

EVOLUTION OF FINANCIAL RELATIONS BETWEEN THE CENTRE AND THE STATES

Four periods.—For the purposes of our review the history of financial relations between the Centre and the States in India may be divided broadly into four periods: the period of about sixty years before the coming into effect of the Government of India Act, 1919; the period from 1st April 1921 to 31st March 1937, during which the Government of India Act, 1919, remained in force; the period covered by the Government of India Act, 1935, namely, from 1st April 1937 to the coming into force of the Constitution of India in early 1950; and the period subsequent to the commencement of the Constitution.

FIRST PERIOD

2. *Financial Devolution and "Divided Heads".*—The first period witnessed a gradual process of progressive devolution of financial authority from the Central Government to the Provincial Governments. In the earlier stages of this period, the system of government was highly centralised and the Central Government retained complete control over provincial revenue and expenditure. The financial authority of Provinces was enlarged, at first through fixed grants for the upkeep of definite services and later by the transfer to them of the whole or part of specified heads of revenue, to stimulate their interest in collections as well as to encourage economy in expenditure. Thus developed a system of allocation known as "provincial financial settlements". The settlements, to start with, were reviewed quinquennially but were later made quasi-permanent and then permanent in 1912. Of particular interest in these arrangements was the system of "divided heads" of revenue evolved by gradual stages. Under the system, the Centre retained the entire profits of the commercial departments and the proceeds of revenue whose *locale* was no guide to its true incidence, such as the net receipts from customs, salt and opium. As the income derived from these sources was not sufficient to cover the central expenditure, other sources of revenue including income-tax were divided between the Central and Provincial Governments. The Central Government retained a proportion—fixed in the case of each Province, but not uniform as between the Provinces—of the proceeds of the main heads of revenue collected in the Provinces, based on an assessment of the respective needs of the Provinces. In practice, since no definite standards of needs had been evolved, allocations to the Provinces were largely a result of history. The revenue from "divided heads", being insufficient to meet

the needs of the Provincial Governments, was supplemented by means of fixed cash assignments, recurring as well as non-recurring, which continued to remain an important feature of the system.

SECOND PERIOD

3. *Separation of Sources of Revenue.*—The Montagu-Chelmsford Report on Constitutional Reforms, which led to the passing of the Government of India Act, 1919, sought to secure for the Provinces a greater measure of financial autonomy by abolishing the “divided heads” and effecting a complete separation between the central and provincial heads of revenue. At the time the heads which were divided in all or some of the Provinces were land revenue, stamps, excises, income-tax and irrigation receipts. Of these, income-tax and general (or commercial) stamps were to be made entirely central receipts; and excise, judicial stamps, land revenue and irrigation receipts were to be given wholly to the Provinces. With all sources of revenue completely distributed on the lines proposed, it was estimated that there would remain a large deficit in the Government of India budget. This led to the proposal in the Report that the Provinces should make contributions to the Government of India.

4. *Provincial Contributions.*—The Financial Relations Committee presided over by Lord Meston was appointed to advise on the amounts of provincial contributions, and also on the claims of Bombay to a share of the proceeds of income-tax. The Meston Committee reported in March 1920. While recognising that it would not be possible permanently to exclude Provincial Governments from some form of direct taxation upon the industrial and commercial earnings of their people, the Committee advised against the division of income-tax with the Provinces. They recommended that general stamps be made provincial for financial and administrative reasons. The Committee proposed a scheme of initial contributions and of standard contributions to be attained over a period of seven years. The standard contributions, which were based on the relative taxable capacity of the Provinces and other economic factors, never came into operation. The initial contributions were computed on the increased spending power of each Province resulting from the new scheme of distribution, i.e., the additional income which each Province would acquire on the separation of the sources of revenue. The scheme of contributions was subjected to criticism from various quarters. Some Provinces disliked the initial contributions, others the standard contributions, and industrial Provinces like Bombay were opposed to the whole basis of the revised scheme. The Joint Select Committee of Parliament on Draft Rules made under the Government of India Act, 1919, suggested a gradual reduction of the aggregate contribution of all Provinces and underlined the idea that contributions should cease at the earliest possible moment.

