ...	4·21	3·16
Total tax revenue ...	64·11	48·08	Pensions ...	5·08	3·81
Forests (net) ...	·69	·52	Education ...	11·80	8·85
Irrigation (net) ...	·49	·87	Medical and Public Health... ..	5·23	3·92
Miscellaneous ...	11·82	8·49	Agriculture and Industries ...	2·89	2·17
N.W.F.P. subvention ...	1·00	·75	Civil Works ...	8·83	6·25
Total ...	77·61	58·21	Miscellaneous ...	7·84	5·51
			Total ...	79·78	59·84

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£ millions

\*63·68  
 †58·62  
 ‡68·48

§58·62

||66·19  
 ¶58·21  
 \*\*·94  
 ††1·50

4. These figures cannot be taken as representing a normal budget; they reflect the results of depression and of the severe economies in both Army and Civil expenditure undertaken to meet it. If a comparison be made with the table given on page 215 of Volume II of the Report of the Statutory Commission, it will be seen that the Central revenue has declined from 84.9 crores\* in 1929-30 to 78.16 crores† in the present budget year, and the expenditure has been reduced from 84.9 crores\* to 77.91 crores.‡ (In order to make the two sets of figures comparable the cost of collection has been treated as a deduction from revenue instead of an item of expenditure.) The figure of 78.16 crores§ has only been attained by emergency taxation, i.e. the surcharge on income tax, customs and salt. The provincial figures represent a fall in aggregate income from 88.25 crores|| to 77.61 crores;¶ and the aggregate surplus of 1½ crores\*\* shown in 1929-30 has been converted into a deficit of 2 crores.†† The abnormality of the current budget makes it an insecure basis for estimating the result of the adjustments which will be required in the relations of the Centre and the Provinces, and the subsequent paragraphs will furnish proof of the great difficulty we must encounter in gaining a clear financial perspective of the effect of the constitutional changes now under discussion.

5. If the Provinces are to become autonomous, it will be necessary to place them in possession of resources secured to them by statute, and to consider what power, if any, the Centre (however constituted) should have to call upon these resources in a national emergency. On the other hand, separation of finance must be complete in the sense that the finances of the Provinces must be self-contained; we must envisage the end of a situation in which Provinces can feel that they have a right to rely on Central assistance in the event of a breakdown of their own finance. The allocation of powers and resources must obviously be such as to recognise the strength of the claims which the spheres of action assigned to the Centre and the Provinces respectively entitle them to make upon the total available finances of British India. Viewing the total sum available as a common pool, it is legitimate to regard the demands of the Centre upon that pool as normally definable and subject to limitation, since supply is required by it mainly for charges such as Defence, Debt Services, and the comparatively restricted sphere of Central Civil Administration. It must at the same time be accepted as an axiom that the dominant importance of the safety and credit of India requires that the Central demand for supply should constitute a prior charge. Moreover, the means available to the Centre must be adequate to fulfil additional demands due to emergencies, such as frontier war or economic depression. Such demands, it is suggested, ought normally to be capable of fulfilment from within the Central field of taxation. Although it is possible to give the Centre a power of precept upon the incomes of the Provinces in such emergencies, in practice this would create great difficulties because a sudden derangement of their administrative and other activities would probably result, even to the point of a breakdown. While the scope of Central demands is thus to a large degree measurable, the demand of the Provinces must, on the other hand, be regarded as unlimited, since they are concerned with all the important activities necessary to national development. For the present purpose however it is to be noted that there are two immediate claims which take priority over this more general claim. The first comes from those Provinces

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which experience shows to be more or less permanently in deficit or on the border-line of deficit even with the present limited scale of expenditure. There is good ground for feeling that it would be impracticable to give autonomous powers to these Provinces before such a situation is rectified. Secondly, in addition to the maintenance of special provision for the North-West Frontier Province, substantial sums will be required to finance the new Provinces which it is proposed to create, viz. Sind and Orissa. Moreover, when considering the effect of these various claims, it will be necessary to have regard in any calculations to the possibility of the separation of Burma.

£ millions

6. It will be apparent from this preliminary sketch that the problem of the allocation of powers and resources as between the Centre and the Provinces resolves itself into three objectives, which in order of priority, are as follows:—

(1) To provide the Centre with (a) a secure means of meeting the normal demand on account of the services for which it is responsible, together with an adequate reserve power to raise from its own resources the additional sums which those services may in an emergency require; and (b) some additional reserve to meet necessary developments in its own sphere of work (of which Civil Aviation may be taken as an illustration).

(2) To secure to the Provinces, as a minimum, the amounts now available to them, together with the sums required to meet the ascertained deficits of certain Provinces and to establish the newly-created Provinces.

(3) To secure that, when (1) and (2) are satisfied, the main benefits of any improvement in Central finances will inure to the benefit of the Provinces.

7. In applying the principles thus stated, it is of course necessary to abandon the convenient supposition of a common pool, and to take up the concrete problem of the assignment of sources of revenue. Their assignment must be conditioned by the respective spheres of legislative and administrative control, which connotes that, in the main, they will be the same as are shown in Table I above. Such a distribution of sources gives the Centre most of the elastic heads of income, such as Customs, Taxes on Income and Salt. In general these heads have in the past shown themselves to be expanding or readily capable of expansion. The Provinces on the other hand possess heads of income which are relatively inelastic and incapable of expansion. Thus Land Revenue (which is responsible for nearly half the present aggregate income of the Provinces) is permanently fixed in some Provinces, while in others it can be reassessed only at fixed intervals, which in some cases are as much as 40 years. Excise, the second largest provincial head, may with a recovery to normal conditions show some return towards the figure of 1929-30 (namely, 19.44 crores\*) included in the table given at page 215 of the Report of the Statutory Commission; but progress in this direction is always liable to be retarded by the tendency of local Legislatures to support schemes of restriction based on a policy of prohibition. With these general considerations in mind, we may now turn to the first question arising, viz. what are the requirements of the first principle stated in paragraph 6 above, and how far is it possible

\*14-58

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£ millions

to provide, after its satisfaction, for a surrender by the Centre, either in the present or in the future, of any part of the income which it can draw from the sources assigned to it?

8. It would not be useful to attempt any estimate of the provision required to satisfy the first principle of paragraph 6 except on the basis of existing conditions and modifications which can be clearly foreseen. For instance, credit cannot be taken for fundamental reductions in the scale of Defence or for new taxes which cannot be expected to materialise in the immediate future and the yield of which is problematical. In approaching the expenditure side of the current Central budget, it must again be emphasised that the figures shown represent the result of severe economies. The principal item, Defence Services, stood at 56.23 crores\* net 10 years ago, and the fall to 46.20† net is due largely to retrenchment, though also (to the extent of about 1 crore‡) to the fall in commodity prices—a factor which may prove to be temporary. The present budget figure is regarded by the Military authorities as barely satisfying the normal requirements of the Army at its present strength, for it has involved the depletion of stocks of supplies and the postponement of building and other programmes. The next largest head, Debt Services, already reflects a substantial proportion of the possible savings by conversion, so that the range of possible decrease in the near future is limited. Civil Administration has already been heavily reduced, the figure of 8.76 crores§ net representing a decrease of 2½ crores|| in four years. The expenditure side of the Central budget certainly appears to bear out the Finance Member's description of "fine cut." Furthermore, there are certain more or less visible increases to be accounted for. The complete restoration of the pay cuts would cost rather more than 1½ crores¶ (excluding Railways). We are here considering only items that can be foreseen apart from the federalising of the Centre; the possible additional cost of the new constitutional machinery due to Federation will be considered in a later paragraph. The only offsetting factor in prospect appears to be the gain of .6 crore\*\* through charging the Provinces with the cost of their Audit and Accounts at present paid for by the Centre. On the whole, it seems improbable that obligatory expenditure will decline in the next few years, and even possible that it will rise slightly above its present level.

