

GOVERNMENT OF INDIA
MINISTRY OF STATES



सत्यमेव जयते

REPORT
OF THE
INDIAN STATES FINANCES
ENQUIRY COMMITTEE
1948-49

PART I

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TABLE OF CONTENTS

Particulars	Paragraphs	Pages
SECTION I—PRELIMINARY		
Terms of Reference	1	1-2
Items (1) and (5) of Terms of Reference withdrawn	2	2
Plan of Work	3	2-3
Certain States not dealt with; reasons therefor	4	3-4
"States" includes "Unions of States"	5	4
SECTION II—FINANCIAL RELATIONSHIP BETWEEN THE CENTRE AND THE STATES—CONSTITUTIONAL AND ECONOMIC POSITION		
Financial Relations between States and Centre, part of wider question of general relations	6	5
"Paramourncy", the basis of relations between States and Centre in the past	7	5
Circumstances compel uniformity in matters of common concern, such as :	7	5
Defence	7	5-6
Economic and Fiscal matters	7	6
Emergence of Agreements and Codes, in exercise of "Paramourncy".	7	6
Indian Independence Act; lapse of "Paramourncy" and of the "Codes" built upon it	8	6
the resultant void	8	7
was filled by Instruments of Accession and "Stand-still" Agree- ments	8	7
thereby establishing a "constitutional" relationship with Centre	8	7
Accession by Unions etc. over a larger field of subjects	8	7
Participation by States in the Constituent Assembly of India	9	7
New basis: the "Objectives" Resolution; fundamental principles of new constitution	10	8
Union of India consists of Provinces and States, as equal partners	10	8
Powers and functions of Centre should be uniform in Provinces and States	11	8
Centre should act through its own officers in States as in Provinces	12	9
Centre should have uniform sources of revenue in States and Pro- vinces	13	9
New relationship between States and Centre, summarised	14	9-10
Its result,—complete federal integration in all spheres including Finance	15	10
The urgent need for federal fiscal integration	16	10-11
and its far-reaching advantages	16	11
Integration of federal finances desirable and feasible	17	11-12
SECTION III—FINANCIAL INTEGRATION—GENERAL PRINCIPLES FOLLOWED BY THE COMMITTEE		
Scope of federal financial integration	18	13
"Federal" Revenues and Expenditure of States to be taken over by the Centre	19	13-14
Accounts and Audit	20	14
Further points of difference between Provinces and States	21	14
Internal Customs Duties	22	14-15

Particulars	Paragraphs	Pages
Defence	23	15-16
Privy Purses	24	16
"Federal" Assets and Liabilities to be taken over by Centre	25	16
Whether federal financial integration should be gradual	26-27	16-18
Financial integration need not be gradual, if effected subject to certain transitional adjustments	28	18-19
Financial consequences of federal financial integration	29	19
No "compensation" payable for "federal" assets passing to Centre ;	30	19-20
but appropriate liabilities to be also taken over ;	30	21
and dislocation of finances of States to be avoided	30	21
No "Compensation" payable for "federal" revenues passing to Centre ;	31	21
but financial dislocation to be avoided	31	21
Federal financial integration schemes for individual States ; financial adjustments over transitional period	32	22-23
Income-tax—gradual raising of State rates to Indian level	33	23-24
Income-tax—"divisible pool"	34	24-25
Individual integration schemes are workable ;	35	25
and equitable, both to States and Centre ;	36	25
their "legal" basis would be as "agreements" under Art 258 ;	37	25
special machinery for watching their working	38	25 26
Administrative matters arising out of federal financial integration	39	26-28
Date of federal financial integration	40	28-29
Plan of Part II of Report, containing individual integration schemes	41	29
Federal Financial Integration will have far-reaching consequences	42	29
SECTION IV—SUMMARY OF RECOMMENDATIONS		
Summary of conclusions and recommendations	43	30-33
Acknowledgments	44	33
ANNEXURE		
Section I—Introductory		
Scope of Memorandum	1	37
Definitions	2	37
States	2 (1)	37
Rates of Tax	2 (2)	37
Prescribed date	2 (3)	37
Pre-existing rates of tax	2 (4)	37
Amount of tax	2 (5)	33
Section II—Gradual Raising of State Rates of Income-tax		
Income-tax in States, gradual raising of State rates to Indian level	3	38
States in which no income-tax levied	4	38
Gradual raising of pre-existing rates of Tax		38-44
Relevant considerations	5	38-40
and the scheme proposed	6	40-43
Comments on the Scheme	7-8	43-44
Section III—Technical Matters Relating to Income-tax		
Matters affecting most "federal" subjects, including taxes on income	9	44-45
Legal matters especially concerning Income-tax	10	46-47
Other Technical matters concerning Income-tax	11	47-53
Remittances	11 (1)	47-48

Particulars	Paragraphs	Pages
Double Income-tax Relief	11 (2)	48-49
Immunities from Taxation	11 (3)	49-51
Income-Tax Investigation Commission	11 (4)	51
Collections under "PAYE" and "Provisional" assessment schemes	11 (5)	52
Income-Tax "Divisible Pool"	11 (6)	52
"Royalties" computed by reference to Profits	11 (7)	52-53
 Section IV—Other Taxes on Income and Taxes on Capital, etc.		
Excess Profits Tax	12 (1)	53
Capital Gains Tax	12 (2)	53
Business Profits Tax	12 (3)	53
Industrial Profits Tax	12 (4)	54
Bikaner "Income-tax"	12 (5)	54
Other Federal Taxes	12 (6)	54
 Section V—Summary		
Summary of recommendations	13	55-57

APPENDIX

I. Government of India (Ministry of States) Resolution No. F. 60-IB/48 dated the 22nd October, 1948	61-63
II. Government of India (Ministry of States) Letter dated the 10th April, 1949 to the Indian States Finances Enquiry Committee.	64

I. PRELIMINARY

The Committee was appointed by a Resolution of the Government of India (Ministry of States), No. F. 60-IB/48, dated the 22nd October 1948, (reproduced as Appendix to this Report) with the following Terms of Reference :—

“ To examine and report upon :

- (1) the present structure of Public Finance in Indian States and Unions of States ;
- (2) the desirability and feasibility of integrating Federal Finance in Indian States and Unions of States with that of the rest of India, to the end that a uniform system of Federal Finance may be established throughout the Dominion of India ;
- (3) whether, and if so, the extent to which, the process of so integrating Federal Finance in the Indian States and Unions with that of the rest of India should be gradual and the manner in which it should be brought about ; and the machinery required for this purpose, especially as regards the legislative groundwork and the administrative organisation necessary for the imposition, assessment and collection of Federal Taxes ;
- (4) the results of such a policy of integrating Federal Finance upon the finances of Indian States and Unions and the consequential financial adjustments and relations which should subsist between the Governments of the Indian States and Unions on the one hand and the Government of India on the other ;
- (5) the measures which the Committee may consider necessary and/or desirable for revising, in the light of present day conditions and standards, and having regard to the requirements of modern administration, the structure of Provincial Finance and, in particular, the levels and sources of Provincial Revenues in Indian States and Unions of States ;
- (6) any other consequential and/or cognate matters which the Committee may consider as arising out of the foregoing terms of reference ”.

These terms fall, broadly speaking, into two categories :—

- (i) those relating to what may be termed “provincial finance” *i.e.*, revenues etc., which according to the “Draft Constitution of India” appertain to the “Provinces” in India—items (1) and (5) of the Terms of Reference.
- (ii) those relating to “federal finance” *i.e.*, revenues etc., which, according to the “Draft Constitution of India”, come within the sphere and competence of the Union of India—items (2), (3) and (4) of the Terms of Reference.

Items (1) &
(5) of Terms
of Reference
withdrawn.

2. The Committee found, after a preliminary survey, that a detailed investigation of the first group of questions—those relating to the “Provincial” field—in States and Unions of States would require detailed and elaborate local enquiries, necessitating the employment of special officers in the areas concerned. Such an investigation would have taken up much more time than was first thought would be needed. The Committee, therefore, suggested that this group of questions should be reserved for subsequent examination and that it should confine itself to the problems connected with the evolution of a system of federal finance in States and Unions of States which would be uniform with the system in Provinces, so that its report might be available to the Government of India at about the time when the Constituent Assembly would be taking up for consideration the portion of the “Draft Constitution” relating to “Finance, Property, Contracts and Suits”—Part X. This proposal was accepted by the Government of India (Ministry of States) in their letter dated the 10th April 1949. The present report deals, therefore, only with the subjects mentioned in items (2), (3), (4) and (6) of the Terms of Reference.

Plan of Work

3. Soon after we commenced work, we called for preliminary Memoranda and data from all States and Unions of States, and from certain Ministries of the Government of India. We then issued a set of questionnaires covering the whole field of our enquiry in order that States and Unions of States might be assisted in the preparation of the statistical and other information we needed. After this, one of us (Mr. Dandekar) and our Secretary (Mr. Swaminathan) visited States and Unions of States and gave such instructions as the Governments needed for the compilation of figures and their scrutiny. They also had preliminary local discussions of an exploratory character concerning the problems arising out of our Terms of Reference. In the meantime, the Committee itself held a series of meetings in order to formulate general principles in conformity with the provisions of the “Draft Constitution of India” and accepted principles of federal finance, to guide it in its plans for integration. As complete information

became available for each State or Union of States, a scheme of integration was prepared for it. The Committee then arranged to meet the Government concerned and discuss the scheme in detail after explaining the general principles which the Committee thought should be followed. Often the Committee met the same Government more than once. The integration scheme for Baroda was discussed at a meeting in Bombay with the Hon'ble the Premier and the Hon'ble the Finance Minister of Bombay, the Dewan of Baroda and a representative of the Finance Ministry of the Government of India ; and the integration schemes for Travancore and Cochin were finally discussed at a joint meeting in Ernakulam, attended by the Hon'ble the Prime Ministers, the Hon'ble the Finance Ministers and other Hon'ble Ministers of the two Governments. We have also had the benefit of the views expressed by several representative associations of mercantile, industrial and planting interests, both within and without the States and Unions of States and by the Indian Coffee Board, concerning matters in which they were especially interested. The various Ministries of the Government of India have assisted us with their views on particular problems, and with the data relevant thereto. We have also had the benefit of the views of M. V. Narahari Rao, the Auditor General of India, who has had long association with, and specialised experience of, financial problems connected with Indian States. As a result of these close consultations, the Committee has found it possible to prepare schemes of federal financial integration for States and Unions of States, the important features of which have been accepted by all the Governments concerned except one and the committee hopes that this Government will find it possible to modify its attitude.

4. We have not specifically dealt with the following States or groups of States—

- (i) States, other than Baroda, whose administrations have been integrated with those of certain provinces of India under the Instruments executed in that behalf by their Rulers and under the powers conferred by the Extra-Provincial Jurisdiction Act, 1947 ;
- (ii) States whose administrations have been similarly integrated into newly constituted Chief Commissioners' Provinces ;
- (iii) Non-viable States ; and
- (iv) Jammu and Kashmir.

Certain States not dealt with reasons therefor.

States of the first two categories will be automatically integrated with the Central Government in India in the entire "federal" field, including finance, as soon as orders in respect of them are passed by the Governor-General under Section 290-A of the Government of India Act,

1935. The principles recommended by us in the case of Baroda in our First Interim Report, will be applicable, *mutatis mutandis*, to all such cases. We have, therefore, considered it unnecessary to deal with them specifically.

As regards States of the third category, *viz.*, non-viable States such as Manipur, Tripura and Cooch-Bihar, we consider that when their future is decided upon, they should be dealt with—both as respects the general principles involved and the details of transitional adjustments required—on the same basis as States for which we have prepared schemes. We have not accordingly dealt with them specifically in this Report.

Finally, as regards Jammu and Kashmir, the present circumstances in that State preclude us from working out an integration scheme for it.

“States”
includes
“Unions of
States”.

5. Wherever in this Report we refer to “States ” we should be understood as referring to States and Unions of States.

II. FINANCIAL RELATIONSHIP BETWEEN THE CENTRE AND THE STATES—CONSTITUTIONAL AND ECONOMIC POSITION

6. In the Government Resolution constituting the Committee it is explained how the question of the financial relations between the Centre and the States arose in connection with subsidies to States to meet the loss resulting from the sale of imported foodgrains in their areas at prices fixed by the Government of India. This question of financial relations is, however, only one aspect of the entire ambit of relationships between the Central Government on the one hand and the States on the other in an Independent India and should be examined in that wider context.

Financial Relations between States and Centre, part of wider question of general relations.

7. Prior to the 15th August 1947, Provinces and States developed on different lines—the former under the Governor-General in Council exercising the powers vested in him by Government of India Acts and the latter under the Governor-General in Council upto 1935, and later under the Crown Representative exercising undefined powers in the name of “paramountcy”.

“Paramountcy,” the basis of relations between States and Centre in the past.