5. The Committee were definitely opposed to provincialising income-tax but recommended that some share in the growth of revenue from taxation of income should be granted to all Provinces in so far as that growth was attributable to an increase in the amount of incomes assessed in each Province. The scheme of financial arrangements contained in the Report on Indian Constitutional Reforms, as modified on the recommendations of the Joint Select Committee on Draft Rules, was incorporated in the Devolution Rules under the Government of India Act, 1919, which were promulgated in December 1920.

6. *Beginnings of Income-tax as Balancing Factor: Devolution Rule 15.*—The recommendations of the Joint Select Committee relating to income-tax were embodied in Devolution Rules 14 and 15. Rule 15 provided that a Province should receive 3 pies in each rupee of the amount by which the assessed income of any year exceeded that of the year 1920-21. Inasmuch as collection might not accurately reflect the income-tax revenue due to the economic activity of a Province, some *ad hoc* adjustments were made on account of industrial units located in a Province different from the Province in which they were assessed to income-tax. The operation of the rule gave unequal results as between Provinces. It did not lead, on the whole, to any significant accretion to provincial revenues and, in particular, virtually failed to secure for the larger industrial Provinces a share in the yield of income-tax. The rule, however, represented a slight departure in principle from the scheme of complete division of sources originally proposed, and thus marked the beginning of the use of income-tax as a balancing factor.

7. *Abolition of Contributions.*—The trends in central and provincial budgets in the early twenties belied the estimates on which the schemes of contributions was based. The Provinces pressed insistently for the abolition of contributions. They were remitted over a period, were wholly suspended from 1927-28 and were abolished from 1928-29. The abolition of the contributions considerably eased the situation of the agricultural provinces which had the largest contributions to make.

8. *Defects of Financial Settlement: Enquiries with a view to Revision.*—Two main criticisms were made against the general scheme of financial relations under the "Reforms" of 1919, which is often somewhat inaptly described as the Meston Settlement. While the needs in the provincial field were of an expanding nature, the sources of revenue assigned to the Provinces were relatively inelastic; on the other hand, the more elastic and expanding sources of revenue were given to the Centre whose needs were then viewed as comparatively stationary. Secondly, while agricultural Provinces received a welcome accession of resources in land revenue which, of all the central

and provincial heads, was the most important at the time, the revenues of industrial Provinces were precluded from benefiting by the prosperity of business enterprise in their areas.

9. The framework set up in 1919, however, remained unaltered till the Government of India Act, 1935, came into operation. The period covered by the Government of India Act, 1919, was marked by frequent discussions on the structure of financial relations between the Centre and the units. A principal objective of these discussions was to equip the Provincial Governments with greater financial resources. The inadequacy of the existing resources, both of the Centre and the units, and a search for fresh avenues of taxation, also represented a thread running through the discussions. During this period there was also the first systematic enquiry into the whole field of Indian taxation by the Indian Taxation Enquiry Committee, 1924-25.

10. *Indian Taxation Enquiry Committee, 1924-25.*—The Indian Taxation Enquiry Committee examined, among other matters, the division of sources of revenue and the structure of financial relations between the Centre and the Provinces. They recommended that general stamps and the excise duty on foreign liquors manufactured in the country should be transferred to the Centre, and also suggested that the whole of the revenue from opium might well be transferred similarly. They considered that if any division of taxes was to be made at all, the choice of income-tax as the main balancing factor was inevitable. The other possible balancing factors which, however, they thought should be used only in the last resort, were the export duties, the restrictive excises, besides those on opium and foreign liquor, and the probate duties.