9. Clearly therefore the resources reserved to the Centre must continue to produce no less revenue than is at present available. Any margin for transfer to the Provinces must arise either from a higher yield of the existing taxes and an improvement of the non-tax sources, or from the opening up of new sources of revenue. An examination of the potentialities of improvement in existing sources is not easily reduced to concrete figures, but one consideration is of relevance. Non-tax receipts, especially from the "commercial" departments, have declined heavily under the influence of depression. The extent of this decline is shown by a comparison of the figures at page 215 of the Statutory Commission's Report which took credit for 6.25 crores†† from Railways and 2.35 crores‡‡ from Opium. In spite of economic depression, tax rates have been so enhanced as to give an actual increase of over 3½ crores;§§ this has involved very high rates and a strain which it is difficult to maintain. An improvement in the position is dependent on world economic recovery, to which India may be expected to react as rapidly as almost any country; railway receipts, for instance, have on previous occasions shown great resilience to a sudden recovery in trade

††4.69

‡‡1.76

§§2.68

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conditions, and it has just been shown how important a part they can bear in the total Central receipts. On the other hand, there are some rather more ponderable adverse factors to be considered. Firstly, unless and until recovery takes place, the position is bound to remain somewhat precarious. Thus the trade balance depends on gold exports, a discontinuance of which would affect India's power to finance imports and make serious inroads on Customs revenue. Secondly, whether or not there is an early recovery, the following points must be noted. Customs receipts are already being heavily reduced owing to the effect of a protective tariff in stimulating a rapid growth of the white sugar industry; while the high protective duty on piece-goods may also produce a deterioration in receipts. Currency receipts would be reduced by rather more than 1 crore\* per annum in the early years of the proposed Reserve Bank, pending its development of full profit-earning capacity. Receipts from Opium (now .63 crore† net) may be expected to vanish after 1935 owing to the policy of restricting exports. Moreover, the separation of Burma would occasion a net loss to the Central budget of from 2 to 4 crores‡—the exact amount cannot be stated as several important questions have yet to be settled, but this seems a safe estimate of the probable range. Thirdly, the scope and rapidity with which the effects of recovery would be felt are subject to further limitations. Some 13 crores§ of revenue in the current budget are attributable to the recent "emergency" surcharges on Customs, Taxes on Income, and Salt. A reduction in the present high rates is generally considered desirable, and presupposes a very considerable economic recovery if the present yield is to be maintained at lower rates. Again, although recovery should bring about an appreciable improvement in receipts from "commercial" departments, yet in looking at the levels attained in the years of comparative prosperity it must be remembered that the Railways now bear heavier interest charges than in the previous period; their reserves are heavily depleted and must presumably be restored as conditions improve; and even the present unsatisfactory position is arrived at after benefiting to the extent of nearly 1½ crores|| from pay cuts. The Posts and Telegraphs Department is also in a less favourable position owing to the burden of revised salaries. To summarise the Central revenue position therefore, it may be said that, without a general trade recovery, the position is not only precarious but liable to some deterioration. With trade recovery, the Central position will rapidly improve, but the exact measure of improvement is not predictable, and it is not until we have seen the earlier stages of recovery that we shall be able to determine the extent of the additional resources on which we can count.

£ millions

•.75

†.47

‡15 to 8

§9.75

||1.13

10. As regards immediate prospects of opening up new sources of revenue, there is nothing to be added to the conclusions in Chapter III of the Federal Finance Committee's Report. These were that a Central excise duty on tobacco grown or manufactured in India could not be relied on to yield any substantial revenue in the near future; that an excise duty on matches was a practical proposition and might yield 2½ crores¶ in British India; but that no immediately reliable sources of new revenue could be detected in the direction of other excises, monopolies or special treatment of certain stamp duties. Though the Central Government (whether Federalised or not) may be compelled to make the attempt to raise fresh revenues by means of new excises, yet it is possible only to conclude that the excise on matches is the sole new tax which can now be taken into account as an immediate reinforcement of Central revenues.

¶1.88

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11. Summarising the position at the Centre, it may broadly be stated that everything depends on world economic recovery, and the factors have been given which will be likely to operate on the rapidity or extent to which Central finances will react to recovery. Moreover, in estimating the practicability of utilising any future expansion for the benefit of the Provinces, it must not be overlooked that the reserve power required by the first principle enunciated in paragraph 6 above has to be established; in other words, that a repetition of depression cannot entirely be ruled out of the reckoning. The conclusion may be stated in general terms as follows. The position of the Centre is at the moment such that it has great difficulty in meeting the obligatory demands of Central expenditure, demands which are not in themselves easily susceptible of further reduction. An improvement would therefore be required before it could make the provision required for the satisfaction of the second principle as stated in paragraph 6 above, the cost of which will now be discussed in paragraph 12. A further much more substantial improvement would be required before it would be in a position to provide funds for the satisfaction of the larger requirements of the third principle stated in paragraph 6 above.

12. Turning now to the provision necessary to satisfy the second principle, issues are raised which have occasioned much controversy in the past. The financial settlement following the passing of the Act of 1919 placed considerable additional resources at the disposal of the Provinces and thus depleted the finances at that time available to the Centre. This was adjusted by levying fixed sums by way of "contributions" from the Provinces (except Bihar and Orissa); the method of assessment of these contributions gave rise to much debate and to some contention both between the Provinces and the Centre and between Provinces themselves. It was finally decided to assess them on the amount of the additional revenues which the settlement made available to each Province. As a result, the Provinces which contained industrial centres complained that the assignment of income tax to the Centre deprived them of revenues earned or collected in their Provinces, leaving them only fixed or unexpanding heads of revenue. Those which produced commodities on which an export tax is levied (such as jute) or material on which an excise is levied (such as oil) complained that the assignment of those taxes to the Centre deprived them of sources of taxation which were legitimately provincial. The agricultural Provinces complained that the contribution levied from them did not take into account the need for working up to standards of administration which previous circumstances had made possible for more developed Provinces; and they were also inclined to resent the burdens which, in their view, a protective policy thrust upon them, largely in the interests of industrial Provinces. The contributions were remitted with early effect in the case of Bengal; and the improvement of Central finances, due partly to the gradual reduction of Defence expenditure to more normal levels and partly to the resilience of customs and income tax receipts to the increased taxation imposed in 1922-23, permitted the complete extinction of the contributions of the remaining Provinces in 1927-28. Though this left the Provinces as a whole with larger resources, there remained inequalities between the standards of administration which those resources permitted. That disparity in standards was, in fact, a result primarily of historical developments and of the inequality of natural conditions. Thus, the permanent settlement of land revenue which obtained in some Provinces was less favourable to the development of income than settlements which could in other Provinces be revised in accordance with the

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increase of cultivation or the rise of prices. Again, the possession of sources of water supply had enabled some Provinces to improve their resources more rapidly than others less favourably situated. (For example, in 30 years the Punjab has brought about one-third of the cultivated area of the Province under irrigation from State canals.) The resultant disparity in standards is illustrated by a statement given in the Report of the Statutory Commission (Vol. II, p. 223):—

TABLE II.

(1) *Expenditure per head of population according to 1929-30 Budgets in rupees, and*  
(2) *Density of population per square mile.*

	Madra	Bombay	Bengal	United Provinces	Punjab	Burma	Bihar and Orissa	Central Provinces	Assam
(1) Rs.	4.1	8.2	2.5	2.7	5.5	8.6	1.8	3.7	3.9
(2)	279	156	608	427	207	56	409	139	143

13. It was the general conclusion of the Statutory Commission that it would not be feasible to undertake now a radical readjustment of Provincial finance on a basis which would allow of an equalisation of standards as between Provinces. It is almost impossible to evaluate the different factors necessary to such an operation, such as the character of the population, the claims of urban and rural interest, or the effect of differences in administrative methods which have been evolved over a long series of years; nor is it likely that a tribunal could be found the judgment of which would satisfy the rival interests of the Provinces. In any case, the narrow range of finance available seems to leave not alternative to proceeding at present on conditions as they exist in an attempt to satisfy immediate needs. It will presumably be regarded as axiomatic that the position of no Province should be worsened under the new arrangements. There remains the question of implementing deficit budgets, firstly of the existing Provinces, and secondly of the Provinces which it is now proposed to create. The Federal Finance Committee attempted, in paragraph 11 of their Report, to forecast the probable future position of each Province under more or less normal conditions in the future. The result is reproduced in Table III below. As a guide to immediate prospects, however, the figures of the 1933-34 budgets (also given below) are more strictly relevant. These, it should be noted, represent the position arrived at after severe retrenchment in some, though not perhaps all, Provinces.

TABLE III.