Geographically, however, India is one; Provinces and States lie interspersed all over the continent, the boundaries being in most cases artificial and not representing any natural divisions; and all parts of the country are interlinked. With the development of India, the range of matters of common concern between Indian States on the one hand and the rest of India on the other became wider and wider and it was essential to secure co-ordinated action in both halves of India in the larger interests of the country as a whole.

Circumstances compel uniformity in matters of common concern, such as :

In Provinces this was easy enough. The Governor-General in Council could issue orders and have them carried out. In States, however, the Governor-General in Council had to act in a different capacity. He—and from 1935 the Crown Representative—invoked his “paramountcy” powers and, in the course of decades, an elaborate net work of agreements and codes based on “grant, usage, sufferance etc.” came into existence covering an infinite variety of matters in order to regulate relations between what was called “British India” and the States and to ensure that action was taken in the States in furtherance of policies conceived in the interests of India as a whole.

The most important among matters of common concern was Defence and the relationships evolved under this head were political in character and covered a very wide field. These may be grouped under three heads. Firstly, the Indian Army was for the whole country; and for

Defence.

its efficient functioning the Paramount Power entered into detailed arrangements with States for "securing what is necessary for strategical purposes in regard to roads, railways, aviation, posts, telegraphs, telephones and wireless, cantonments, forts, passage of troops and the supply of arms and ammunition". Secondly, Indian States maintained troops, and schemes were introduced under which their number arms and equipment, and the roles assigned to them were regulated. Thirdly, another class of relationship coming under 'defence' arose out of the obligation of the Paramount Power to protect States against rebellion or insurrection. In important States like Hyderabad and Baroda, troops from the Indian Army were stationed for this purpose under special treaties, but the obligation itself was a general one applying to all States alike. This obligation carried with it the responsibility to intervene and prevent misgovernment; and the Paramount Power laid down, as individual cases arose, the circumstances in which it would interfere with the internal administration of States "for the benefit of the Prince, of the State, of India as a whole".

Economic and Fiscal matters.

So much for the field covered by political relationships evolved under 'paramountcy'. Then, there were economic and fiscal relationships. Among the former were arrangements for the working of the Indian Railway system in Provinces and States alike, and for the working of the railway systems owned and operated by Indian States on essentially the same principles as the Indian Railway system in regard to safety, rates, etc. Similar co-ordinated arrangements existed for posts and telegraphs, telephones etc. Among fiscal matters may be mentioned agreements with maritime States for sea customs and those with all States for the effectuation of the salt monopoly and abolition of all barriers to trade.

Emergence of Agreements and Codes, in exercise of "Paramountcy."

In this way, the inherent necessity for concerted action in matters of common concern was recognised, and numerous agreements and codes built up steadily over a long period. It was by the exercise of paramountcy that these agreements and codes were brought into existence, modified from time to time to suit changing conditions and enforced whenever necessary. And in this way India attained a large measure of working unity. The second world war strengthened these political and economic bonds, under the need for concerted war efforts.

The Indian Independence Act; lapse of "paramountcy" and of the "codes" built upon it;

8. With the attainment of Independence by India, however, there came a complete change. Under Section 7 of the Indian Independence Act, the "suzerainty of His Majesty over Indian States" lapsed. With this also lapsed the entire code referred to above except for "provisions of any..... agreement which relate to customs, transit and communications, posts and telegraphs or other like matters," until they were denounced by the Ruler or the Dominion.

A void was thus created. For instance, all arrangements in the whole of the field covered under "defence" as set out above came to an end. This was a serious state of things, specially at a time when post-war conditions demanded more co-ordinated and unified action over the whole country than ever before.

the resultant void,

But the logic of facts is more powerful than legal formulae; and India and the States could not afford the severance or loosening of ties which had been forged over a long period of a century and had become integral parts of their political and economic systems. This was appreciated by the States and as the result of consultations in July 1947 almost all States, with the exception of Hyderabad, Kashmir and Junagadh, "acceded" to the Dominion in the three subjects of Defence, External Affairs and Communications with effect from the 15th August 1947 and also executed "stand-still" agreements which maintained the existing 'codes' in regard to most matters of common concern. (Kashmir also acceded in October 1947 and executed the same stand-still agreement.) This was an epoch-making event. For the first time in the history of India the States came into a defined 'constitutional' relationship with the Central Government; and Central legislation within the defined sphere, could be applied to States exactly as in Provinces.

was filled by Instruments of Accession and "Stand-still" Agreements;

thereby establishing a "constitutional" relationship with Centre

Soon another important step was taken in the same direction. When States were formed into Unions approximating in size and resources to Provinces, a wider field of "accession" was considered necessary.

Accession by Unions etc. over a larger field of subjects.

* Saurashtra Union
Madhya Bharat Union
Vindhya Pradesh Union
Patiala & P S Union
Rajasthan Union
Travancore—Cochin Union

All the Unions* have now acceded to the dominion of India in the subjects comprised in List I (Federal) and List III (Concurrent) of the Seventh Schedule to the Government of India Act, 1935, as adapted by the India (Provisional Constitution) Order, 1947, with the exception of those relating to finance and taxation. Mysore has also accepted similar accession; Hyderabad and Kashmir alone remain out of this field of wider relations.

9. Concurrently with this, States are taking part through their representatives in the Constituent Assembly of India and are assisting in the task of establishing new relationships between States on the one side and the rest of India on the other which would accord with present day conditions. All States except Hyderabad are now represented on the Constituent Assembly.

Participation by States in the Constituent Assembly of India.

New basis :
the 'Objectives' Resolution; fundamental principles of new constitution.

10. In the 'Objectives' Resolution, the Constituent Assembly has unanimously accepted the fundamental principles that should govern the new constitution. The portions of this Resolution relevant for our present purposes are :—

“ This Constituent Assembly declares its firm and solemn resolve to proclaim India as an Independent Sovereign Republic and to draw up for her future governance a Constitution :

(2) WHEREIN the territories that now comprise British India, the territories that now form the Indian States, and such other parts of India as are outside British India, and the States as well as such other territories as are willing to be constituted into the Independent Sovereign India shall be a Union of them all ; and

* * * * *

(4) WHEREIN all power and authority of the Sovereign Independent India, its constituent parts and organs of Government, are derived from the people ; and

* * * * *

Union of India consists of Provinces and States, as equal partners.

The essential points in the new relationship are that there shall be a Union of India in which Provinces and States shall be equal partners and in which all power and authority are derived from the people. (It is unnecessary to mention that a system of constitutional monarchy in Indian States is not incompatible with a Republican constitution for India). The bearing of this on the position of States in Independent India—in so far as they concern our terms of reference—should now be examined.

Powers and functions of Centre should be uniform in Provinces and States;

11. From the concept of States and Provinces as equal partners it inevitably follows that the Central Government should function in States over the same range of subjects and with the same powers as in Provinces. It is only in this way that the Union of India will gain in strength and its policies in effectiveness. There is no federation in which the Central Government possesses different levels of power and authority in the units comprised in it. Such differences in jurisdiction from unit to unit are bound to be a source of weakness and to produce a sense of unfairness among the less favoured units which will be fatal to friendly relations and orderly progress.

12. Another result that follows is that the Central Government should act through its own officers for the exercise of its important functions in States in the same way as in the Provinces.

Centre should act through its own officers in States as in Provinces;

In all federations, the federal Government has its own organised services spread over the whole of its area. It is a recognised feature of the federal system "that general and regional Governments both operate *directly* upon the people; each citizen is subject to two Governments". Further, for the federal Government to rely on the agency of States to carry out its policies will lead to conflicts.

13. Uniform sources of federal revenues and, consequently, equality of the basis of contribution to federal finances follow necessarily from the concept of the sovereignty of the people and equality of Provinces and States.

Centre should have uniform sources of revenue in States and Provinces.

When paramountcy existed, inequality in financial contribution between Provinces and States was possibly unavoidable. The Butler Committee put the case for this thus:—"But, whether or not a State makes a contribution to the cost of defence, the Paramount Power is under a duty to protect the states. It follows from this duty of protection, first that the British Government is bound to do everything really necessary for the common defence and the defence of the states". This basis no longer exists; it has been substituted by the concept of equality of Provinces and States, founded upon the sovereignty of the people of the whole of India including the States. It follows that States should contribute to federal finances like Provinces; it follows further that they should also receive grants and all other forms of financial and other assistance from the Centre just like Provinces.

14. The new relationship between the States and the Union of India should thus rest on the following principles:—

New relationship between the States and the Centre, summarised.

- (i) The Union Government should have authority in States over the same range of subjects as in Provinces.
- (ii) The Union Government should exercise its functions in States through its own administrative agency as in Provinces.
- (iii) The States should contribute to the finances of the Union on exactly the same basis as the Provinces and receive grants and other forms of financial assistance on the same basis.

It is not for the Committee to say how effect should be given to this in the new constitution;—whether, for instance, the provision for a process of "accession" by individual States embodied in Article 225

should be enacted or whether the constitution,—or at least the federal portions of it—should apply to these units automatically as it applies to Provinces. This is for the Constituent Assembly to decide.

Its result,—
complete
federal inte-
gration in all
spheres inclu-
ding Finance.

15. What we have said above practically amounts to this—that under the new set-up, the Union of India will conform to the pattern of other Federations and function with the same rights and obligations throughout the country, and that all the units will likewise have equal rights and obligations. Only so can the Union of India make an effective contribution to the solution of the difficult economic problems that face India, meet the strains and stresses of the post-war world and maintain national unity. The States themselves will also derive substantial advantages among which the following may be mentioned :—Firstly their people and Governments will take their place in the polity of India alongside of the people and Governments in the rest of India and share in its wider life with equal rights and obligations. Secondly, administrative standards and efficiency will increase by closer contacts with the administration of the Central Government and especially by the uniform accounting and audit system which will result from the supervision of the Auditor-General of India, recruitment to the higher services on an all India basis, a unified judicial system and access to technical advice and assistance furnished by the Central Government. Thirdly, States will have their share of such federal revenues as may be made divisible from time to time and of the grants, loans and other forms of financial assistance given by the Centre, on the same basis as Provinces ; an impetus will thus be given to development programmes in these areas.

The urgent
need for
federal fiscal
integration;

16. The advantages which will be derived by the country as a whole, including the States, from an integrated system of federal finance operated uniformly by the Central Government throughout the country cannot be over-emphasised. The following observations of the Joint Parliamentary Committee on Indian Constitutional Reforms (1933—34) indicate that the dangers of uncoordinated fiscal administration in India were fully realised even at that time :—

“The existing arrangements under which economic policies, vitally affecting the interests of India as a whole, have to be formulated and carried out are being daily put to an ever-increasing strain, as the economic life of India develops. For instance, any imposition of internal indirect taxation in British India involves, with few exceptions, the conclusion of agreements with a number of States for concurrent taxation within their frontiers, or, in default of such agreement, the establishment of some system of internal customs duties—an impossible alternative, even if it were not precluded by the terms of the Crown’s

treaties with some States. Worse than this, India may be said even to lack a general customs system uniformly applied throughout the Sub-Continent. On the one hand, with certain exceptions, the States are free themselves to impose internal customs policies, which cannot but obstruct the flow of trade. Even at the maritime ports situated in the States, the administration of the tariffs is imperfectly co-ordinated with that of the British India ports, while the separate rights of the States in these respects are safeguarded by long-standing treaties or usage acknowledged by the Crown. On the other hand, tariff policies, in which every part of India is interested, are laid down by a Government of India and British India Legislature in which no Indian State has a voice, though the States constitute only slightly less than half the area and one-fourth of the population of India.

Moreover, a common company law for India, a common banking law, a common body of legislation on copy-right and trademarks, a common system of communications, are alike impossible. Conditions such as these which have caused trouble and uneasiness in the past, are already becoming, and must in the future increasingly become, intolerable as industrial and commercial development spreads from British India to the States".

These difficulties will disappear by the institution of a uniform and integrated federal fiscal system throughout the country. There will then emerge uniformity of law, rates, interpretation and administration of all federal fiscal measures resulting in uniform policies, principles and practice in the levy, assessment, and collection of Central taxes and duties. And tax-evasion, always a serious evil, will be more effectively checked. The abolition of internal customs duties will result in freedom of trade within the country. A co-ordinated trade and tariff policy will have a uniform impact throughout the country. Ports and other important links in the country's system of communications and transport will be free to serve their natural hinterlands. National and regional economic planning on all-India basis will become possible. In this, as in all other respects, the States will play their part, and they will become entitled to all the benefits which accrue from the execution of such plans as require the aid of Central resources and technical assistance.

and its far-reaching advantages

India will thus have an opportunity to emerge as a well-knit unit, fully integrated in all spheres, political, constitutional and economic. Its essential fundamental unity will be re-inforced.

17. We have now dealt with item 2 of the Committee's Terms of Reference :—

“the desirability and feasibility of integrating Federal Finance in Indian States and Unions of States with that of the rest of India,

Integration of federal finances desirable and feasible.

to the end that a uniform system of Federal Finance may be established throughout the Dominion of India”.