11. The Committee expressed themselves against giving the Provinces power to levy and administer an income-tax as well as against the imposition by the Centre of surcharges for the benefit of the Provinces. They suggested that the most appropriate solution for this problem was the assignment to the Provinces of a share of the tax. In regard to its distribution, the Committee proposed that this should be based primarily on the principle of domicile. They proposed to give the Provinces the proceeds of a basic rate on personal incomes, graduated proportionally to the general rate. Under their scheme, collections on incomes not pertaining to residents in particular Provinces such as the tax on undistributed dividends of companies or on incomes of persons resident outside the Province or the country and the whole of super-tax would be retained by the Centre. In addition to the allotment made on the basis of personal incomes, the allocation of which would be based entirely on domicile, the Committee also recommended the giving of a partial recognition to the principle of origin by assigning to each Province a small portion of the receipts of the corporation profits tax. They contemplated that this might be

distributed on the basis of the collections of each Province, subject to adjustments similar to those agreed upon for the purpose of the distribution of income-tax under Devolution Rule 15, in cases where profits assessed in one Province originated in another.

12. *Indian Statutory Commission Report, 1930.*—The next important review of the Indian financial arrangements was made by the Indian Statutory Commission, whose report was issued in 1930. The Commission accepted the general principles of the scheme drawn up by their Financial Assessor, Sir Walter (now Lord) Layton, for the division of resources between the Central and Provincial Governments. Lord Layton envisaged the use of income-tax as the main balancing factor in the reallocation of revenues between the Centre and the Provinces. He suggested that in order to meet the claim of the industrial Provinces a substantial part of the revenue from income-tax should be assigned to the Provinces. He endorsed the general method of division proposed by the Taxation Enquiry Committee and recommended that one-half of the income-tax paid by residents of a Province (including tax on dividends received by them from companies carrying on operations outside the Province) be assigned to the Province concerned. Super-tax would remain entirely Central, subject to reconsideration after ten years. The Provincial Governments were also to have the option of levying a surcharge on tax collected on the incomes of residents in the Province limited to half the tax transferred to them, i.e., one-fourth of the total tax. The Commission also suggested that the exemption of agricultural incomes from income-tax should be abolished by definite stages and the whole of the proceeds of the taxation of these incomes should be assigned to the Province of origin.

13. Lord Layton further recommended that a Provincial Fund be formed out of the proceeds of certain new excises on such commodities as cigarettes and matches and, when the central budgetary position permitted, the duty on salt, for distribution among the Provinces on a *per capita* basis. The Commission endorsed this proposal.

14. *First Peel Committee, 1931.*—The problem of allocation of resources between the Centre and the units came up again for consideration by two sub-committees of the Federal Structure Committee of the Second and Third Round Table Conferences, both of them presided over by Viscount Peel, and by an Expert Committee presided over by Lord Percy, which came in between. The First Peel Committee suggested that all income-tax proceeds should be transferred to the Provinces at the very outset of federation, collection and administration being in federal hands: federal tax revenues would be mostly derived from indirect taxation. Any resultant federal deficit could be met from provincial contributions which would be extinguished in definite stages over a ten to fifteen year period. Later, if

any permanent federal surplus were to materialise, the federal government should be free to allocate the surplus to the units as an alternative preferable to reduction of taxation. The Committee suggested that it was desirable that the Constitution itself should lay down the proportions in which funds thus available should be divided among the units, whether according to respective revenues or to population or to some other criteria. They recommended that an expert committee should advise on this aspect as well as on the criteria by which the proceeds of income-tax should be allocated among the Provinces.

15. *Percy Committee, 1932.*—The Percy Committee were accordingly appointed to examine these questions. The basis of distribution of income-tax among the units was considered in detail by this Committee. They held that a proper basis of distribution of income-tax receipts should satisfy what they called three fundamental tests: it should be simple, easily understood and administratively workable; it should give results likely to be accepted as fair between Province and Province; and it should be compatible with the idea of a federation of autonomous units. They considered that an allocation on the basis of collections would lead to gross injustice as between Province and Province and ruled it out. While distribution by population had equally no scientific basis it could be adopted with advantage for the distribution of taxes on certain forms of income not easily assignable to any locality. Theoretically, the basis of origin had much to commend it, but it would be administratively unworkable unless the allocations were made on arbitrary lines. The Committee did not, therefore, recommend the adoption of this basis. Ultimately, they expressed themselves in favour of the basis of residence in one of two forms, either the basis of personal incomes assessed or assessable in each Province or the amount of income-tax attributable to each Province.