Provinces.	Federal Finance Forecast.				1933-34 Budgets.				
	(Surplus + ; Deficit -).		(Surplus + ; Deficit -).		(Surplus + ; Deficit -).		(Surplus + ; Deficit -).		
	Rs. crores	=	£ million.	Rs. crores	=	£ million.	Rs. crores	=	£ million.
Madras ... ..	- .20		- .15	+ .04		+ .80			
Bombay ... ..	- .65		- .49		- .28			- .21	
Bengal ... ..	-2.00		-1.50		-2.19			-1.64	
United Provinces ...	+ .25		+ .19	+ .04		+ .80			
Punjab ... ..	+ .80		+ .22	+ .51		+ .88			
Burma ... ..		(No estimate)		+ .26		+ .20			
Bihar and Orissa ...	- .70		- .58		- .14			- .11	
Central Provinces ...	- .17		- .18		- .02			- .02	
Assam ... ..	- .65		- .49		- .85			- .26	
North-West Frontier Province.		(No estimate)		+ .04				- .08	
	+ .55	-4.87	+ .41	-3.28	+ .85	-8.02	+ .64	-2.27	
Or deducting Burma and N.W.F.P....				+ .59	-2.98	+ .44	-2.27		



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£ millions 14. It is claimed by the Provinces now in deficit that they are more or less permanently in that state, even at the present reduced scale of expenditure. It is also probable that the sum of their deficits is not likely to be much less than the present 3 crores,\* while the Federal Finance Committee's forecast of about 4½ crores† may perhaps represent an upper limit. It must be remembered that a complete remission of pay cuts in the Provinces would cost nearly 1½ crores‡ in a full year and that additional expenditure on Accounts and Audit (mentioned at the end of paragraph 8 above) would amount to about .6 crore.§ Moreover, increased Provincial expenditure on new Constitutional institutions cannot be less than an annual charge of ½ crore.|| For the purposes of the present survey it would be safe to assume that deficits of not less than 3 to 4 crores¶ are to be expected. This, however, is a mere working hypothesis, and it will not be possible to state the exact sum necessary to obviate these deficits until an examination of the facts has been made by some competent authority, which should, it is suggested, take account only of actual commitments, and not of general needs or projected programmes of expenditure. It may be noted that there are certain outstanding questions of accounts between the Provinces and the Centre referred to in the Percy Committee Report, of which the pre-Reform irrigation debt may be taken as an illustration. The accumulated deficits of certain Provinces also constitute an "overdraft" of considerable size on the Centre. It is desirable that the adjustment between the Centre and the Provinces should now be final, and it may perhaps be indicated to the authority above mentioned that it should make recommendations which would secure this result. Finally, there are the requirements of the new Provinces of Sind and Orissa to be implemented. Estimates of the amounts involved are given in the Appendix to the Report of the Third Round Table Conference on Federal Finance (pp. 60-61 of Cmd. 4238). For about seven years Sind would require .805 crore\*\* per annum, and during the succeeding eight years it is anticipated that the amount would gradually be reduced to zero. Orissa is likely to require .285 crore†† at first and .35 crore‡‡ after about 15 years. Against this may be set the probability that the separation of Sind would leave Bombay free from deficit, and that the surplus position of Madras would be slightly improved by the separation of Orissa. Altogether, it is possible that the provision required for deficit and new Provinces may amount to between 4 and 5 crores.§§

\*\*\*60  
††21  
‡‡26  
§§8 and 8.75

15. It is necessary to consider whether this provision must come entirely from the Centre. Provincial revenues are more stable than Central in the sense that they react less quickly to general causes such as economic depression, but they are consequently likely to respond less quickly than Central to an improvement in general conditions. For these reasons it is difficult to rely on the possibility of economic recovery so increasing the yield of provincial resources as to supply the funds required to meet the immediate shortcomings described in the preceding paragraph. The possibility of raising revenue from new sources was examined by the Federal Finance Committee (Chapter III of their Report). They concluded that Provincial taxation of tobacco was not likely to provide much new revenue in the near future, though eventually it might be useful; that succession duties and the taxation of agricultural income (in addition to land revenue) are so controversial as to be unreliable in planning for the future; and that terminal taxes would have to be strictly safeguarded, and should not be regarded as a normal source of revenue. It was their general conclusion that "such provincial taxes as appear to be within the range of practical politics in the immediate future cannot be relied on to yield any substantial early additions to provincial

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revenues." It seems to follow that the fulfilment of the second principle enunciated in paragraph 6 above must depend very largely on the ability of the Centre to make over the requisite funds. The review of the Central position which was concluded in paragraph 11 shows that the discovery of the necessary margin depends on the initial recovery of the Central position. Even a decision to defer the institution of the two new Provinces would not appreciably alleviate the situation.

£ millions

16. Assuming, however, that funds will at some time become available for the satisfaction of the second principle of paragraph 6, it remains to discuss the methods by which they should be distributed among the Provinces. The first method is the grant of subventions, whether permanent or terminable. The second is the allocation of the proceeds, in part or whole, of some Central head or heads of revenue, an addition to which is the grant of power to surcharge particular Central heads. There are really two stages to be considered in the grant of assistance to the Provinces, i.e., the initial stage of implementing deficits and the secondary stage of placing additional resources at their disposal which will allow of their future development (the third principle of paragraph 6). It will perhaps be agreed that the method of direct subvention is more appropriate to the first stage. At this stage a logical distribution of particular heads on some principle such as that of population is likely to involve a greater draft on the Centre, because some benefit is almost certain to be conferred where it is not essential. Perhaps the only obvious exception to this observation is afforded by the possible allocation of revenue from the export duty on jute. That may be represented as based on considerations of convenience rather than of principle, in view of the peculiar position of Bengal. Its deficit is large, and will clearly continue. The allocation of proceeds from the duty on jute would be mainly confined to Bengal itself; half the duty would cost the Centre about 1.5 crores,\* giving Bengal about 1.35,† Bihar and Orissa .1‡ and Assam .05.§ The chief apparent objection to subventions is the evident breach in the general principles of provincial autonomy which they involve. On the other hand, their claim is strong when finances are so straitened, while some breach in the autonomous principle seems inevitable even on the alternative plan, since it seems necessary that any of the present Central taxes, even if distributed, must form the subject of uniform Central legislation. Some of the considerations affecting distribution on the basis of specific heads of revenue will be apparent from the succeeding paragraph.

\*1.13  
†1.01  
‡.08  
§.04

17. The third principle advanced in paragraph 6 has now to be considered. As already indicated, the provision of means for the future development of the Provinces must depend partly on their capacity to exploit their own rather restricted sources of revenue, but in the main must depend on such improvement in Central finances as will permit the assignment to the Provinces of resources available in excess of the requirements of the first two principles. A further difficult field of enquiry is now revealed, and it will perhaps be convenient to state the problems very briefly as a series of questions to be answered. *First*, is it feasible in present circumstances to lay down any scheme of dates which the distribution of resources should follow? The Federal Finance Committee concluded, in a slightly different connection, that in effect no prescription of dates at which the Centre could dispense with revenue was possible. The developments since they reported, as reflected in the later facts quoted in this note, will perhaps be felt to confirm this conclusion. *Second*, if this be agreed, what authority shall decide when the time has come at which assignment may properly commence, by what methods, and to what extent? (Conversely, if there be a programme,

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what provision must be made for its suspension?) The difficulty of placing the decision on the Central Executive, whether this is federalised or not, lies in the fact that the interests of the Centre and the Provinces may here be held to be in conflict. The alternative is an Order in Council, and there may be held to be justification for this in the fact that His Majesty's Government would not merely be acting in an arbitral capacity, but would be concerned in safeguarding what must here be the dominant consideration, the stability of Central finance. *Third*, on what basis should shares be allocated to the Provinces, and from what sources of revenue? This question raises highly technical issues and also impinges on the field of inter-provincial controversy to which allusion has been made in paragraph 12.

The problem is complicated, contentious and difficult to state briefly. Arbitrary subventions will doubtless be recognised to be out of place in this connection. The method of permitting local surcharges upon Central taxes would only possess advantages if the basic rates on which such surcharges were founded were so moderate as to enable surcharges to be imposed at a figure likely to yield real benefit to Provinces. The rates are at present too high to allow of any effective imposition of Provincial surcharges, and the method must be deferred until the position of the Centre permits of its adoption as one of the means by which a Central surplus can gradually be passed off to the Provinces. It would then have a definite value as allowing Provinces to vary (within prescribed limits) the pitch of their taxation to suit their own needs. In the meanwhile discussion must centre chiefly upon the distribution of heads of revenue centrally raised. If it were decided to distribute the revenue from salt, no problem of great difficulty would arise, since distribution would no doubt follow consumption; but hitherto discussion has, for various reasons, turned on the distribution of income tax. Here we at once re-enter the field of controversy regarding the claims of the industrial and agricultural Provinces, the former demanding that their position as main producers of this tax should be considered before any general distribution takes place. But apart from the counter-claims of the agricultural Provinces, who base their claim chiefly on the needs of a large and backward population, there are serious technical difficulties in attempting to trace the geographical derivation of income tax. A reference to paragraphs 59 to 75 of the Percy Committee Report will explain some of these difficulties and at the same time provide details of a suggested scheme of allocation which attempts to pay regard to both points of view. It is necessary to state here that expert examination of the basis proposed by the Federal Finance Committee reveals some practical difficulties in the application of its details, though these may perhaps not be found to be insurmountable. On the whole, perhaps the most hopeful line will be found in the distribution in the first instance of income tax, proceeding on an agreed basis which will recognise the incidence and the derivation of the tax, while contemplating that at a later stage we may proceed to the distribution of some indirect head of revenue, such as salt.