Our answer to this is that such an integrated system is an essential part of the new relationship between States and the rest of India resulting from the attainment of Independence by India ; that it is feasible ; and that its establishment would be in the best interests of India as a whole and also of the States.

III. FINANCIAL INTEGRATION—GENERAL PRINCIPLES FOLLOWED BY THE COMMITTEE

18. We now proceed to explain briefly the scope of federal financial integration and the general principles followed by us in preparing schemes for that purpose for individual States. Scope of federal financial integration.

19. When federal financial integration comes into effect, the following items (*inter alia*) of "Central Revenues" and "Federal" Services together with the administration of the departments concerned should be taken over from the States by the Central Government :— "Federal" Revenues and Expenditure of States to be taken over by the Centre.

CENTRAL REVENUES :—

- (1) Duties of customs including export duties.
- (2) Income-tax and Corporation tax (excluding agricultural income-tax).
- (3) Central Excises.
- (4) Railways.
- (5) Posts, Telegraphs and Telephones.
- (6) Opium (so far as regards cultivation and manufacture or sale for export).
- (7) Taxes, other than Stamps Duties, upon transactions in Stock Exchanges and "futures" markets.
- (8) Taxes on the Capital value of assets (exclusive of agricultural land) of Individuals and Companies ; and on the Capital of Companies.
- (9) Salt.

OTHER "CENTRAL" SERVICES :—

- (1) Defence. ("I.S.F." Units only).
- (2) Aviation.
- (3) Broadcasting.
- (4) Meteorology.
- (5) Archaeology.
- (6) Geological Survey.
- (7) Patents, Copyrights, Trade marks.
- (8) Registration of Joint Stock Companies.
- (9) National Highways.
- (10) Currency Coinage and Mints.
- (11) Accounts and Audit.

It will be observed that in our view federal financial integration in States involves not merely the taking over of all their "federal" revenues by the Centre, but also the assumption of all expenditure in States upon Departments and Services of a "Federal" character. The extent to which their *administration* need also immediately be taken over is a different question which we have considered separately; for the present we are concerned with making it clear that any financial integration of this kind, whether considered, as we think it should be, on the wider "functional" basis—(paragraphs 11 to 15)—or on the narrow financial basis, necessarily involves that the Centre must undertake also the financial responsibility for all expenditure of a "federal" character in the States.

Accounts
and Audit.

20. Considered strictly in terms of the Draft Constitution, Accounts and Audit need not necessarily become 'Central' by reason merely of the existing practice in the provinces, since Articles 210 and 211 of the Draft Constitution allow an option, which in principle, States are entitled to exercise, to have their own organisation in this respect, subject to the powers conferred upon the Auditor-General of India under Clause (6) of Article 210. Some States have preferred to exercise this option; and we have taken this as the basis in preparing our computations of the revenue effects of financial integration. We ourselves would prefer, however, to see the States adopting the Provincial practice in this matter. If this recommendation is carried out, our computations of the expenditure to be borne by the Central Government upon integration of federal finance will have to be suitably modified.

Further
points
difference
between
Provinces
and States.
of

21. There are, further differences between Provinces and States in the following respects :—

- (i) Most of the States derive considerable revenues from internal customs duties upon trade with the rest of India ; in Provinces, such duties are not levied.
- (ii) States maintain armed forces, portions of which are integrated with defence and security arrangements of the Central Government under a carefully devised scheme.
- (iii) States have to pay the Privy Purses of Rulers.

On these points we make our recommendations below.

Internal Customs
Duties.

22. As regards internal customs duties upon trade with the rest of India, the Sub-Committee of the Constituent Assembly on Fundamental Rights recommended that they should be abolished as they constituted a serious hindrance to trade. It was felt, however, that this reform, which was needed in the interests of the States themselves, should be effected gradually so that there might be no sudden dislocation of their finances, as the revenue derived from this source constituted a fairly

large proportion of the total revenues of some States. Accordingly, as recommended by the Fundamental Rights Sub-Committee and the Union Powers Committee and agreed to by the Constituent Assembly, the Draft Constitution provides for the total abolition of all internal customs duties within a period of ten years—Article 16 read with Article 244.

In this connection, in paragraph 88 of its Report, the Expert Committee on the Financial Provisions of Union Constitution recommended as follows :—

“ As a first step it may be arranged that—

- (1) a State shall not in future levy land customs on a commodity on which there is no such duty now ;
- (2) a State shall not after a fixed date, increase the rate on any commodity ; and
- (3) a State levying land customs should grant refunds on re-exports.

Gradual abolition over a period of 10 years should not cause any serious dislocation to the finances of these States, nor can there be any question of paying any compensation to these States, for the simple reason that the Union Government will not gain any corresponding revenue. ”

Our reviews of the position of individual States have shown that except in one or two cases there should be no difficulty whatever in abolishing these duties immediately upon the integration of federal finances in the States. In most cases, the immediate financial gains, both direct and indirect, resulting from federal financial integration, together with the estimated receipts from alternative sources of “ provincial ” revenues,—for example, Sales Tax,—and, in one or two cases, some direct financial assistance from the Centre, should enable the States concerned to replace the resultant loss of revenue in the first year following financial integration. Our intergation schemes for individual States embody recommendations to this effect. We endorse, of course, the Expert Committee’s recommendation that no compensation should be paid for the abolition of these duties in any case.

23. We referred in paragraph 21 to armed forces maintained by the States. In computing the effects of federal financial integration upon the revenues of States, we have included the cost of the I.S.F. units (*i.e.*, Units of the “ Indian States Forces ” properly so called) as an item to be borne by the Centre. These units have roles assigned to them in defence and internal security arrangements ; and their main-

Defence.

tenance should accordingly be a charge on federal revenues. This does not, of course, affect the existing arrangements for the *administration* of these forces.

The "irregular" forces maintained by States are in a different category and do not come into the computation.

Privy Purses.

24. As regards Privy Purses of Rulers, it has been urged before us by most States that the liability for paying these should be taken over by the Centre on the grounds that—

- (i) Privy Purses have been fixed by the Centre ;
- (ii) they are "political" in nature ; and
- (iii) similar payments are not made by Provinces.

Similar arguments have also been urged in regard to political payments made in some States to subordinate chiefs. This question raises constitutional and political issues on which we, as a Committee appointed to report on financial integration, are not competent to advise. We have, therefore, prepared for each State a computation of the financial adjustments required, consequent upon federal financial integration, on the basis that such payments will continue to be made by the State concerned ; but we have also indicated the lines on which these computations would require modification if the liability should be taken over by the Central Government.

"Federal" Assets and Liabilities to be taken over by the Centre.

25. So far we have dealt with the integration of "federal" Revenues and Services. There remains the question of Assets and Liabilities. We indicate below the (general principles which should govern their allocation and apportionment between the Centre and the States; more elaborate exposition of these principles and the detailed workings in accordance with them for individual States are contained in Part II of our Report.)

The main principle to be observed in the allocation of assets and liabilities between the Centre and the States is that (it should also follow the concept of "functional" division adopted as the basis for the integration of "federal" revenues, expenditure and Service Departments of the States with the Centre. Accordingly, all assets and liabilities, of whatever character, connected with "federal" revenues, expenditure and Service Departments—paragraph 19—should be taken over by the Centre; the rest, being associated with "provincial" functions, should remain with the States. No question of payment for the assets so transferred to the Centre can arise; this is dealt with more fully in paragraph 30 below.)

Whether federal financial integration should be gradual.

26. The integration of federal finances affects a wide field of functions and will have important financial and administrative repercussions upon the States. (It will be convenient, therefore, to examine at this

stage the first part of our third Term of Reference, which asks us to consider and report

“whether and, if so, the extent to which, the process of so integrating Federal Finance in the Indian States and Unions with that of the rest of India should be gradual and the manner in which it should be brought about.....”

27. Our reviews of the finances of States have convinced us that the integration of their federal finances with the Centre, *if unaccompanied by appropriate financial adjustments over a transitional period*, will in most cases cause dislocation of their finances and lowering of standards of administration which will cause discontent. The net “revenue-gaps”, *i.e.*, the net short-fall of revenues, resulting from federal financial integration are shown in the separate chapters relating to each State in Part II of our report and we do not propose to repeat the details here. It should be noted, however, that in some cases the net revenue-gaps are *negative* that is, they are favourable to the States and would require appropriate financial adjustments over a short transitional period in favour of the Central Government. The need for proceeding with financial integration cautiously is thus apparent.

We may here invite attention to the following extract from paragraph 2 of the report of the Union Powers Committee :—

“We realise that, in the matter of industrial development, the States are in varying degrees of advancement and conditions in British India and the States are in many respects dissimilar. Some of the above taxes are now regulated by agreements between the Government of India and the States. We, therefore, think that it may not be possible to impose a uniform standard of taxation throughout the Union all at once. We recommend that uniformity of taxation throughout the Units, may, for an agreed period of years after the establishment of the Union not exceeding 15, be kept in abeyance and the incidences, levy, realisation and apportionment of the above taxes in the State Units shall be subject to agreements between them and the Union Government. Provision should accordingly be made in the Constitution for implementing the above recommendation. This is in addition to the recommendations of the Sub-Committee on Fundamental Rights regarding internal customs duties.”

This recommendation has been accepted by the Constituent Assembly. But the “Draft Constitution of India” prepared by the

Drafting Committee, while inserting Article 258 in the Constitution to implement this recommendation, has reduced the maximum period from 15 to 10 years. An amendment has, however, been tabled for restoring the maximum period originally recommended by the Union Powers Committee.

Financial integration need not be gradual, if effected subject to certain transitional adjustments.

28. We have examined the whole problem, in all its bearings. In our view, however, financial integration need not itself be a gradual process; for we consider that the difficulties set out above are capable of being adequately met by appropriate devices and adjustments over a transitional period. Morespecially, we recommend as follows:—

- (1) Integration of federal finances of States with those of the Central Government should not itself be a gradual process. Subject to the temporary limitations indicated below, it should be complete in all essential respects from the outset.
- (2) Except in the case of one or two States, internal customs duties should be abolished simultaneously with the integration of federal finances; in the excepted cases, these duties may be abolished gradually over a period of three to five years (*cf.* paragraph 22 above).
- (3) The integration of all federal taxes, duties and revenues, (including Railways, Posts * and Telegraphs, Telephones and Currency and Mints) should be complete in *every respect* from the outset. In regard to other "federal" Departments and Services, however, such as Defence, Registration of Joint Stock Companies and Firms, Patents & Trade Marks, etc., their *administrative* integration with the corresponding Central Services and Departments may, in some (or all) States, be a gradual process, if so desired for administrative or other reasons; but the *financial* responsibility for (and, therefore, the *financial* control over) these Departments and Services should be assumed by the Centre in all States simultaneously with the integration of their federal finances (*cf.* paragraphs 23 above and 39 below).
- (4) In some States, Income-tax cannot immediately be imposed at the full Indian rates; in such cases, provision should be made for graduating the process in convenient stages (*cf.* paragraph 33 below).

* With the exception of the "Anchal" Service in the Travancore—Cochin Union.

- (5) During such transitional period as may be provided under Article 258, financial adjustments will be necessary between the Centre and the State Governments in order that the process of reaching complete parity with Provinces at the end of that period may not throw an undue burden upon either (cf. paragraph 32 below).

In brief, our answer to the first part of item (3) of our Terms of Reference is that we are satisfied that the process of financial integration in States should not itself be gradual ; all that is necessary is to provide for a measure of gradualness in the full effect of its impact in the directions and to the extent indicated in sub-paras (2) to (5) above; and for that purpose we regard the period of 10 years provided in Article 258 of the Draft Constitution as necessary, especially for the transitional financial adjustment between the Centre and the States proposed by us (cf. paragraph 32).

29. We shall now deal with the fourth of our Terms of Reference—

“ the results of such a policy of integrating Federal Finance upon the finances of Indian States and Unions and the consequential financial adjustments and relations which should subsist between the Governments of the Indian States and Unions on the one hand and the Government of India on the other..... ”

Financial consequences of federal financial integration.

30. A general question which arises in this connection at the very outset and to which we have devoted much attention and which we have also discussed with the Governments concerned, is whether, upon the integration of their present “ federal ” functions and finances with those of the Union of India, States are entitled to “ compensation ”, in the form of payment of market value or capital invested according to accounts,—for the “ federal ” assets transferred to the Central Government. The most important of these assets are the Railway systems in States.

No “ Compensation ” payable for “ federal ” assets passing to the Centre; but—

We have no doubt whatever that the question of compensation in this form does not arise and cannot be raised.