18. Is it possible to go beyond this picture, in which the uncertainties occupy so much of the foreground? One can only attempt greater precision with much reserve. The question with which Part I of this note is concerned is the introduction of provincial autonomy. It may perhaps be asked why it is assumed that income must be increased in order to find the additional sum required to implement provincial deficits, since the expenditure is actually being incurred already. But it is being incurred against loans taken from the Centre, and in some cases at least there appears to be some prospect that the Provinces may never be able to repay these "overdrafts"

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which they have secured to finance their deficits. The constitution of the Provinces as separate financial units on the one hand implies the withdrawal from the Centre of any responsibility for the stability of provincial finance, and of any authority to ensure this; on the other, it implies that Provinces must be placed in a position in which they can, without borrowing, meet their current obligatory expenditure, including the discharge of the service of loans already secured by them. Moreover, some part of the sum required (i.e., that needed for the new Provinces and for the new legislative institutions) represents an actual addition of new expenditure.

£ millions

19. It may be convenient to conclude this section with an attempt to evaluate rather more precisely than was done in paragraph 11 the general effect of the various factors to which reference has so far been made. So far as the Centre on its present basis is concerned the Budget is balanced, but no weakening of Central resources in *present circumstances* seems permissible. Before the first principle put forward in paragraph 6 could be regarded as satisfied it might be necessary to stipulate at least that the pay-cuts should be remitted (involving the provision of about 1½ crore\*) and that the emergency surcharges should be withdrawn. The latter postulates that the amount of over 13 crores† at present attributable to the surcharges should, owing to economic recovery, be produced by taxes at un-surcharged rates. It may be assumed roughly that other prospective debit and credit items at the Centre will strike a balance. Thereafter the question of creating new Provinces, including the *séparation* of Burma, has to be considered. For this purpose further improvement of the Central position would be necessary up to a point at which sums, the range of which may be placed roughly at 6 to 8 crores,‡ could safely be spared. It must be realised that, even with this provision, some of the Provinces, and in particular those which have effected drastic economies, will start off on a bare subsistence level. Whatever the precise value of these figures, it is in any case clear that some considerable betterment of Central finances, and on an assured basis, must take place before the Centre can make the surrenders necessary to establish the Provinces as independent financial units on such terms as will allow them to rest securely on their own resources.

\*·94

†9·75

‡4·50 to 6

## PART II.

20. It has been possible to deal separately with the financial adjustments rendered desirable by the creation of autonomous Provinces because the federalising of the Centre will not (save in respect of some items of comparatively less importance which will be subsequently noted) itself involve any immediate change in the expenditure budgets of the Centre or the Provinces. Indeed, it may be found that the task of the Select Committee, in dealing with the financial aspects of Federation, will, owing to the exigencies of the financial position, have to be confined in the main to discussing certain important matters of principle pre-conditioning Federation, rather than adjustments of figures of a similar range to those dealt with above.

21. It will be necessary in the first place to examine the present position of the States in relation to Central finance. The only direct contribution now made by the States to British India finances is the sum of .74 crore§ shown in Table I under the head "Payments from States." These payments have in previous discussions been referred to under the general name of "tributes." The Report of the Indian States Enquiry Committee (1932) shows that the sum of .74 crore§ is the aggregate of a number of payments

§·56

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[Continued.]

£ millions

mostly secured by treaty, but various in origin. Some payments are due to specific causes; that is to say, they represent fixed cash contributions in lieu of the maintenance of a State army, whether under British or Indian State command, or in quittance of the grant of assistance by maintenance of forces for the preservation of law and order in the locality of the State. Others represent tributes originally paid to other States but acquired by the British Government through conquest or lapse. Others again are of a more general nature, representing contributions in acknowledgment of sovereignty. There is no uniform system of "tribute." The list of contributing States is a long one, but the sums paid are of very unequal amount, one State (Mysore) paying as much as one-third of the whole, while many States, including some of the most important, pay no contribution at all.

\* 28

22. The Davidson Committee also dealt with another class of contribution which, though it does not appear among the figures of Central receipts, is claimed to have a common origin with "tributes," namely, the territories "ceded" in the past to the British Government by five of the States in return for specific guarantees of military protection, in preference to paying a fixed cash "tribute." The grounds for treating such cessions as analogous to cash contributions have been fully discussed in Chapter IV of the Committee's Report, and the Committee of the Third Round Table Conference on Federal Finance accepted the view that some form of relief was required in respect of them (page 56 of Cmd. 4238). It was held that retrocession of the ceded territory was impracticable, and that the alternative to retrocession would be the payment to four States of annuities amounting to 37 crore\* of rupees. No calculation was made of the value of the areas ceded by Hyderabad as that State asked that the military guarantee for which it ceded territory should continue in being.

† 50

23. The Davidson Committee further ranked as a "miscellaneous contribution" the voluntary maintenance of State Forces, available for use on the mobilisation of the Indian Army. Here also no uniform system has been followed, and units maintained are unequally distributed between the States. The total annual expenditure is said to amount to 2 crores† of rupees; but valuable as is this voluntary contribution to the military strength of India, the amount mentioned cannot be quoted for the purpose of any financial adjustment, as it takes no account of the sums contributed by the British Government through the supply of arms, &c., nor would State Forces, even where they attained a level of efficiency necessary for modern warfare, be necessarily required for purposes of general defence. There are other minor contributions of a miscellaneous nature (railway and cantonment lands, &c.), which can be neglected for the present purpose.

‡ 29

§ 35

24. The Davidson Committee passed from the consideration of direct and indirect credit items to what are potentially debit items, described under the terms "privileges and immunities." Briefly, these constitute financial advantages which individual States enjoy, by Treaty or Agreement, in respect of certain sources of income which, under Federation, would normally be at the unrestricted disposal of the Federation itself. Thus under a developed Federal system, all receipts from the salt monopoly would accrue to Federal revenues; but certain States enjoy privileges in regard to manufacture or sale of salt, which have been valued at .38 crore,‡ or, if the special case of Kathiawar and Cutch be included, at .46 crore§ annually. Similarly, with regard to customs certain States enjoy by Treaty or Agreement advantages which are of great financial importance to them. The

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Committee examined these advantages at length but found that, in the present unstable condition of trade and uncertainty as to the issue of discussions still in progress regarding the interpretation of treaties, it was impossible to supply a reliable estimate of their future value for the purpose of buying them out. The value of the immunities enjoyed by 14 of the Maritime States amounted in 1931 to 1.80 crores,\* but may since have decreased with the decline in imports. The adjustment of these advantages will have to remain for settlement during the process of negotiating instruments of Accession to Federation. It may be contemplated that if the demands made by individual States for compensation on extinction of these advantages involve too great a burden on Federal finances, it will not be possible to include those States in the Federation.

£ millions

\*1.35

25. These remarks have reference to the financial position of certain States as Governments. The subjects of most of the States make a substantial, though indirect, contribution to British India finance on account of sea customs. Thus the Butler Committee (quoted in Statutory Commission, Vol. II, p. 271) suggested that the share taken by them of imported goods might be reckoned at about 16 per cent. of the total consumption and the share of customs duty paid in the States has since been computed by a Government of India Committee at one-seventh of the total. There is also some indirect contribution through salt purchases, and a more indirect contribution through currency profits and profits of trading companies earned in the States but brought to account in British India. These figures were of some relevance at a period before Federation had come under discussion, since the States had then claimed that they were entitled to a share of the customs duties of which the incidence might rest upon their subjects; but they are of less relevance now that customs, salt and currency receipts may be viewed as Federal and not as potentially divisible between States and British India. On the other hand it is proper to remark that the States point out that they are also as Governments concerned in the receipts from customs duty. The States Governments import a considerable amount of railway, electrical and irrigation plant. They claim that by Treaty they are entitled to Defence without any payment to the British Government (other than the Tributes paid by individual States), and that this contribution to customs duty does in effect constitute such a payment. By entering Federation they would sacrifice the claim which they have hitherto advanced that they should receive a refund of these payments.

26. The discussions relating to Federal finance at the Round Table Conferences were long and intricate, and turned in part on arguments of a somewhat theoretical nature. Thus it was sought to redistribute proceeds of taxation on the assumption that the most appropriate field of Federal revenue lay in indirect taxation, leaving direct taxation to British India units. But, as the figures given above appear to show, the receipts from income tax are (at all events at the present) so far necessary to Federal solvency that their allocation to British India units would probably have to be only nominal. The latter would almost certainly have to pass them back to the Federal Government. Again, it was at one time sought to establish some difference between that portion of the Public Debt for which commercialised or similar assets exist and that which is uncovered by assets of this nature. It was suggested that since the Federal Government would take over the assets to which the first class of debt might be related it should properly be liable for the service of that debt, while the British India units should be liable for the second class, sufficient income tax being

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retained by the Federation to cover the relevant charges. Subsequent discussions show that many debatable questions arise out of this proposition; in fact the suggested division is artificial and divorced from the realities of the position, since the public debt stands as a whole secured, not on definite assets, but on all the revenues of British India. It may certainly be argued that part of the uncovered debt has been incurred for all-India as distinguished from British India purposes. Difficulties, though of a somewhat different nature, arose from the attempt to discriminate between pension charges which could be considered properly as Federal or as British Indian, but here, as the charges are rapidly diminishing and it would be almost impossible to determine the proper incidence of pensionary charges, no useful purpose would be served by pursuing this line. These suggestions were not fruitful of results because they did not in themselves afford a means of satisfying either the States or British India units that the real conditions which they envisage as necessary to their entry into Federation could be fulfilled.

27. These conditions may now be stated as follows. The States desire an assurance of the solvency of the Federation before they enter it. This implies not only a present capacity to pay for existing charges, such as defence and the service of pre-Federation debt, but a reasonable assurance that commitments to the British India units are not likely to place Federal finances in a position which will involve a future demand for increase of Federal taxation in order to maintain solvency. Such a demand might possibly go beyond what could be met by increase of indirect taxation and thus involve a requisition for direct contributions in some form from State units. The Provincial units, on the other hand, are interested in seeing that the commitments to the Provinces are not unduly limited in the interests of Federal solvency. Moreover, responsibility for the future policy of the Federal Government, and the financial consequences thereof, will and should be a mutual concern. The Provinces therefore are interested in obtaining from the States some recognition of the principle of "equality of burdens" in Federation. This does not necessarily mean that the States should make a contribution to Federal finance proportionate to that derived from British India. That would in any case be difficult to calculate, because we should have to set off, *inter alia*, the indeterminate amount of indirect contributions referred to in paragraph 25 above in some attempt to equate burdens with the still more indeterminate factor of benefits; and indeed, as the Davidson Committee point out, the true contribution of the States cannot be weighed in terms of money, since they put into the scales a portion of their own sovereignty. But the Provinces point out that the Federation, in taking over what are now Central sources of revenue, would take credit not only for revenues derived from what may be considered essentially Federal assets, such as customs and salt, but also revenues derived from a head such as income tax, which, but for the overriding necessities of Central finance, might normally go in whole or part to the Provinces from which they are derived. As a reply to this, the States have urged that one of the chief contributory causes of stringency at the Centre will be the erection of new and the continued subsidy of existing deficit Provinces. For these the States have undertaken no responsibility, and they are not asking themselves for any subsidy even to the poorest of the States.

28. In effect, a compromise solution must be found in the answers to the following questions. *First*, will the finances secured to the Federal Government be sufficient to meet the charges which it is known will fall

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on it at its inception? *Secondly*, will any contemplated assignment to the Provinces of shares of future improved revenues involve the likelihood that the maintenance of solvency in the future will place a direct burden on the States? *Thirdly*, is it possible to obtain from the States an agreement to pay some contribution which will recognise the position which has been put forward above as that of the British India units?

£ millions

29. In seeking an answer to the first question account must be taken of the Central Budget as it will stand after making provision for deficit Provinces and new Provinces, for this will not have been the consequence of Federation, but of the institution of autonomous British Provinces. Some addition must be made for the charge which will fall on Federal finances by the establishment of a Federal Court, and the cost of the contemplated Federal Legislature over that now incurred on the Central Legislature; this has been calculated by the Government of India at from  $\frac{1}{2}$  to  $\frac{2}{3}$  crore\* of rupees, though it is possible that the cost of this item may be somewhat reduced by the States paying their own representatives instead of allowing them to be paid from Federal revenues. Allowance must also be made for the charge which would fall on Federal revenues if the States' contributions described in paragraph 21 above were extinguished. There has been a general agreement that "there is no permanent place for such exceptional and unequal contributions in a system of Federal finance" (paragraph 26 of page 96 of Cmd. 4238). The Round Table Conference suggested that their extinction should be completed within 20 years, and that a moiety at least should be extinguished within 10 years; or, in any case, that the whole should be extinguished in a period not longer than that during which the Federal Government would complete surrender to the Provinces of the share of income tax which it was then proposed it should necessarily relinquish. (Reasons have been given above for holding that it may not now be feasible to consider a surrender of the same extent or within the proposed period.) The sum of .74 crore† representing the "tributes" would in any case be reduced by the amount of the "immunities" enjoyed by the individual States paying tribute. (See for fuller explanation paragraph 443 of Report of the Davidson Committee.) It should be emphasised in this connection that though British India is concerned with the aggregate of State contributions and immunities, the States must enter Federation as separate units; the debits of one State cannot be set off against the credits of another, and a balance sheet will be required in the case of each individual State. The resultant cost to Federal finance will have to be determined by further examination, but it will be less than the sum of .74 crore‡ now credited to Central revenues. Provision has also to be made for the credits to certain States on account of ceded territory (paragraph 22). The estimated amount of .37 crore‡ would be reduced by the value of any immunities now enjoyed. Though the acceptance of these claims might constitute a condition precedent to entry to Federation, it might perhaps be decided to spread their actual satisfaction over a period of some length. Moreover, since these contributions are at present an integral part of the resources by which the solvency of British India is preserved, it will probably be contended by the Provinces that any breach in that position as a result of their remission can hardly be charged to British India alone and should fall in part on Federal revenues. This argument, it is true, may find a reply from the States that the tributes are due to the Crown and not to British India (see Davidson Report, paragraph 37) and that the cost of the new Provinces alone exceeds the amount to be remitted on account of tributes and

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ceded territories. As regards the treatment of other immunities and privileges (other than those which come into account as a set-off against the extinction of "tributes" or credits for ceded territories) somewhat different considerations apply. The general principle, applicable throughout, was stated by the Federal Finance Committee of the Third Round Table Conference (Report, paragraph 29) as being that "each State coming into Federation should, as far as possible, assume liability for an equitable portion of Federal expenditure." This general principle is one which will no doubt be brought before the Joint Select Committee for discussion; but, as suggested in paragraph 24 of this note, the final detailed treatment of the complicated questions arising cannot substantially affect the Budget as it will appear at the inauguration of Federation.

30. If, however, the considerations advanced in Part I of this note are correct, the creation of autonomous Provinces will not be possible until there has been a considerable betterment of Central revenues; the charges referred to in the preceding paragraph will impose an additional demand which will presuppose a somewhat larger Central balance as a preliminary to Federation, even though the gross amount of this addition may be reduced by spreading out the period for the extinction of tributes or payment for ceded territories. Even, however, if improved conditions make it possible to discharge these combined obligations without actual deficit to the Central budget, the States may possibly press that the Centre can only be said to have arrived at that state of "solvency" which justifies Federation when the improvement recorded is such as to leave some margin for safety within the region of Central finance.