We shall first take the case of a State like Baroda, which is being “ merged ” in the Bombay Province. The constitutional position here is that the Ruler of Baroda, by agreement with the Dominion Government, cedes to the dominion “ full and exclusive authority and jurisdiction and powers for and in relation to the governance of the State ”. The Dominion Government thereupon takes over all the “ Federal ” or “ Central ” functions appertaining thereto and by an order under Section 290-A of the Government of India Act, 1935, as

adapted by the India (Provisional Constitution) Order, 1947, directs that Baroda State "shall be administered in all respects as if the State formed part" of the Governor's Province of Bombay. When such an order is made the Government of Bombay assumes only the "Provincial" functions in the area, with all the revenues, assets and liabilities appertaining thereto. It is obvious that there can be no question in this case of the Government of India paying compensation to the Bombay Government for any federal assets.

Essentially similar is the case in respect of States which retain their individuality. Like Baroda, before its "merger", they now have "composite" Governments, comprised of two functional entities—one with "federal" functions and the other with "provincial" functions. Complete "federal integration" means a "functional" bifurcation of these composite Governments and upon such bifurcation, the "federal" portions of the State Governments are to become integrated with the Government of the Union of India, leaving behind "provincial" State Governments with purely "provincial functions". There can, therefore, be no question of the revenues of the Union of India paying compensation of the nature indicated, to the "provincial" section of the States' Governments, when the Railways and other services which are to be "federally" administered for the benefit of the people in these areas, are taken over by the Union Government of India.

Federal integration, thus essentially involves a two-fold process,—one, of "functional partition" of the present "composite" State Governments; and the other of "merger" of the partitioned "federal" portions of the State Governments (together with the revenues, assets, liabilities and functions appropriate thereto), with the present Central Government in India (together with its corresponding resources) to constitute a *new* Government of the Union of India.

Fundamentally, it is not a case of the present Government of "British India" purchasing the Railways of "Indian States" as a commercial investment for the benefit of "British India". What is involved is a process of *pooling together* the "federal" resources of the people of the States with the "federal" resources of the people of "British India"; the result is a merger of the "federal" resources of the people of India as a whole,—that is, of the States and of "British India" alike—for administration, in the interests of all, by a new Central Government of the Union of India whose "power and authority", (together with the where withal for their exercise), are derived from all the Units. In the circumstances, no question of payment of "compensation" can obviously arise.

What we have said above in regard to Railways applies equally to all other federal assets. It logically follows, of course,

- (i) that the Centre should also take over all public debts specifically incurred in connection with such assets; appropriate liabilities to be also taken over ; and—
- (ii) that where the public debt of a State is not specifically earmarked as incurred for individual capital assets, it should be distributed between the Centre and the State in proportion to the "federal" and provincial " productive capital assets ;
- (iii) that where, apart from public debt, there is in any State, an excess of current liabilities over liquid assets, such excess should also be distributed between the Centre and the State in the same proportion as above ; and
- (iv) that, to the extent that the loss of *revenue* from those assets taken together with the loss of other "federal" revenues, as reduced by the savings in "federal" expenditure, in consequence of financial integration, is likely to cause sudden dislocation of the finances of any State, the problem will be one of necessary financial adjustments on revenue account between such State and the Centre, *i.e.*, should form part of the over-all problem of the financial consequences of the integration to be dealt with under item (4) of our Terms of Reference. dislocation of finances of States to be avoided.

We consider, therefore, that except for certain necessary financial adjustments referred to above, no "compensation" as such should be paid for any assets passing to the Centre as a result of the integration of the federal finances of the States with those of the rest of India.

31. We are equally clear that no similar question of "compensation" arises in connection with the integration of such "federal" revenues of the States as Customs duties on foreign trade, Central Excise Duties Income-tax and the like. No "compensation" payable for "federal" revenues passing to the Center

We recognise, of course, that the integration of "federal" revenues of States with those of the Centre will give rise to maladjustments in their financial position ; and the remedy for this lies in ascertaining the precise extent of the *net* over-all dislocation likely to be caused, and then providing necessary financial (revenue) adjustments between the Centre and the States, over such transitional period as may be permitted by the Union Constitution under article 258, so as to avoid such dislocation. but financial dislocation to be avoided.

Federal financial integration Schemes for individual States ; financial adjustments over transitional period.

32. For this purpose we have prepared schemes of federal financial integration for individual States based on the principle that integration should be brought about with the least dislocation of their finances. The method followed by us is briefly this :—

Firstly, the initial over-all *net* loss of revenue to the State resulting from financial integration is calculated. This represents the loss from the abolition of internal customs duties, together with the “federal” revenues which would accrue to the Centre, *minus* the “federal” expenditure to be borne by the Centre, as a result of the integration.

[For revenues, averages of the three completed financial years of the State—(in the case of *Unions* the actuals of one completed year only)—immediately preceding, integration are taken; and for expenditure, the figures of the last completed years.]

Secondly, so much of the loss as represents the revenue from internal customs duties is (except to a small extent in one or two cases) to be wholly borne by the State, in the manner already suggested in paragraph 22 above.

Thirdly, in respect of the *balance* of the loss (if any), :—

the Central Government is to guarantee the whole amount of the loss, or the share from the divisible pool of federal revenues allotted to the State,—whichever is higher,—for an initial period of five years ;

thereafter, it guarantees annually the amount of the loss diminishing by certain amounts every year until it is reduced to 60 per cent. of the initial *over-all* net loss (inclusive of the loss of internal customs duties)* in the tenth year, or the State’s share from the divisible pool of federal revenues, whichever is higher ;

there is no guarantee from the 11th year ; (if, however, the time-limit under Article 258 is extended to 15 years, the guarantee in force in the 10th year will continue from the 11th to the 15th year).

*[Note. —Where the loss from the abolition of internal customs duties itself accounts for 40 per cent. or more of the initial over-all net loss, there is no such reduction.]

In some States, there is no loss to be guaranteed in the above manner ; in other words, apart from the loss on land customs, if any, which as stated above is to be wholly borne by the States themselves, the loss on account of ‘federal’ revenues transferred to the Centre upon Financial integration is more than counterbalanced by the amount of

'federal' expenditure to be taken up by the Centre. In such cases there will be a *net profit* to the State with a corresponding burden thrown on the Centre. Our schemes for those States do not, however, provide for any transitional adjustments in favour of the Central Government, except in respect of the additional burden that will be thrown on the Centre if 'Privy Purse' is made a Central liability.

The above plan has been evolved after discussions with the Governments concerned and with due regard to the general, financial and economic position of the States. In some of the States, their present dependence upon 'federal' sources of revenue is considerable and the scope for further development of 'provincial' revenue is rather limited. In other cases, the existing volume of 'federal' revenues is negligible and it will require time to develop these as well as the provincial sources of revenue. In yet another group of case 'federal' expenditure is far greater than 'federal' revenues, so that their contribution to the Centre upon federal financial integration will be negative until the future development of 'federal' revenues is sufficient to overtake the initial unfavourable impact upon the resources of the Centre. The problem is further complicated in some cases by the considerable dependence upon revenues from internal customs duties to which we have already referred.

We are satisfied that the individual schemes prepared by us for the States, following the plan already described, provide the only practical approach to the problem in a manner which would cause the least dislocation during the transitional period and meet the variety of financial situations arising in the different States as a result of federal financial integration.

The Committee is confident that all States will agree to conform to the pattern suggested. It is difficult to forecast what the divisible pool of income-tax will be in the next ten years and what Central excises will be divided between the Centre and the units during the same period. For this reason, it is not possible to give accurately the payments that will be made by the Centre to the States in the ten years. For the same reason, it is also not possible to say whether the transition from the 10th to the 11th year, or from the 15th to the 16th (when guarantees will cease) will not be too sudden, at least in some cases; however this is a point we have especially kept in view in working out individual schemes.

33. Financial integration implies that income-tax should ordinarily be levied in all States at the same rates as in the rest of India. The Committee agrees with the very pertinent observations made in this connection by the Expert Committee on the Financial Provisions

Income-tax:—
gradual raising
of State rates
to Indian level.

of the Union Constitution in paragraphs 92 and 93 of its Report. We consider, accordingly, that income-tax should be imposed, throughout the territories the of Union of India, assessed under a common federal law and uniformly administered directly by the Centre. We think, however that the immediate application of the full Indian rates in areas in which income-tax is not now levied, or in which the rates are low, will give rise to difficult problems both to the Governments and to private interests. We have, therefore, prepared a scheme under which the present income-tax rates in the States will be raised to the level of the Indian Income-tax rates in two or three stages—taking into consideration the income-tax rates now in force, if any, and other considerations. This scheme is embodied in the Annexure to this Report ; the Annexure also deals with special transitory provisions that will be needed when income-tax is first introduced in an area or when existing rates are raised. We desire , however, to emphasise two points :—

- (i) Income-tax should be introduced in all areas as from the date of federal financial integration, the rates being adjusted to local conditions as suggested in the Annexure ;
- (ii) the assessment and collection should be made by the Central Governments's officers under the Indian Income-tax Act.

Among other advantages, the most important is that this will enable the Income-Tax Department to check evasions effectively. Income-tax is eminently a tax for Central assessment and collection, following uniform principles and technique throughout the country.

34. At this stage, we invite the attention of the Government of India to the need for taking up, as soon as possible, the revision of the existing distribution to Provinces of the proceeds from taxes in income. This was specially brought to our notice by the Government of Bombay Areas which were formerly Indian States have recently been added to the Provinces of Bombay, Bihar , Orissa, Madras, East Punjab and the Central Provinces. There are, further, the changes in the existing basis of distribution recommended by the Expert Committee on the Financial Provisions of the Union Constitution (paragraphs 50—56 of its Report).

After orders are passed on the proposals contained in our Report and financial integration takes effect in States, further revision will become necessary. In this connection , we recommend that there should be no departure whatever from accepted principles (such as may be applicable, from time to time, to Provinces) in connection with States,—neither as regards the proportion of the net proceeds of income-tax should which constitute the divisible pool, nor as regards the proportion thereof which may be allocated to individual States. And there should be no separate divisible pool for the States except where over a transitional period

Income-tax
"divisible" pool.

the rates of income-tax may (as proposed by us) be lower than the full Indian rates; some *ad hoc* temporary arrangements would be permissible in such case only.

35. We have now dealt with the fourth of our Terms of Reference. We have explained the need for financial adjustments between the Centre and the States over a transitional period and the general lines on which we have prepared schemes of integration of federal finance in States. We are confident the individual schemes are workable and such as will not cause sudden dislocation of the finances of the States concerned. We find it necessary, however, to sound a note of warning. Representatives of the Governments of States who met us referred to plans prepared in their States for prohibition, abolition of Jagirs, etc., for implementation in the near future. We hold the view that the Governments concerned should proceed in these matters with caution. We are convinced that for a number of years their finances cannot bear the losses of revenue involved and, as has been pointed out by the Government of India to Provinces, the execution of such policies will defeat the efforts now being made to check inflation.

Individual integration schemes are workable and

36. We recommend the individual schemes for sanction. We have already explained that they are equitable from the point of view of the States. We believe also that they are reasonable from the point of view of the Central Government. During the transitional period, we recommend that the general revenues of the Central Government should be entitled to a subvention from the Railway budget in view of the fact that part of the "revenue-gap" arising in States is due to the loss of railway income to them. We also recommend that an announcement should be made that, with effect from the date of integration, States will be eligible for all grants (including those referred to in Article 255 of the Draft Constitution), "subsidies", and other forms of financial and technical assistance from the Central Government on the same basis as Provinces.

equitable both to States and Centre;

37. The legal basis for these schemes is to be found in Article 258 of the Draft Constitution. They are "agreements" entered into with States as contemplated under sub-paragraph (1) of Article 258 and will come under review by the Financial Commission contemplated in Article 260 of the Draft Constitution at the expiration of five years from the commencement of the Constitution of India and thereafter every fifth year or at such other time as the President considers necessary.

their "legal" basis would be as "agreements" under Art. 258.

38. We consider that there is need for a special machinery to watch the working of the sanctioned schemes of integration. This need not take the form of a special "States Commission" such as that suggested by the Expert Committee on the Financial Provisions of the Union Constitution, in paragraph 94 of its Report. Our proposal

special machinery for watching their working.

is that, as soon as the schemes have become effective, the President of the Union should appoint a Committee whose duty will be to keep in continuous touch with the manner in which the schemes are worked and submit annual reports to the Government of India, with special reference to the following points :—

- (1) *Internal Customs*.—Whether steps are being taken for their abolition—(Paragraph 22 of this Report) ;
- (2) whether the financial arrangements in the States are organised from the outset in such a manner that the diminution of the Central guarantee from the 6th year onwards and its total withdrawal from the 11th year (or the 16th year) onwards will not have an upsetting influence on the finances—(Paragraph 32 of this Report); and
- (3) whether there is any deviation from the scheme of integration sanctioned for each State and, if so, in what respects—(cf individual schemes in Part II of our Report).

The Committee might consist of—

- (i) a member drawn from the States.
 - and (ii) } one representative each of the Ministry of States and of
 - (iii) } the Ministry of Finance,
- with a Chairman who will be a non-official gentleman selected by the President in view of his high qualifications.

Such a Committee will also be of assistance to the States in the administration of their finances.