31. As to the second question proposed in paragraph 28 the considerations advanced in Part I of this note point to the conclusion that any assignments contemplated in favour of the British India units must be viewed as the promise of future drafts on a Federal surplus; that surplus can only come to hand at a further stage of recovery in advance of the initial stage which is required to satisfy the conditions precedent to Federation. It is here possible only to make the point that the facts revealed regarding the present Central position may dispose the States to press that any assignments to British units now laid down for future operation shall be on a scale compatible rather with the requirements of Federal stability than with the desires of the Provinces; they are likely also to lead them to scrutinise carefully the character of the authority empowered to decide when the assignments shall become operative (paragraph 17 above). It is further pertinent to emphasise here a conclusion which is implicit in previous paragraphs, that in making assignments it will be necessary to make provision for the proper "balance" of Federal finances. The alienation of an undue share of sources of direct taxation (e.g., income tax) would leave Federal finances at a disadvantage if indirect sources (e.g., customs) were affected by trade depression or by a protective policy, even admitting that some part of the loss resulting from a successful protective policy would be made good by increased receipts from income tax. This is a consideration of importance to the maintenance of Federal solvency, but it is not purely financial. It is essential that the Federal Government, in discussing tariff policy, should be able to weigh the results of that policy on its general finances and must have adequate control over both sources of income, direct and indirect, in order to give effect to its policy.

32. In regard to the third question propounded in paragraph 28, the Provinces may contend that the general claim put forward by British India units (paragraph 27) would be reinforced by the surrender of tributes and

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the payment of annuities of ceded lands. That loss would not have accrued to existing British Indian revenues as the result of constituting autonomous Provinces; it is incidental to the institution of Federation; and, though the relief granted will admittedly accrue to the benefit of individual States, yet British India units might perhaps press for a contribution from the States as a whole equivalent to a loss which has not been due to the requirements of British India units. There may be some hesitation on the part of non-tributary States in accepting the principle of this claim; but the contention of British India would to some extent be met by the agreement of the States recorded at the Third Round Table Conference (paragraph 8 of the Report of the Federal Finance Committee of the Conference of 1932). The States have throughout been opposed to the application to them of any form of direct taxation, but they then agreed (though with some dissentients) to assume the burden of a "corporation" tax (i.e., tax on profits of companies) as from the date on which the Federal Government would complete surrender to the Provinces of the share of income tax which the Conference proposed to assign to them. It must be mentioned, however, that this agreement was linked up with the condition that "a satisfactory yield from taxes on income is permanently assigned to the Federation." That condition takes us back to the answer which can be given to the second question (paragraph 28), and does not refer to the particular argument given in the earlier part of the present paragraph. The agreement was also subject to the condition that, the assessment on the companies having been made, the State may raise the amount due to the Federal fisc by any method it may choose, and not necessarily by the actual levy of the tax. This condition would avoid direct taxation, though it is perhaps useful to note that circumstances might be held to require that in the interests both of companies and of Federal finance, assessment should be made by an agency of the type of that now employed on the assessment of this tax in British India, and that some arrangement should be made for hearing assessment appeals by an authority of a type similar to that now available to companies assessed in British India.

£ millions

33. It is not easy to assign a precise value to the benefit which Federal finance will receive from the payment of a "corporation" tax by the States, but it will clearly not be considerable. Its importance lies rather in the concession of principle. Indeed, although the adjustment of tributes, immunities, and the like, are of the greatest political importance, and the concession of a corporation tax also possesses its own value, these questions, even if satisfactorily settled, will not have any decisive bearing on the solution of the main difficulty described in Part I of this Note. That solution must be found in the rehabilitation of Central finance; Federation, even on the most satisfactory terms, will not itself assist in its achievement.

## PART III.

34. It may be useful to summarise here the proposals of the White Paper for dealing with the allocation of revenues. It will be seen that while retaining for the Federal fisc the major and exclusively Federal heads of revenue such as Customs and Railway receipts, it provides that, as regards a second class, namely, salt, Federal excises (e.g., oil) and export duties (e.g., jute), the whole or part of the net revenues derived from any one or more of these sources may be assigned to the units, while in the case of the export duty on jute the assignment to the producing units would be compulsory and would amount to at least 50 per cent. of the duty. As shown in paragraph 16, Bengal would on present figures receive about 1.35 crores,\*

Paragraph 187.

\*1.01

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- £ millions  
\*·04  
†·08  
‡1·18
- Paragraph 138. Assam about .05 crore,\* and Bihar and Orissa about .1 crore,† or a total loss to Federal revenues of 1.50 crores.‡ This assignment would proportionately reduce the claims of these Provinces to initial subventions on account of their budget deficits. In addition to strictly provincial sources secured by the Constitution Act, the Federal Legislature would be empowered to impose and assign for the benefit of the Provinces certain sources of revenue, viz., death duties, terminal taxes on railway-borne goods or passengers, stamp duties subject to all-India legislation at the time of federation, taxes on mineral rights and personal taxes on capital other than land; the Federal Legislature would determine the basis of distribution to Provinces. In the main these taxes represent only potential sources of income of which it is not at present possible to estimate the benefit, and they cannot be taken into account in estimating the position now or in the immediate future. It is also proposed that the Federation shall be empowered to impose and retain a surcharge on such taxes for Federal purposes.
- Paragraph 139. 35. The major addition proposed to the existing provincial resources consists in the allocation of a share of not less than 50 per cent., but not more than 75 per cent., of the income tax, excluding the tax on profits of companies, and excluding also sums derived from taxes on emoluments of Federal officers or taxes collected in areas federally administered (Delhi, etc.).
- Paragraph 145. The exact figure will be prescribed by Order in Council, which will be laid before Parliament for approval. A scheme is laid down for progressive surrender of this source of income, to be completed in 10 years after the commencement of the Constitution Act; but the process of surrender in whole or part may be deferred at his discretion by the Governor-General, if he considers, after consultation with Federal and Provincial Finance Ministers, that the continuance of the process for the time being would endanger the financial stability of the Federation. It may be mentioned that out of the present income tax revenue of 17½ crores,§ approximately 3½ crores|| represent corporation tax and income tax on the emoluments of Federal officers or attributable to federally administered areas. Of the remainder, 10½ crores¶ would come for distribution under the proposed system of sharing with Provinces, the balance of 3½ crores\*\* being ranked as a Federal surcharge, as will presently be mentioned. The amount of each of these items would be reduced by about one-eighth if Burma were separated.
- Paragraph 141. 36. The Federation would have power to impose for its own benefit surcharges on the income tax, and no part of these surcharges would go to the British India or State units. While such surcharges were in operation each State member of the Federation would, unless it had agreed that the Federal income tax should extend to the State, contribute to Federal revenues a sum to be assessed on a basis prescribed by Order in Council. As an exception to this, no contribution would be required from the States if the present emergency surcharge (which would rank as Federal) were still in force. Finally, it is proposed that the Federal Legislature should be empowered after an expiry of 10 years after the commencement of the Constitution Act, to extend the corporation tax to the State members of the Federation. This may, if the State prefers, be collected directly from the State and not from the companies concerned. (On this see paragraph 32 above.)
- Paragraph 142. 37. The Appendix attached gives certain figures which, though only approximate, may be found of some use in an attempt to evaluate the financial significance of the White Paper proposals relative to the Central Government's position as sketched above. As regards these proposals, discussion will no doubt be mainly directed to the proposal to leave income tax as a Federal source, while assigning a certain share to British India
- §12·94  
||2·68
- ¶7·88  
\*\*2·44

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units, to the proposed extent of the assignment, and to the proposal to fix dates, as from the commencement of the Constitution Act, for the operation of the assignment. A second point will be the proposal to make compulsory the assignment to certain Provinces of a fixed portion of the jute duty; a third will be the measure to which the levy of a corporation tax (in the manner proposed) will meet the claim of British India for a States' contribution to Federal finances. But apart from any questions of this nature which may arise in consideration of the scheme as set out in the White Paper, or indeed of any scheme involving surrender of Central revenues, it may be felt necessary to examine the fundamental questions whether financial conditions are such as to affect any assumption we may make as to the date on which provincial autonomy can be introduced; and further, whether we can assume such further general recovery as will enable us now to plan out the lines of a Federation on terms which will satisfy the States on the one hand that their financial future under Federation is secure, and British Indian units on the other that under Federation they can hope to obtain the funds to which they look for development. In considering these questions, the assumptions made in paragraphs 19 and 30 regarding the extent of the requisite improvement in Indian finances will, if accepted, have an important bearing. Attention is also invited, in this connection, to the second half of paragraph 60 of the Introduction to the White Paper,\* and to the Secretary of State's remarks in the House of Commons on 22nd February last.†

\* "His Majesty's Government attach the highest importance to securing to the Federation adequate resources, without which the Federal Government cannot ensure the due fulfilment of liabilities upon which must depend the credit of India as a whole.

"A possibility which cannot be dismissed from consideration is that economic and financial conditions might on the eve of the inauguration of the new Constitution be such as to render it impracticable to supply the new Federal and Provincial Governments at the outset of their careers with the necessary resources to ensure their solvency. If, after the review contemplated above, the probability of such a situation should be disclosed, it would obviously be necessary to reconsider the position, and it might, *inter alia*, be necessary to revise the federal finance scheme contemplated in these proposals."

† "Having made these two general observations, let me take my hon. and gallant Friend's points in order. He says, first of all, that the state of Indian finance will not admit of setting up a Federal Government at the centre. I agree with him that the state of Indian finance, much improved as it is, is not yet as satisfactory as we should desire. I agree with him further, that if an attempt is made here and now to finance the Federal centre, and finance at the same time autonomous Provinces, it will be very difficult to find the money. I do further say that it is impossible for us to-night to forecast the exact position when the act of Federation takes place. I further say to him, and I hope this may to some extent reassure him, that I do not suppose anybody here, or indeed in India, will be prepared to bring Federation into being if it is quite obvious that the Federation will be insolvent. My own view, which is supported by many of my expert advisers, is that the Federal Government would not cost substantially more than the existing Central Government, and that the problem of adjusting finances between the centre and the Provinces is much the same whether Federation is set up, whether Provincial autonomy is started, or whether we keep the centre as it is now."

6<sup>o</sup> Julii, 1933.] THE FINANCIAL IMPLICATIONS OF [Continued.  
(1) PROVINCIAL AUTONOMY AND (2) FEDERATION.

## APPENDIX.

## (1) WHITE PAPER PROPOSALS.

(a) <i>Deterioration.</i>	Rs. crores=£ million	
(i) Cost of new or enlarged constitutional machinery	Say 1	.75
(ii) Alienation of half jute export duty (present yield)	1½	1.13
(iii) Subventions to deficit and new Provinces (additional to (ii))	Say 2½	1.88
(iv) Alienation of income tax (assuming Burma not separated):—		
(a) 50 per cent.	About 5½	3.94
(b) 75 per cent.	About 8	6.00
(v) Settlement of States' excess contributions	About 1	.75

(b) *Improvement.*

(i) States' payments under corporation tax or surcharges	( ? )
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## (2) CENTRAL BUDGET.

(a) *Deterioration.*

(i) Loss of opium receipts	.6	.45
(ii) Decline in customs...	( ? )	
(iii) Loss of currency receipts	Say 1	.75
(iv) Restoration of civil and military pay cuts	About 1½	.94
(v) Separation of Burma	Say 3	2.25

(b) *Improvements.*

(i) Excise on matches	About 2½	1.88
(ii) Other new taxation (small)...	( ? )	
(iii) Improvement under loan charges (small)...	( ? )	
(iv) Saving under Accounts and Audit	.6	.45

(c) *Other factors retarding effects of recovery.*

(i) Withdrawal of emergency surcharges	About 13	9.75
(ii) Restoration of railway pay cuts	About 1½	.94

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## Statement by the Secretary of State for India on the subject of Federal Finance.

*Sir Samuel Hoare:* My Lord Chairman, this is one of the most difficult and complicated questions that we have got to consider. It is difficult in itself, but it is made ten times more difficult by the conditions in which we approach it. Obviously, with the state of the world as it is, with the financial and economic uncertainties that face us, it is extraordinarily difficult to make even general estimates for the future.

Now, my Lord Chairman, there have been many inquiries into the questions that we are here to consider this morning. There was first of all the inquiry carried out by Sir Walter Layton on behalf of the Simon Commission. I think my colleagues will agree that there is no more comprehensive chapter in the whole of the Report of the Simon Commission than the chapter dealing with Finance. Then, after that, came a series of inquiries carried out either by the Round Table Conference itself or by the Percy Committee of the Conference. I suppose that there was no question that gave us more trouble or took up more time in our deliberations in London, and there was no more complicated inquiry connected with the constitutional proposals than the inquiry which was made by Lord Eustace Percy and his Committee in India. Since then we have had a constant interchange of communications between the India Office and the Government of India, and between the Government of India and every one of the provincial Governments. I make this preliminary observation for the purpose of showing to the Committee and the Delegates that from the very first we have fully investigated the difficult problems connected with Federal Finance, and never, from the beginning, have we shirked the formidable issues that they create. My Lord Chairman, with this great mass of material, this series of inquiries, and this flood of statistics in which we have been involved now over many months past, it seemed to you that it would be well to have an objective summary made for the use of the Committee's discussions. You and I had some talk upon the subject, and it seemed to me that the best thing that I could do to carry out your desire and to meet what I believed to be the wishes of the Committee and the Delegates as a whole, was not to put in a memorandum from the India Office but rather to ask Sir Malcolm Hailey to take all the material that is at my disposal and with his experience, quite a unique experience, both as a former Finance Member of the Viceroy's Council and as the Senior Governor in India, who has been Governor of two of the greatest provinces in India, to ask him to make such a summary and to have it circulated to the Committee. The figures in the summary are all taken from the official documents, and the India Office and the Government of India take full responsibility for them. Apart, however, from that, we have left Sir Malcolm Hailey absolutely free to present the statement\* in his own way as he thought fit. The document, my Lord Chairman, is before the Committee to-day, and I think we should all say that it is a very full and comprehensive summary; and, speaking for myself, I would say it is just the kind of memorandum that we needed if our discussions are to be instructive discussions in the future. My Lord Chairman, not only is it a very comprehensive document, but it is a document, I claim, that does not shirk any awkward facts; it puts the whole case before the Committee; it does not make light of the financial difficulties in the way of progress, and

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\* Memorandum entitled "The Financial Implications of (1) Provincial Autonomy and (2) Federation."

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6° Julii, 1933.] STATEMENT BY THE SECRETARY OF STATE [Continued.  
FOR INDIA ON THE SUBJECT OF FEDERAL FINANCE.

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it ignores none of the awkward problems that are connected with the question. My Lord Chairman, I imagine that the first impression left upon every Member of the Committee and upon every Delegate is a rather depressing impression. There we see set out in all their nakedness the awkward financial facts connected with the Government of India to-day and the Government of India of to-morrow. Let me allude to one or two of them. Let me take, first of all, the case of the provinces. There, my Lord Chairman, you will see, if you look at the figures, connected with the setting up of provincial autonomy, Sir Malcolm Hailey comes to a general conclusion that the expenditure involved may be something between 6 and 8 crores (see para. 19 of Sir Malcolm Hailey's memorandum). If you analyse the figures you will find first of all that about three-quarters of a crore is needed for the overhead expenses of setting up the new provincial machinery; that is to say, the cost of the provincial legislatures and the cost of the electorates (including  $\frac{1}{4}$  crore for new machinery of government in the new Provinces of Sind and Orissa). Next there is another figure of about half a crore that is involved by the provincial governments taking over certain expenditure that is now borne by the central government. Then there is a further figure of from two to three crores, assuming that Burma is separated from India; and lastly there is a figure of from three to four crores that would be involved if the provincial deficits were to be removed, and the provinces to be set up upon a self-supporting basis. This includes the provision of resources to cover deficits that would otherwise arise in the areas of Sind and Orissa on their being constituted separate provinces.

That comes in all to a figure of between 6 and 8 crores. My Lord Chairman, that looks a very formidable figure, and I will come to analyse it in some greater detail in a moment or two; but let me pass from the provinces to the Federal centre. I think you will find that the expenditure for the Federal centre is a figure of about  $2\frac{1}{2}$  crores. Of this about  $\frac{2}{3}$  crore is for fresh expenditure on the legislature, etc. The other item is a figure of perhaps  $1\frac{1}{2}$  crores which would be a temporary budgetary loss on the establishment of the Reserve Bank, due to the proposed diversion of currency profits to the building up of the reserves of the Bank. When these have been built up currency profits should again accrue to Government in the shape of surplus profits of the Bank. In actual practice the building up of a banking reserve ought to have some effect upon the method by which the Indian Federal Government deals with its sinking funds. If they get better credit at one end, they might possibly make some alteration in their sinking fund arrangements at the other. We also have to remember that there is the complicated problem of States tributes, ceded territories and "immunities" which was so fully investigated by the Davidson Committee. Part II of Sir M. Hailey's memorandum includes a review of the subject. For the moment it is only necessary to bear in mind that the *ultimate* cost to federal revenues of these adjustments is likely, after a period of years, to reach about 1 crore a year.

Now, my Lord Chairman, all that looks a very formidable state of affairs, and the question arises as to whether there are any countervailing factors that ought to be taken into account. First of all there are certain countervailing factors, but they are of such an uncertain character that it is very difficult to know what reliance to place upon them. There is, however, one fact that is beyond doubt and contradiction, and that is a factor that must not be forgotten when we approach these broad issues, namely, that Indian credit is steadily improving. I do not linger on

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FOR INDIA ON THE SUBJECT OF FEDERAL FINANCE.