Administrative
matters
arising out
of federal
financial
integration.

39. We now come to the second part of item (3) of our Terms of Reference, *viz.*, the question of the administrative organisation needed to give effect to our proposals. As we have already said, it is an essential feature of our scheme that the Central administrative machinery should function in States exactly in the same manner as in the Provinces, though there is no objection to the Central Government purely as a temporary measure, entrusting certain functions to the agency of States until the necessary Central personnel becomes available.

We do not think there will be any difficulty in the Central Government taking over the administration of Customs, Central excises and minor departments like Broadcasting, Telephones, etc. In regard to "Posts", Cochin and Travancore have referred to the extensive facilities provided for the rural population by the "Anchal" system and are anxious that these should not be curtailed. We have dealt with this in our Second Interim Report (relating to those States).

Nor do we think that the taking over of Railway administrations by the Centre will present difficult problems of personnel. Railway systems in States are being worked from a long time on lines more or less

similar to the railway systems under the Central Government and the bulk of the local staffs can be taken over without impairing efficiency. The taking over by the Centre of railways in States is linked up with the larger question of the regrouping of railway systems all over India. The whole subject should be considered by the Railway Board immediately, so that proposals, viewing the railway systems in India as a whole, may be worked out before the 1st April 1950.

It is in regard to Income-tax that special arrangements will be needed for the training of administrative personnel. In Cochin, Travancore, and Mysore, where Income-tax is already levied and in which there is a well-organised public service, competent staffs are available who can be taken over by the Centre. They may need a short period of training in the methods of assessment and technique of scrutinising accounts now prevalent in the Provinces of India; but that should present no special difficulty. For States in which no Income-tax is levied or the tax has only recently been introduced, special arrangements must be made at once to recruit and train staffs. Such areas are Hyderabad, the Saurashtra Union, the Madhya Bharat Union, the United State of Rajasthan, the Vindhya Pradesh Union and the Patiala and East Punjab States Union. We think that approximately 80 Income-tax probationers together with an appropriate complement of subordinate staff should be recruited immediately and trained for work in these areas. Recruitment should be made on a regional basis, as knowledge of local languages in which accounts are maintained is essential.

If, as recommended by us—paragraph 20—the Centre takes over Accounts and Audit in States, this will also require trained staffs in considerable numbers. We attach much importance to these functions being assumed by the Centre. Nothing is more essential in States than independent compilation of Accounts and an independent Audit system functioning under the Auditor-General of India and ensuring compliance with regulations and sound financial canons.

In any case, there is, in our opinion the urgent need to appoint at once a Deputy Auditor-General for States, with appropriate staff, working directly under the Auditor-General of India and in consultation with the Ministry of States, with the following immediate responsibilities, *inter alia* :

- (a) in the case of those States which may retain their own Accounts and Audit organisations, to plan the arrangement required for the efficient accounting and audit of "federal" transactions with effect from the date of federal financial integration so as to enable the Auditor-General to fulfil his statutory responsibilities in that connection ;

- (b) in the case of those States—*e.g.*, Vindhya Pradesh, Saurashtra, etc.—where it may be decided to accept our recommendation to “centralise” the Accounting and Audit of both “federal” as well as “provincial” transactions (as in the case of Provinces), to work out details of the organisation and staff that will be necessary to enable smooth transition to be made from the existing arrangements with effect from the date of federal financial integration ; and
- (c) in the case of *all Unions of States* ; immediately to report upon their present system, and its effectiveness, in the matter of
- (i) expenditure control generally ;
 - (ii) technical and administrative scrutiny of proposals for new expenditure ;
 - (iii) the nature and extent of *independent* control exercised by the Finance Department and the Chief Accounts and Audit Officer(s) ;
 - (iv) accounting and control of expenditure *at its origin*, that is, in Treasuries and Sub-treasuries and at P.W.D. and other departmental divisional offices ;
 - (v) compilation of accounts at Headquarters ;
 - (vi) progress of expenditure generally, and with special reference to sanctioned grants ;
 - (vii) Audit, particularly “appropriation” audit.

Date of
federal finan-
cial integ-
ration.

40. As regards the date from which integration should come into force, the Committee recommend that this should be the 1st of April 1950. By this time, the new Constitution of India will have been settled by the Constituent Assembly and, perhaps, already come into operation. In regard to Cochin and Travancore, however, the Committee has suggested and the Governments concerned have accepted, integration from the 17th August 1949—the commencement of their next financial year. These two States which have since merged into a United State, are now faced with complicated problems arising out of the Union and, as explained in our Second Interim Report, integration with effect from August next appears to be the best course in their case. If this be accepted, the Travancore-Cochin Union will accede also on items relating to taxation and finance comprised in Lists I and III of the Seventh Schedule of the Government of India Act, 1935, as adapted under the Indian Independence Act.

The other States will have to comply with the legal formalities, prescribed under the new Constitution. As we have already said, it will be for the Constituent Assembly to decide whether Article 225 providing for accession by States and Unions of States should be enacted or whether the Constitution should apply to States and Unions of States automatically in the same way as it applies to Provinces. If individual accession is provided for, the States will have to accede in all subjects in the Seventh Schedule, Lists I and III, in the new Constitution. The accepted schemes of integration will be agreements contemplated under Article 258. Formal agreements will, we think, have to be entered into with all the States after the enactment of the constitution, and before it comes into actual effect. The special machinery we have suggested in paragraph 38 will also have to be embodied in these agreements.

41. The plan of Part II of our Report,—in which are set out the integration schemes for individual States,—is as follows :—

- | | |
|-------------|---|
| Chapter I | Introductory. |
| Chapter II | Specific matters concerning "Federal" Revenues and "Federal" Service Departments. |
| Chapter III | Allocation of Assets and Liabilities (General). |

Then follow separate Chapters for individual States setting out the integration scheme appropriate to the facts and circumstances of each case.

The schemes already submitted by us in our First and Second Interim Reports, concerning Baroda and the Travancore-Cochin Union, respectively, are not reproduced in Part II.

Hyderabad is dealt with in a separate (supplementary) Report which will follow shortly after this Report.

42. We desire, before concluding this section of our report, to express our gratitude to the Governments of States for the assistance they have given us in the formulation of our proposals. All of them had a clear understanding of the basic principles of the Draft Constitution and co-operated with us in evolving schemes equitable to the Central Government as well as to the States. The financial proposals embodied in these schemes concern large areas and populations; and they will have effects of a lasting character upon the economy of the whole country. We are confident that the Governments concerned will work them with every desire to promote the happiness and well-being of the people of the States.

Plan of Part II of Report, containing individual integration schemes.

Federal Financial Integration will have far-reaching consequences.

IV. SUMMARY OF RECOMMENDATIONS

Summary of
Conclusions
and Recom-
mendations-

43. The Committee's main conclusions and recommendations in this Part of the Report are summarised below:—

- (1) Items (1) and (5) of the Committee's Terms of Reference having been withdrawn, this Report is concerned only with the problem of the integration of "federal finance" in States. (Paras. 1 and 2)
- (2) Close consultations with all the interests concerned have rendered possible the preparation of schemes of federal financial integration for individual States, the important features of which have been accepted by the State Governments concerned with the exception of one State. (Para. 3)
- (3) Non-viable States, and (with the exception of Baroda) those which have been "merged" into existing Provinces or integrated into new Chief Commissioners' Provinces, have not been dealt with; so also Kashmir. (Para. 4)
- (4) The new relationship established between States and the rest of India based on the 'Objectives' Resolution demands that the Central Government should have the same range of powers and authority over Provinces and States alike and function in them in the same manner through its own agency and derive the same revenues from them. Federal Financial Integration inevitably follows from this.

Financial integration is necessary and desirable on broad economic considerations as well. (Paras. 10 to 17)

- (5) When federal financial integration comes into effect, all "Central" Revenues and all "federal" Services (including Railways, Posts and Telegraphs, Telephones, and Currency and Coinage), together with the administration of the Departments concerned should be taken over by the Central Government; Accounting and Audit should also be taken over, if possible. (Paras. 19 and 20)
- (6) Except in one or two States, internal Customs duties can be totally abolished in all States simultaneously with federal financial integration; the loss of revenue will be covered by the

direct and indirect gains resulting from financial integration together with proceeds from Sales Tax. In the excepted cases the abolition of these duties should be gradual. No compensation should be paid in any case. (Para. 22)

- (7) As regards Armed Forces, financial integration should affect only the regular "Indian States Forces", properly so called; even there, it need not involve any change in the present administrative arrangements concerning them. (Para. 23)
- (8) The question whether Privy Purses should be a "Federal" or "Provincial" liability is left open, and financial integration schemes have been worked out on the assumption that the liability will continue with the States; but the modifications required, in the event of this liability being undertaken by the Centre, have been indicated. (Para. 24)
- (9) Integration of federal finance in States involves also the allocation of assets and liabilities of States between them and the Centre on a "functional" basis. (Para. 25)
- (10) The integration of federal finances in States need not be gradual; but provision should be made for a degree of gradualness in the full effect of its impact in certain directions. (Paras. 27 and 28)
- (11) No compensation should be paid for any "federal" assets (such as Railways) or revenues (such as Customs) which would pass to the Centre, or for any "rights and immunities" which would be extinguished, as a result of federal financial integration; but provision should be made for the prevention of dislocation of finances of States that may be caused by the loss to them of these sources of revenue in the manner indicated; also, public debt and other liabilities should be shared. (Paras. 30 and 31)
- (12) Financial integration schemes for individual States have been evolved upon the basis of principles which take account of their varying circumstances, the need to avoid any sudden dislocation of their finances, and the necessity to provide for smooth transition to the full "provincial" pattern in the 11th year, or the 16th year, as may be provided under article 258 of the (Draft) Constitution of India. (Para. 32)
- (13) The detailed integration schemes for individual States, except Hyderabad, are in the Committee's two Interim Reports and in Part II of this Report; that for Hyderabad

will follow in a supplementary Report. These schemes are workable. They are also equitable, both to the States and to the Centre. Their legal basis would be as "agreements" entered into with States under Article 258 of the (Draft) Constitution of India. (Paras. 41 and 35 to 37)

- (14) A Committee should be appointed to watch the working of these schemes. (Para. 38)
- (15) Income-tax should be introduced in all States (including those where there is none at present) at rates adjusted to local conditions. Its assessment and collection should be by officers of the Central Government under the Indian Income-tax Act. (Para. 33 and Annexure)
- (16) The existing distribution to Provinces of the proceeds from Income-tax needs revision; it will need further revision when federal financial integration takes effect in the States. In this respect no distinction should be made between Provinces and States. (Para. 34)
- (17) Except as regards the "Anchal" post in the Travancore-Cochin Union (for which special arrangements are needed), the regular "Indian States Forces", and some miscellaneous "federal" Service Departments, the administration of all other "federal" subjects in States should be taken over by the Centre simultaneously with the integration of federal finances. Consideration of the problems arising out of this recommendation,—staff, training, organisation etc.,—should receive immediate attention. (Paras. 39 and 23)
- (18) Financial integration should be effective from the 1st April 1950, the necessary "agreements" under Article 258 being executed before that date, after the new Constitution has been enacted. (Para. 40)
- (19) It should be announced that upon financial integration, States and Provinces will be treated alike in the matter of all grants, "subsidies", and other forms of financial and technical assistance from the Centre. (Para. 36)
- (20) During a transitional period, the general revenues of the Centre should receive a subvention from the Railway Budget. (Para. 36)
- (21) Integration of federal finances in States will have most important and far-reaching consequences; there is need, therefore, for caution in proceeding with such matters as prohibition, abolition of Jagirs, etc. (Paras. 42 and 35)

- (22) A Deputy Auditor-General for States should be immediately appointed with certain special responsibilities between now and the date of financial integration. (Paras. 39 and 20)

44. The Chairman and Shri S. K. Patil desire to place on record their warm appreciation of the help they have received from their colleague Mr. N. Dandeker. The preliminary work of the Committee—the collection of the material and its verification and the drafting of proposals as a basis for discussion—was undertaken by him with the assistance of the Secretary, Mr. G. Swaminathan. The care and thoroughness with which Mr. Dandeker carried this out has considerably lightened the labours of the Committee which has also benefitted by his knowledge of the administration of Income-tax and other Central revenues.

Acknowledgements.

The Committee also desires to record its appreciation of the work done by the Secretary, Mr. Swaminathan. He shared in the preliminary work of the Committee which was extremely arduous; and his wide and intimate knowledge of problems connected with federal and provincial finance has been of great use to the Committee.

The office staff of the Committee also performed their duties in an eminently satisfactory manner.

V. T. KRISHNAMACHARI,
Chairman.

S. K. PATIL,
Member.

G. SWAMINATHAN,
Secretary.

N. DANDEKER,
Member.

HYDERABAD HOUSE,
NEW DELHI,
Dated, the 9th July, 1949.

ANNEXURE

ANNEXURE

MEMORANDUM CONCERNING MATTERS RELATING TO TAXES
ON INCOME

I. INTRODUCTORY

1. This Memorandum deals with—

Scope of
Memoran-
dum.

- (1) The stages by which rates of Income-tax, Super-tax, and Corporation Tax in States and Unions of States may be raised to the level of the corresponding Indian rates ;
- (2) Certain technical matters which will arise when Indian Acts and Ordinances relating to “federal” taxes on income are extended to Indian States and Unions of States in consequence of the integration of their “federal” finances with those of the Centre.

2. In this Memorandum, except where the context otherwise requires, the expression—

Definitions :

- (1) “States” should be understood as including “Unions of States”, and as excluding those States whose administrations have been integrated with those of certain Provinces of India or into new Chief Commissioner’s Provinces.

States ;

- (2) “Rates of tax” should be understood to mean—

- (i) in relation to Companies, the maximum rate of Income-tax *plus* the maximum rate at which Corporation Tax is leviable upon Indian Companies in India, or upon locally registered companies in States, as the case may be;

Rates of
Tax ;

- (ii) in relation to all other assesseees, the “combined average-tax-rate curve” for Income-tax *and* Super-tax (taken together) in respect of incomes of individuals*.

“Prescribed date” means the date from which federal financial integration becomes effective.

Prescribed
date ;

- (4) “Pre-existing rates of tax” means the rates of tax in force in States on the day preceding the prescribed date ; and where there are no taxes on income in any State, it shall mean the rates of tax in force in the Saurashtra Union—the lowest scale of rates—on the day preceding the prescribed date.

Pre-existing
rates of tax ;

* Where a distinction is made—as in the Indian rates—between “earned” and “unearned” incomes, the rate relevant to the latter should be taken.

Amount of tax.

(5) "Amount of tax" means the amount of Income-tax and Corporation Tax
 ————— taken together.
 Super Tax

II. GRADUAL RAISING OF STATE RATES OF INCOME-TAX

Income-tax in States; gradual raising of State rates to Indian level;

3. On the general question of introducing income-tax in States and the stages by which State rates should be raised to the level of Indian rates, we observed in paragraph 33 of Part I of our Report as follows :—

"We consider, accordingly, that Income-tax should be imposed throughout the territories of the Union of India, assessed under a common federal law and uniformly administered directly by the Centre. We think, however, that the immediate application of the full Indian rates in areas in which Income-tax is not now levied, or in which the rates are low, will give rise to difficult problems both to the Governments and to private interests.....We desire, however, to emphasise two points :

- (i) Income-tax should be introduced in all areas as from the date of federal financial integration, the rates being adjusted to local conditions as suggested in the Annexure;
- (ii) the assessment and collection should be made by the Central Government's Officers under the Indian Income-tax Act."

States in which no income-tax levied.

4. Our first recommendation, therefore, is that in those States in which no Income-tax is now levied, it should be at once imposed with effect from 1st April 1950 or the prescribed date (whichever may be earlier), at rates not lower than the lowest pre-existing rates in the other States, viz., those of the Saurashtra Union. If the date on which Income-tax is so introduced happens to be earlier than the prescribed date, the Income-tax Act under which this is done should conform as closely as possible to the Indian Income-tax Act.

Gradual raising of pre-existing rates of Tax; relevant considerations;

5. Next, as regards the degree of gradualness required in raising the pre-existing State rates of tax to the level of Indian rates, the relevant considerations are the following :—

- (1) The pre-existing rates of tax are spread over a wide range, from those of the Saurashtra Union, which are below two-fifths of the Indian rates, to those of Cochin, which correspond to the Indian rates;

- (2) No gradualness at all being possible in the case of States which have merged into Provinces or into new Chief Commissioners' Provinces, the degree of gradualness permissible in the case of continuing States is limited to such as would cause no serious discontent among the assesseees of the former, or indeed among the assesseees of the Provinces of India generally, on the ground of "discriminatory treatment" by the Centre.
- (3) The extent to which rates of tax are, or have been, *relatively* an effective factor (or operative cause) in stimulating or retarding industrial and commercial development in *particular areas* has generally been exaggerated. This is clear from a dispassionate consideration of the following:—
- (a) Industrial and Commercial development in the Provinces of India has been more rapid, despite higher rates of taxation, than in States;
- (b) A close study of the circumstances in which certain "advanced" States out-stripped others in industrial and commercial progress shows that low rates of taxes (compared to those contemporaneously in force in the Provinces of India), or special concessions in the matter of taxation, were *not* the decisive, or even among the more important determining factors. The only exception to this is furnished by the undoubted "shift" of industry and trade to some States during the later years of the recent World War, when "legitimate tax avoidance" doubtless constituted the chief incentive for locating industries in States.
- (c) It is well known that there are ample capital resources in States, especially in those areas which have had no income-tax at all, (or have had it at very low rates, indifferently administered); nevertheless, they are precisely the areas where industrial and commercial development has been significantly low.
- (4) Income-tax is a tax on profits; and its amount is, therefore, dependent upon the amount of profits. If particular areas, being unsuited for industrial and commercial development, show low profit-returns, the tax payable is also correspondingly low. But the taxable capacity of

two or more assesseees with the *same* amount of total income cannot obviously be different. In these circumstances, the case for extending any special or discriminatory concessions to assesseees in States (by way of a generous measure of gradualness in reaching the Indian level of rates), beyond those already admissible (in respect of *new* industrial ventures) under the Indian Income-tax Act, uniformly throughout the country, is decidedly weak. Moreover, the consideration of any such claim would be beyond our terms of reference ; for it raises large and important issues of fiscal policy, *viz.*, whether special tax concessions (in the form of low rates or otherwise) can in fact effectively stimulate trade, industry and commerce, and if so, the extent to which such concessions may legitimately be confined to particular areas (including States *and* parts of Provinces, alike) for deliberately fostering industrial and commercial developments there, in the general national interest.

The considerations set out above indicate that the degree of gradualness which would be justified in this matter is far less than is commonly believed, or than we have been pressed to concede by the interests concerned. This does not mean, of course, that there should be an abrupt change-over to the full scale of Indian rates ; for in India itself those rates were reached gradually, except for the sudden spurt in 1947. Apart from this, there is the obvious necessity to avoid any serious maladjustment of private and "corporate" finance in the States, such as would result from the sudden raising of rates to a high level. This last point has two aspects :

firstly, as regards the incomes earned or accrued up to the prescribed date ;

secondly, as regards the incomes accruing thereafter

It is doubtful whether the former can be expected equitably to bear any material raising of the tax rates at all,—especially in those areas in which Income-tax was only recently introduced or in those where rates were only recently enhanced ; and as regards the latter—incomes accruing after the prescribed date—clearly a measure of gradualness in reaching the Indian level would be justified.

6. We recommend accordingly that the various pre-existing State rates of tax should be raised to the full level of Indian rates by varying stages as shown in the Table below and according to the "instructions" set out thereunder.

and the
scheme pro-
posed.

Indian assessment year, assuming 1-4-1950 to be the prescribed date	Rebate to be allowed from the amount of tax payable at Indian rates, when the pre-existing State rates of tax are :—			
	Two-fifths of the Indian rates, or less	Three-fifths of the Indian rates or less, but above two- fifths	Four-fifths of the Indian rates or less, but above three- fifths	Over four- fifths of the Indian rates
(1)	(2)	(3)	(4)	(5)
1950-51	D	D	D	D
1951-52	D	D	D	D
1952-53	40%	20%	10%	<i>Nil</i>
1953-54	20%	10%	<i>Nil</i>	
1954-55	10%	<i>Nil</i>		
1955-56	<i>Nil</i>			

INSTRUCTIONS :—

- (1) Pre-existing State rates should be grouped into four categories, *separately for Companies and "others"*—(vide paragraph 2 above)—as in Cols. (2) to (5) of the Table, with reference to the corresponding Indian rates for the assessment year in which the prescribed date falls,—(1950-51, if the prescribed date should be 1-4-1950).
- (2) In so grouping the pre-existing rates, the following principles should be observed—
 - (a) The group in which each State's pre-existing rates *substantially* fall (having due regard to their range as a whole upto, say, income groups of Rs. 5 lakhs) should be the decisive consideration. The best technique for this purpose is to draw *large-scale* graphs (on the *same* sheet) of :
 - (i) Indian rates 1950-51 (full, 80% 60% and 40% average-rate curves) ;
 - (ii) Pre-existing State rates (average-rate curves).

The appropriate group for each State's rates can then be read-off at a glance.
 - (b) Where the pre-existing rates apply to "total incomes" which include Agricultural Income (*e.g.*, Hyderabad and Travancore), such rates (other than Company rates)

should be grouped under the next *higher* groups than those to which they would otherwise belong (on a simple comparison of rates).

- (3) The grouping, once made, should be final.
- (4) The process of gradually reaching the full level of Indian rates should take the form of a gradually diminishing scale of Rebates from the amount of tax otherwise payable under the Indian law and at the full Indian rates of tax *of the assessment year concerned*. In other words, assessments would be made in complete accordance with the Indian law; and the tax so payable would first be computed according to the Indian rates for the assessment year concerned. From the amount of tax so determined, a rebate would be allowed in accordance with the scale of rebates indicated in the Table, calculated in the manner indicated in sub-paras. (5) and (6) below.

- (5) Subject to what is stated in (6) below, the rebates to be allowed should be computed as follows :—

(a) For 1950-51 } A rebate equal to the difference (shown as
and 1951-52 } "D" in the Table) between—

(i) the amount of tax payable according to the Indian law and rates for the assessment year in question, determined as above;

and

(ii) the amount of tax payable according to the pre-existing State rates applied to the total income as determined for (i)*.

(b) *For subsequent years.* A rebate of an amount, calculated at the percentage indicated in the Table, from the amount of tax otherwise payable according to the Indian law and rates for the assessment year in question.

- (6) The amount of rebate so computed under 5(a) or (b) above would be *worked down* by the factor $\frac{X}{Y}$

where Y = the total income ;

where X = the portion thereof which, had the provisions of the present section 14(2)(c) of the Indian Income-tax Act continued to be operative, would have been entitled to the exemption there provided.

* If as may happen for some income brackets in Cochin, the amount of tax payable at the pre-existing rates should exceed that payable at the Indian rates, no rebate would be admissible; and the assessment would be finalised at the Indian rates.

The resultant amount would thus be the rebate finally admissible.

7. Such a plan, read with the recommendation made in paragraph 4 above and the definitions set out in paragraph 2 above—will ensure the following :— Comments
on the
Scheme.

- (1) With effect from the prescribed date, there will be Income-tax in all States ;
- (2) the pre-existing rates will be “frozen” for the first two assessment years, thereby ensuring that all incomes earned or accrued in the States upto the prescribed dates will be assessed at the pre-existing rates ;
- (3) *thereafter*, there will be gradual assimilation of pre-existing rates to the Indian rates prevailing in the assessment year concerned, at a varying pace depending upon the divergence between the pre-existing rates and the 1950-51 Indian rates ; the pace may also vary for companies as compared with other assesseees of the same State ;
- (4) the process by which this will be achieved takes the form of a varying scale of rebates (diminishing year by year) to be allowed from the tax otherwise payable at the Indian rates. This method has three practical advantages :—
 - firstly*, simplicity;
 - secondly*, complete abandonment of any calculations by reference to pre-existing rates ;
 - thirdly*, any changes in Indian rates effected by the Finance Acts of the years concerned would have their appropriate effects upon the net tax payable by assesseees having income accruing or arising in States ;
- (5) The scheme applies only to incomes to which, but for federal financial integration, the provisions of Section 14(2) (c) of the Indian Income-tax Act would apply ; that is to say, income, profits and gains which would, in any case, be taxable at the full Indian rates will continue to be so taxed.
- (6) Taking 1st April 1950 as the prescribed date, and assuming that Indian rates of tax in 1950-51 and the pre-existing State

rates of tax remain as they are now, the periods required in accordance with our plan for gradually raising the latter to the level of the former would be as shown below :—

STATE	PERIOD OF GRADUAL- NESS IN YEARS	
	For Com. pany Rates.	For other Rates.
Cochin	2*	2*
Travancore	3	2
Mysore	2	4
Hyderabad	4	3
Patiala & E-P. States Union	2	3
Saurashtra Union	5	5
Madhya Bharat Union	5	5
Rajasthan Union	5	5
Vindhya Pradesh Union	5	5

8. We consider that the plan is simple and equitable ; that it provides the necessary measure of gradualness to the extent justifiable ; and that it will be accepted by the Governments of all States. We recommend its adoption.

III. TECHNICAL MATTERS RELATING TO INCOME-TAX

Matters
affecting
most
“federal”
subjects,
including
taxes
on income

9. Our suggestions concerning certain legal and other matters of general importance, affecting most federal subjects (including taxes on income), which will arise in connection with federal financial integration in all States, have been set out in paragraph 11 of Chapter II in Part II of our Report. Those relating to legal matters are, however, reproduced below for convenient reference :—

“(5) Apart from the *constitutional* requirements in connection with the integration of federal finances in States—*vide* paragraphs 37 and 40 of Part I of our Report—certain important issues of a legal nature will arise in connection with the actual taking over of “federal” subjects in the States by the Centre.