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that point at this stage, but it is a material factor in our general considerations. Next there is the fact that, anyhow judged by past experience, India responds more quickly than almost any country in the world to an upward movement in the economic field. India being dependent to a great extent upon primary commodity prices, responds equally quickly when commodity prices fall and when commodity prices rise. Thirdly, there is, I believe, still opportunity for economies to be carried out in certain fields of administration in India, particularly provincial administration, and lastly there is the fact—or perhaps I should say there is the hope (I do not put it higher than that at this moment)—that as a result of the proceedings of the capitulation Tribunal, the Tribunal that was to analyse the expenditure of Great Britain and India for the defence of India, which has finished its deliberations, and out of those deliberations might eventuate (I do not put it higher than that) a contribution of some kind towards the defence expenditure of India; but, my Lord Chairman, I quite admit that anyhow two or three of those factors are uncertain factors, and that we must come to a much closer analysis of the figures. We must base our reasons upon much more definite data if we are to say that the picture painted by Sir Malcolm Hailey in his summary is not as black as appears at first sight.

Before proceeding to further analysis of the position as I have so far described it, I will digress in order to give some figures regarding the public debt of India, which are, of course, important in relation to the credit of India. The total obligations of India are 1212 crores. Of this amount 705 crores are held in India and 507 crores in England. The division into remunerative and dead-weight debt is as follows. Remunerative debt—that is debt represented by interest-bearing assets, railways for instance in particular—is 969 crores. Not so represented 206 crores, leaving a small sum of 37 crores that is held in cash and bullion.

Sinking fund provision, of which the aggregate amount is calculated with reference to the whole debt, is nearly seven crores a year.

Now, my Lord Chairman, I return to the analysis of the position already set out. I think two significant facts emerge from the figures. The first fact is that the greater part of this deficit, call it, if you will, from six to 10 crores, is due not to the setting up of the Federal Government in the centre but to the setting up of autonomous provinces upon a self-supporting basis. I would lay especial emphasis upon this fact, that by far the greater part of the deficit is due not to the setting up of the Federal centre but to the setting up of the autonomous provinces upon a self-supporting basis. Next, a second fact that emerges is that a very small part of this deficit, take it if you will at the highest figure, say, of 10 crores, is due to actual fresh expenditure. If you analyse the figures you will find that, apart from a comparatively small sum, namely, about three-quarters of a crore, for setting up the new machinery in the provinces, and a figure of about the same amount, namely, about three-quarters of a crore for setting up the Federal institutions in the centre, the rest of this amount is not fresh expenditure at all, and it is due in the main to two changes in the allocation of the revenues of India, namely, first of all, the change, supposing Burma is separated from India, of leaving Burma two or three crores that it now contributes to the Indian Central Government. Secondly, it is due to a figure of about the same amount, some two crores, that is necessary whether changes take place in the constitutional field or whether they do not, to put a stop to the permanent deficit in Bengal and the permanent deficit in Assam.



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Now, my Lord Chairman, what are the conclusions that I draw from those facts? The first conclusion that I draw is that the greater part of this six to 10 crores is needed anyhow, whether we make constitutional changes or whether we do not, that the greater part of it is needed for putting the provinces on a self-supporting basis, and that in my view, whether constitutional changes are made or whether they are not, it is urgently necessary in the interests of the Central Government and in the interests of a great province like Bengal to bring to an end a system of finance that leaves Bengal in a state of permanent deficit and allows its finances to get deeper into a hopeless slough.

My Lord Chairman, the second conclusion that I draw from this analysis is that if the state of the world does not get better, if we still go on with commodity prices either at their present level or actually falling, not only does it make any change almost impossible but it makes the existing system of Indian finances almost equally impossible. We shall then have to readjust our whole system of finance in India to meet the state of affairs with which we shall be faced. Let me emphasise this point, that if the state of the world does not improve the problem of the present Government in India is almost as great as the problem of any Federal Government and any autonomous Provincial Governments, and we have got then, in that event, to readjust our ideas to these new conditions. But I would venture to urge that in the meanwhile, my Lord Chairman, the wise course is, first of all, to go on making our plans, to make them as reasonable and as secure as we can, but frankly to admit the fact that if the state of the world does not improve we may have materially to readjust them; and, secondly, I think it is most important to emphasise the fact that, so far as we can see, for quite a number of years to come, there is no orange to divide up in India between the Centre and the Provinces. The fact that does emerge, anyhow, in my mind as definitely as any other is that for some years to come the Central Government, whether it be the present Government or whether it be a Federal Government, will need substantially its present resources if the credit of India is to be maintained and if its financial obligations are to be met. I would, therefore, venture to impress upon my friends amongst the Indian Delegates who particularly represent Provincial opinion at this Conference, that, with the best will in the world, if we are to have a stable Central Government, if Indian credit is to be maintained, and if Indian commitments are to be met, there is no sum at the moment to be divided up amongst the Provinces other than, say, a part of the jute tax or some such payment of that kind for dealing with the very exceptional position of Bengal. In saying this I do not in the least overlook the fact that in any permanent plan for the division of resources it is necessary to bear in mind that the requirements of the Provinces are almost unlimited while their present sources of revenue, and in particular land revenue, are in-expansive, whereas the present central sources of revenue are more elastic heads and the field of expenditure is, in the main, well defined. I would venture to suggest, with deference, my Lord Chairman, that if that conclusion is correct, it points once again to the Provincial Governments using every possible economy in their administration, and (I know very well what great efforts many of them have made) to look at the problem again in view of what I have said and to see whether they cannot still further economise in certain branches of their administration. I think it also points—if I may make this suggestion both to the Committee and to the Delegates—to this, that in all our discussions on which we are going to embark in the whole field of the Constitutional proposals, we should keep constantly

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in mind the fact that there is very little money to go round and that we must keep the lowest possible limit on any expenditure that may be needed by Constitutional changes. I think in the course of our discussions we must look with even more meticulous and closer attention to every aspect of the Constitutional proposals from that angle. Now, my Lord Chairman, I have spoken, in the main, in general terms, but I hope I have said enough to show, first of all, that there is very little money to go round; secondly, that if the economic state of the world does not improve we must readjust our views generally to the whole problem of Indian Revenue and Indian expenditure; thirdly, that the main cause of the deficit shown in Sir Malcolm Hailey's Summary is a deficit due, not so much to any Constitutional changes, as to the system of Indian finance generally.

Let me end, my Lord Chairman, by saying, even after painting the picture as blackly as it has been painted, that we can congratulate ourselves upon India, as a whole, being financially—uncertain and black as the picture is that I have just painted—sounder than most of the countries in the world. After all, my Lord Chairman, we are balancing our Budget.

The budgetary position has responded to the great efforts made to deal with the serious deterioration which resulted from the world-wide economic depression. 1932-33, according to the Revised Estimates, closed with a surplus of Rs.2.17 crores; and the Budget for the current year, in spite of a partial restoration of cuts in pay, provides for a small surplus.

The continued improvement which has taken place in the credit of India is evidenced by the fact that, for example, the 4½ per cent. sterling Stock 1950-55, which in September, 1931, was quoted as low as 61, had risen by May, 1932, to 91, and now stands at about 106. Another manifestation of the stronger financial position has been the great progress made, during the last year or so, with the repayment and conversion of short term debt, both rupee and sterling.

After all the efforts that we have made in the Provincial Administrations in the last year we are going, as I believe to show that, at the end of the year, there will be very few Provinces—perhaps no Provinces other than Bengal and Assam—in a state of deficit, and that upon those facts we can well congratulate ourselves. The wise course, I suggest to the Committee to-day, in view of these facts, is that we should keep them constantly in mind, but that they should not debar us from proceeding with our Constitutional plans, and that we should keep in mind the fact that there is no government in the world, either the Indian Government or the British Government, or any other Government, that can accurately say, in the uncertainties of the world, what the state of its finances is going to be in 12 months' time. We must go on hoping that there will be a turn for the better in the world, and we must rely upon the fact that we have always assumed, in our previous discussions in the Round Table Conferences, that we can never make definite estimates until the last moment, and at the last moment there must be an expert Inquiry into the financial position with a view to readjusting that position, if readjustment is necessary, to the conditions of the time.

My Lord Chairman, I hope I have stated, in general terms, the main factors that have impressed themselves upon my mind.