This is a difficult subject upon which we are not qualified to offer competent advice. We have endeavoured, however, to indicate below the main features of what we conceive will be required in order to establish “continuity of proceedings” in regard to all “federal” subjects—whether relating to revenues, expenditure or Service Departments—at the point of their transition from the States to the Centre ;

* This is merely theoretical ; effectively, Cochin rates are already at (and, for some income brackets, even above), the Indian level ; assessments will, therefore, be made at the lower of the two rates.

- (a) Almost every "federal" subject is dealt with in the States, as in the rest of India, under powers conferred by appropriate legislation consisting of relevant Codes, Acts, Ordinances and Statutory Rules and Regulations. Subject to the limitations indicated below,—which are designed to secure legal "continuity" of pending proceedings and "finality and validity" of completed proceedings under the pre-existing State legislation—, we think the whole body of State legislation relating to "federal" subjects should be repealed and the corresponding body of Central legislation extended *proprio vigore* to the States, with effect from the prescribed date or as and when the administration of particular "federal" subjects is assumed by the Centre.
- (b) For the above purpose, as well as for future "federal" administration in States, it may be necessary specifically to extend not merely the legislative, but also the executive and administrative competence of the Centre, its officers and "authorities", and the judicial authority of its Courts, to the territories of the States.
- (c) Such State Courts (except Courts of *final* appeal from orders of the State High Courts) as may in fact correspond to particular grades and classes of "British Indian" Courts (Civil and Criminal) may have to be statutorily "recongnised" as "corresponding judicial authorities" for purpose of dealing with cases arising in the States under the "federal" laws of the Union of India ; and the Supreme Court in India will have to be made the Court of final appeal from decisions of the State High Courts to the same extent as in the case of Provincial High Courts.
- (d) Those sections of the various Indian Acts and Ordinances which set out their territorial "extent of application" will require amending so as to include State territories with effect from the prescribed date.
- (e) It will be necessary to provide that all matters and proceedings pending under, or arising out of, the pre-existing State Acts shall be disposed of under *those* Acts, by so far as may be, the "corresponding authorities", (nominated by the Chief Executive Authority) under the corresponding Indian Acts."

Legal
matters
especially
concerning
Income-tax.

10. We now deal with certain other legal matters especially concerning income-tax.

- (1) The recommendation made in the last two sub-paragraphs quoted above should be understood as requiring that all income-profits and gains accruing or arising in States, of all periods which are "previous years" of the States' assessment years 1949-50 or earlier should, subject to the provisions of Section 14(2)(c) of the Indian Income-Tax Act, be assessed wholly in accordance with the States' laws and at the States' rates, respectively, appropriate to the assessment years concerned, notwithstanding that some of these "previous years" may also be the "previous years" for the Indian assessment year 1950-51. In the last mentioned cases, no Indian assessment for 1950-51 should be made in respect of such income.
- (2) As respects income, profits and gains of all subsequent periods, the assessment will be wholly in accordance with Indian law; but as regards the rates applicable to such assessments, the proposals made in Section II of this Memorandum concerning the gradual raising of State rates to the level of Indian rates should be applied.
- (3) In making assessments according to the Indian law in respect of income, profits and gains of periods referred to in sub-para. (2) above, certain transactions of the periods upto the prescribed date (which, but for federal financial integration would be outside the ambit of the Indian law), should be dealt with, if possible, *not* in accordance with Indian law but in accordance with the State law concerned. The particular transactions referred to are those covered by Act XXII of 1949 and the undermentioned provisions of the Indian Income-Tax Act,

Section 18

Section 18A

Section 23A

Section 16(1) (c) and (3)

Our intention is that the benefit of the above proposal should be restricted only to the assessment of incomes accruing in the States up to the prescribed date. This can, perhaps, best be done by executive instructions.

(4) It will be necessary appropriately to modify certain provisions of the Indian Income-tax Act for the purposes indicated below :—

(a) The definition of “British India” in Section 2(3A) of the Indian Income-tax Act will require to be so modified as to include specifically and without any antecedent limit of time, the territories of the States integrating with the Centre on federal finance. Unless this is done, it will be impossible effectively to administer the Act from the prescribed date, since many of its most important provisions *e.g.*, those relating to computation of income, have reference to the state of affairs in the “previous year”, and others, *e.g.*, those relating to “residence”, have reference to the state of affairs in several years preceding the assessment year.

There will be no danger of the suggested amendment enabling Indian assessments to be made for any year earlier than 1950-51, since the amendment of Section 1 (2) of the Act—its “extent of application”—will be effective only from the prescribed date.

(b) The provisions of Section 4 (b) (iii) of the Indian Income-tax Act will require modification in relation to States so as *not* to render taxable incomes arising without the State, (other than in the Provinces of India) in periods prior to the prescribed date and remitted *to the States in any previous year* (before or after the prescribed date), to an extent more than they would have been taxable under the State law itself.

(c) Section 14(2)(c) of the Indian Income-tax Act must be deleted in respect of States integrating on federal finance for assessment purposes with effect from the Indian assessment of periods subsequent to the “previous years” of the States’ assessment years 1949-50 ; but power should be retained for the use of the *principle* there stated in connection with the proposal gradually to simulate State rates to Indian rates set out in Section II of this Memorandum.

11. Certain other technical matters which will arise in connection with Income-tax are dealt with below :—

(1) (i) Under the Indian Income-tax Act, incomes, profits or gains accruing or arising in Indian States are not taxable in India, unless they are received in, remitted to or brought

Other Technical matters concerning Income-tax : Remittances.

into "British India", or are deemed to have accrued or arisen or been received in "British India", in the "previous year". This position must continue unchanged in respect of transactions upto the close of the "previous years" of the States' assessment years 1949-50.

- (ii) Remittances to the States from "British India" (or anywhere else) prior to the end of the "previous years" of the States' assessment years 1949-50 would have significance only in relation to the pending assessments of the States. Their relevance to the corresponding Indian assessments would be, not *qua* remittances, but only *qua* "information", e.g., as material (under Section 34) disclosing possible escape-ment of income which might (had its existence been known) have been otherwise taxable under the Indian Income-tax Act in any case.
- (iii) Funds which may be already (physically) in the States at the close of the "previous years" of the States' assessment years 1949-50 should not be treated as "remitted" to "British India" subsequently by the mere fact of financial integration or as a consequence merely of the changed definition of "British India".
- (iv) Any movement of funds to/from the States from/to the present "British India" after the end of the "previous years" of the States' assessment years 1949-50 should have no significance *qua* remittances, being merely an internal movement of funds within "British India" (as redefined). If, however, such remittances from States happen to be out of the profits accruing or arising in the States after the close of the "previous years" of the States' assessment years, 1949-50, they will be relevant for rate purposes, since, under the scheme of gradual raising of State rates set out in Section II of this Memorandum, such profits (if remitted to India) would be assessable at the full Indian rates.

We would suggest the issue of instructions in the above sense by the Central Board of Revenue at the earliest opportunity; we apprehend that in the absence of some such specific instructions there is some danger of a misunderstanding concerning this highly technical matter.

- (2) Where double-taxation has already occurred, or may (perhaps) inadvertently occur even after federal financial integration, we recommend that relief should continue to be

given in accordance with the existing D.I.T. Relief arrangements. Technically, double-taxation must necessarily occur, even after financial integration, in respect of the States' assessments for 1949-50 and earlier years, since all such assessments (whether already completed or pending at the prescribed date) will be made according to the State laws (in respect of incomes assessable in States), and according to the Indian law (in respect of incomes assessable in "British India" as at present defined); in all such cases suitable arrangements will have to be made for granting relief promptly (if double-taxation has already occurred), or for giving credit for the amount of relief due (if double-taxation is liable to occur) in connection with pending assessments.

- (3) (a) We recommend that all taxation immunities now enjoyed by (1) Rulers, and (2) Political pensioners (former subordinate Chiefs) should be protected. A list of such persons, the amounts involved and the exact nature and terms of the immunities enjoyed by them should be furnished by the States to the Central Government.

Immunities
from
Taxation:

So far as the *Rulers*, (and their successors) are concerned, the problem is largely political and should be settled on that basis; but broadly speaking, what is involved is—

Rulers ;

- (i) the continuance of the immunities from "federal" taxation which they now enjoy in "British India", with the *addition* that their privy purse shall also be totally exempt from taxation (by outright exclusion from "total income");
- (ii) the continuance of the immunities from "federal" taxation which they *now* enjoy in the States, with the *limitation* that such immunities should be restricted to their incomes from such *present sources* only (including properties) as may be declared to be their "Personal and Private Property".

As regards *Political Pensioners*, our recommendation involves the continuance of the immunities from "federal" taxation which they now enjoy in the States, with the *limitation* that such immunities will extend only during the life-time of the present incumbents, *unless* it be that similar political pensioners in India enjoy perpetual immunity from the "federal" taxation.

Political
pensioners ;

Industrial
Corporations ;

(b) With regard to any *Industrial Corporations* now in enjoyment of such immunities, it will be necessary to examine the principal items of the taxation concessions granted to them. Each case must be dealt with on merits, the general objective being to continue in their favour for some reasonable period, not exceeding ten (or fifteen) years, the existing concessions, if they happen to be more favourable than those admissible under the Indian Income-tax Act itself (*e.g.*, in the case of newly established industrial enterprises).

State Gov-
ernment's
Immunity
from
"Federal"
Taxation ;

(c) Industrial and Commercial enterprises wholly owned and operated by States at present enjoy immunity from federal taxation *within* their respective territories. As regards the incomes, if any, accruing or arising to these enterprises within "British India", however, their liability to Indian Income-tax and other federal taxes is governed by the Government Trading Taxation Act, 1926, which provides that they shall be chargeable in respect of such income,

(i) to Income-tax, as if they were "companies";

(ii) to any other tax, as if they were "individuals" or "associations of individuals".

In other words, their position in respect of liability to federal taxation is not dissimilar to that of Provinces under Section 155 (1) of the Govt. of India Act, 1935. If, therefore, federal financial integration in respect of any State should become effective under the present Govt. of India Act, no special difficulty will arise, since the present degree of immunity will effectively continue under Section 155(1) of that Act.

But Article 266 of the Draft Constitution will, if enacted, introduce a radical change; it will make the income of such enterprises liable to federal taxation, irrespective of the place ("within the territory of India") of its accrual. This is subject only to the very limited exemption contained in the "Explanation" to Article 266. The problem so arising will, however, affect not only the Indian States and Unions, but also the Provinces; and we have no doubt it will accordingly be examined in all its bearings in the Constituent Assembly of India before this Article is enacted into Law. It is not, therefore, necessary (nor, perhaps, would it be

proper) for us to express any opinion on the merits of the proposed Article 266 of the Draft Constitution. We cannot, however, overlook the fact that if it should be enacted in its present form, it will have adverse consequences upon the finances of Indian States, to the extent that they are now dependent upon the tax-free income from those enterprises; in some States such income is considerable:

We recommend, therefore, that should Article 266 be enacted in its present form, the *existing* State-owned and operated enterprises should be exempted from federal taxes on income to the extent to which they *now* enjoy such immunity in the States and under the Government Trading Taxation Act, 1926, in "British India".

(d) If the continuance of any of the immunities referred to in the preceding sub-paragraphs cannot (as we think) be ensured by executive instructions or statutory (exemption) Notifications, necessary powers should be taken by appropriate legislation.

(4) Except in Travancore, there is no Income-tax Investigation Commission in any State. Should the Travancore Commission still be functioning at the time of federal financial integration, all cases pending with it should be taken over by the Indian Commission. The disposal of those cases will, however, (as in the case of pending assessments) have to be in accordance with the pre-existing Travancore Law.

Income-tax
Investi-
gation
Commission

The Indian Commission has already the power to call for such information as it may require from any person—including Banks—in the States. This power has been conferred upon it by legislation recently passed in the States. It will be for the Commission to decide whether such State legislation should be replaced by the Indian Acts under which it functions in the Provinces of India; if so, the Indian Acts should be extended in their territorial application to include the States also.

No State assessments (other than those already under investigation in Travancore) should be referred for investigation to the Indian Commission, since all such assessments of 1949-50 or earlier years and, therefore, all cases of evasion in States in those years, would be governed by the laws of the States.

Collections under "PAYE" and "provisional" assessment schemes.

- (5) There should be no financial adjustments between the Centre and the States in respect of collections made by the States before the prescribed date under provisions of the State Laws corresponding to those of the Indian Income-tax Act in regard to "advance payment" of tax under the "Pay-as-you-Earn" Scheme, or "provisional assessment" of tax in anticipation of final assessments. But credit for such collections should be given to the assessee concerned in the ordinary way when their relevant final assessments are made by officers of the Central Government after the prescribed date.

Income-tax "Divisible Pool";

- (6) We have dealt with the "divisible pool" of Income-tax in paragraph 34 of Part I of our Report, which is reproduced below for convenient reference:—

"At this stage, we invite the attention of the Government of India to the need for taking up, as soon as possible, the revision of the existing distribution to Provinces of the proceeds from taxes on income. This was specially brought to our notice by the Government of Bombay. Areas which were formerly Indian States have recently been added to the Provinces of Bombay, Bihar, Orissa, Madras, East Punjab and the Central Provinces. There are, further, the changes in the existing basis of distribution recommended by the Expert Committee on the Financial Provisions of the Union Constitution (paragraph 50-56 of its Report).

After orders are passed on the proposals contained in our Report and financial integration takes effect in States, further revision will become necessary. In this connection, we recommend that there should be no departure whatever from accepted principles (such as may be applicable, from time to time, to provinces) in connection with States, neither as regards the proportion of the net proceeds of income-tax which should constitute the divisible pool, nor as regards the proportion thereof which may be allocated to individual States. And there should be no separate divisible pool for the States, except, where over a transitional period, the rates of income-tax may (as proposed by us) be lower than the full Indian rates; some *ad hoc* temporary arrangements would be permissible in such cases only."

"Royalties" computed by reference to Profits.

- (7) In some of the covenanting States of Rajasthan Union a system of "Royalties" is in force in connection with certain industrial enterprises; similar arrangement may exist in other States also. These, in so far as the "Royalties" are

computed by reference to the *profits* of such concerns, should be dealt with as follows :—

“Royalties” computed by reference to income or profits are of the nature of taxes on income and so cannot continue to be imposed by the States after federal financial integration becomes effective. After the prescribed date, they will be substituted by income-tax in the ordinary sense. The bearing of this upon any pre-existing concessions in the matter of “income-tax” will require careful consideration, for it may well be that the conversion of such Royalties into “federal” income-tax may render the continuance of any of the pre-existing concessions superfluous.

Any profit-sharing arrangements between States and particular industrial concerns, *after* payment of “federal” taxes on income, will of course remain unaffected by what has been said above.

IV. OTHER TAXES ON INCOME AND TAXES ON CAPITAL, ETC.

12. (1) Excess Profits Tax has been abolished in all States where it was originally levied, but there may be some cases still pending under the old State Excess Profits Tax Acts. They will have to be disposed of by officers of the Central Government in the same manner as pending cases under the Indian E.P.T. Act ; the law and rates applicable will, however, be those of the States concerned.

Excess
Profits
Tax.

Liability to the assesseees in respect of returnable E.P.T. deposits and in connection with any refundable portion of the E.P.T. previously levied by the States will have to be taken over by the Centre ; similarly the liability to give credit for collections made against “provisional” assessments.

In any State in which there was no Excess Profits Tax but only Excess Profits Deposits, the most practical arrangement would be to leave it to such States to return these Deposits to the persons concerned in accordance with the pre-existing Laws.

(2) As Capital Gains Tax has been abolished in India, there will be no question of levying such a tax in respect of capital gains accruing in States prior to the prescribed date.

Capital
Gains Tax.

(3) We recommend that the commencing date of first chargeable period for purposes of Business Profits Tax should be the prescribed date.

Business
Profits
Tax.

**Industrial
Profits
Tax.**

(4) In one of the Covenantee States of the Madhya Bharat Union—Indore—there used to be levied a tax described as “Industrial Profits Tax” on the income of certain industrial enterprises. It is understood that with the formation of the Madhya Bharat Union, the imposition of this tax has been discontinued ; but there are still several pending cases to be disposed of. These will have to be taken over by the Centre and disposed of (in the same way as pending income-tax cases) in accordance with the pre-existing law of the Indore State. Should there be any portion of this tax which is “returnable” to the assesseees, the liability in this respect should be dealt with in the manner suggested above in connection with the liability for the refundable portion of E.P.T.

**Bikaner
“Income-
tax”.**

(5) In one of the Covenantee States of the Rajasthan Union—Bikaner—there is levied a tax, described as “Income-Tax”, at 12½% on the net profit of ‘minor’ factories. This tax will have to be discontinued as from the date preceding the date of federal financial integration, if it is not already discontinued before that date. The pending cases, if any, will have to be taken over by the Centre and disposed of in accordance with the pre-existing law of the Bikaner States. Should there be any portion of this tax which is “returnable” to the assesseees, the liability in this respect should be dealt with as suggested in connection with the liability for the refundable portion of E.P.T.

**Other
Federal
Taxes.**

(6) There is no Estate Duty in any State nor is there any taxation on the capital value of assets (exclusive of agricultural land) of individuals and companies or on the Capital of companies. These are federal taxes ; accordingly, if and when they are imposed by the Centre, they will be leviable in the States in the same way as in Provinces and their distribution will also be governed by similar principles for States as for Provinces.

V. SUMMARY

13. The Committee's main conclusions and recommendations in respect of the matters dealt with in this Memorandum are summarised below :-

Summary of
recommend-
ations.

- (1) Income-tax should be imposed in all States under a common "federal" law and should be administered by the Centre ; but the immediate application of full Indian rates will give rise to difficult problems in some States . (Para. 3)
- (2) In States where there is no Income-tax at present, it should be imposed from 1st April, 1950, or the date from which federal financial integration becomes effective (whichever may be earlier) at rates not lower than the pre-existing rates of the Saurashtra Union. (Para. 4)
- (3) The wide range of pre-existing State rates compared with the Indian rates, and the need to avoid any sudden dislocation of private and " corporate" finance in States, such as would result from the immediate imposition of the full Indian rates of tax, necessitates a certain measure of gradualness in reaching the Indian level of rates ; but the degree of gradualness required is far less than is commonly believed. (Para. 5)
- (4) We have worked out a scheme which embodies the principle of gradualness, to the extent we consider justifiable. (Para.6)
- (5) The essential features of the scheme are the initial imposition of income-tax in all States, the " freezing" of pre-existing rates for two assessment years, thereby ensuring *inter alia* the taxation of incomes earned upto the prescribed date at pre-existing rates, and thereafter the gradual assimilation of pre-existing rates to Indian rates. Incomes which would, in any case, have been chargeable at the full Indian rates, would continue to be so charged. The procedure suggested is simple, abandons (after the first two years) all calculations with reference to the pre-existing rates, and takes account automatically of changes in Indian rates effected by the annual Finance Acts. The whole process requires a period of three to six years only, depending upon the level of pre-existing rates. (Paras 7 and 8)

- (6) Certain matters of general importance affecting all "federal" subjects have been dealt with in paragraph 11 of Chapter II in Part II of our Report ; the suggestions made there relating to legal matters are reproduced in this Memorandum. (Para. 9)
- (7) We have also dealt with certain further legal matters *especially* concerning Income-tax. (Para. 10)
- (8) Important technical problems arise in connection with Income tax; concerning remittances, Double Income-tax Relief, "Immunities" from Taxation (in respect of Rulers, Political Pensioners, Industrial Corporations and States Governments), Powers of the India Income-tax Investigation Commission, cases now pending with the similar Commission of Travancore, treatment of collections made by the States by way of "advance payment" under the "Pay—you—Earn" Scheme or by "provisional assessment" of tax in anticipation of final assessment, revision of the arrangements connected with the "divisible pool" of Income-tax, and treatment of "Royalties" on Income levied in certain States. We have dealt with all these. (Para. 11).
- (9) Cases pending under the Excess Profits Tax Acts of States should be disposed of, according to the law and rates of the State concerned, by officers of the Central Government. The Centre must assume liability in respect of returnable E.P.T. deposits, refundable portion of the E.P.T. previously levied, and for giving credit for collections made against "provisional" E.P.T. assessments ; but where there was no E.P. Tax but only E.P. Deposits, it should be left to the States concerned to return such deposits in accordance with the pre-existing laws.

Capital Gains Tax should not be levied in respect of capital gains accruing prior to federal financial integration.

The commencing date of the first "chargeable" period for purposes of Business Profits Tax should be the date of federal financial integration.

Pending cases under the Industrial Profits Tax Acts of the former Indore State (now included in Madhya Bharat Union) should be taken over by the Centre and disposed of, in the same way as pending Income-tax cases in accordance with the pre-existing law of that State. The liability in

respect of any "returnable" portion of this tax should be dealt with in the same manner as the liability for the refundable portion of E.P.T.

"Income-tax" levied on 'minor' factories in Bikaner State (now included in Rajasthan Union) should be discontinued as from the date preceding the date of federal financial integration, if it is not already discontinued before that date. Pending cases, if any, should be taken over by the Centre and disposed of in accordance with the pre-existing Bikaner law. The liability in respect of any "returnable" portion of this tax should be dealt with in the same manner as the liability for the refundable portion of E.P.T.

If and when Estate duty, or any taxes on the capital value of assets (exclusive of agricultural land) of individuals and companies, or on the Capital of companies, are imposed by the Centre, they would be leviable in the States in the same way as in Provinces and their distribution should be governed by similar principles for States as for Provinces. (Para. 12)

APPENDIX

I

GOVERNMENT OF INDIA
MINISTRY OF STATES
RESOLUTION

New Delhi, the 22nd October 1948

No. F.60-IB/48.—Pursuant to the decisions reached at a Conference which was attended by representatives of Indian States, Unions of States and Provinces, the Government of India have decided that the loss, resulting from the sale of imported foodgrains in Indian States and Unions of States at prices fixed by the Government of India, should be shared equally between the Governments of the States and Unions concerned and the Central Government. The Government of India have been pleased to grant this subsidy in addition to the bonus which they have already agreed to pay to the Governments of Indian States and Unions, exactly as in the case of Provinces, in respect of foodgrains procured in the States and Unions or exported by them to other parts of the country. This arrangement will hold good for the present till 31st March, 1949.

2. During the course of the discussions at the Conference referred to above, the financial position consequent upon the integration of certain States into Unions of States came under review. There was general agreement that the existing taxation and financial structure in the Unions should be examined by a Committee of Experts, who should also make proposals regarding the sources and levels of taxation in the Unions, and the methods and machinery for their imposition, assessment and collection, having due regard to the requirements of modern standards of administration. It was, moreover, agreed that such an enquiry could, with advantage, be extended to the States which had not merged into Unions.

It was further agreed that the proposed Committee of Enquiry could also usefully consider and make recommendations concerning the question whether the States and Unions of States should not, in financial matters, be brought into a position similar to that of the Provinces, so that there might eventually emerge a uniform system of federal finance throughout India, and if so, to suggest the manner in which such an objective could best be achieved.

3. The Government of India have, after careful consideration, accepted these decisions; they are satisfied that an enquiry of the kind agreed to at the Conference would be in the best interests not only of the States and Unions, but also of the country as a whole

They have accordingly decided to constitute a Committee of Expert to enquire into the finances of Indian States and Unions of States, with the following Terms of Reference :—

“ To examine and report upon :

- (1) the present structure of Public Finance in Indian States and Unions of States ;
- (2) the desirability and feasibility of integrating Federal Finance in Indian States and Unions of States with that of the rest of India, to the end that a uniform system of Federal Finance may be established throughout the Dominion of India ;
- (3) whether, and if so, the extent to which, the process of so integrating Federal Finance in the Indian States and Unions with that of the rest of India should be gradual and the manner in which it should be brought about ; and the machinery required for this purpose, especially as regards the legislative groundwork and the administrative organisation necessary for the imposition, assessment and collection of Federal Taxes ;
- (4) the results of such a policy of integrating Federal Finance upon the finances of Indian States and Unions and the consequential financial adjustments and relations which should subsist between the Governments of the Indian States and Unions on the one hand and the Government of India on the other ;
- (5) the measures which the Committee may consider necessary and/or desirable for revising, in the light of present day conditions and standards and having regard to the requirements of modern administration, the structure of Provincial Finance and, in particular, the levels and sources of Provincial Revenues in Indian States and Unions of States ;
- (6) any other consequential and/or cognate matters which the Committee may consider as arising out of the foregoing Terms of Reference”.

4. The Government of India are pleased to appoint the following gentlemen as Members of the Committee.

Chairman.—Sir V. T. Krishnamachari, K.C.S.I., K.C.I.E., Diwan, Jaipur State.

Member.—Shri S. K. Patil, Member of the Constituent Assembly of India.

Member.—Mr. N. Dandekar, I.C.S.

The Government of India have no doubt that the Governments of all States and Unions of States will afford all facilities and assistance to the Committee in conducting the Enquiry. It is hoped that the Committee will complete its work before the end of April 1949.

M. K. VELLODI, Secy.

II

Letter dated the 10th April 1949 from the Ministry of States to the Indian States Finances Enquiry Committee, New Delhi.

With reference to your letter No. FM/I.S.F.E.C./48 dated the 10th March 1949, I am directed to say that the Government of India accept the recommendation of the Committee that matters covered by their Terms of Reference Nos. 1 and 5 should be excluded from the scope of their enquiry.