16. On the question of distribution of income-tax between the Centre and the Provinces, the Percy Committee expressed the view that if the entire proceeds of income-tax were transferred, the Centre would be faced with a substantial deficit. They, therefore, proposed the following scheme: corporation tax (super-tax on companies), tax paid by residents in federally administered areas and tax paid on salaries of federal officers should be retained by the Centre; of the remainder of the net proceeds, a Province should receive the amount of personal super-tax on the basis of collections from residents, an estimated amount of personal income-tax creditable to it, and a share on the basis of population of the tax on non-residents and undistributed profits of companies, both to be taken as an estimated percentage of the total collections. From the point of view of stability of provincial budgets they suggested that the share of income-tax due to the Provinces should not be altered from year to year even if the data for this were readily available on the bases suggested by them, but should

be fixed for a term of years, subject to revision every five years in the light of figures of personal income-tax for the previous quinquennium. For a transitional period, provincial contributions were proposed, primarily with reference to the additional resources of Provincial Governments, i.e., generally in proportion to the share of income-tax. The federal government would have the power to impose a surcharge, for its own purposes, on any tax levied by it for the benefit of the Provinces. Federal grants, if and when they became feasible, should be made on a population basis as the Committee believed that the surplus would arise mostly from taxes on consumption.

17. *Second Peel Committee, 1932.*—The Second Peel Committee proposed a two-fold division of the proceeds of taxes on income into shares which would be assigned as a permanent constitutional arrangement to the federal government and to the Provinces respectively. The federal government would be entitled to a share based on the proceeds of heads of tax which were not derived solely from the residents in British India, such as corporation tax, tax on federal officers, tax in federal areas, tax on Government of India securities and taxes on the incomes of persons not resident in British India. The whole of the remaining proceeds from income-tax were to be assigned to the Provinces, but until sufficient time had elapsed for the development of new sources of revenue, the federal government should retain a block amount out of the provincial share of income-tax. The Committee as a whole were in favour of the federal government having the power to levy for its own purposes a surcharge on the heads of income-tax permanently assigned to the Provinces. Most of the members of the Committee were also agreed that the Provinces should have a right to levy a surcharge on the personal tax levied on its residents under the heads permanently allocated to the Provinces, subject to a maximum of 12½ per cent. The Committee also proposed subventions from the Centre to the deficit Provinces in approved cases and on certain conditions, to enable them to balance their budgets on the basis of providing for bare necessities. The Committee suggested that the exceptional difficulties of Bengal might perhaps be met by granting it some share in the revenue from the jute export duty, but made no definite proposal as to the form which this share should take. They thought that it was desirable to provide in the constitution for emergency powers for the federal government to levy contributions under defined circumstances.

18. *White Paper on Indian Constitutional Reforms, 1931.*—The White Paper on the Proposals for Indian Constitutional Reforms issued by His Majesty's Government in December 1931 contemplated that a prescribed percentage, not being less than 50 per cent. nor more than 75 per cent., of the net revenue derived from taxes on income, other than agricultural income, except taxes on the income of companies should be assigned to the Provinces on a prescribed basis. It also

proposed that the federation should retain for the first three years a prescribed sum out of the provincial share which would continue to be retained for a further period of seven years with a reduction of one-eighth of the original sum in each successive year. Both the federation and the Provinces were to have power to levy surcharges on income-tax for their own purposes. The White Paper proposals introduced two new features into the plan for the division of sources of revenue. The federal legislature was to be empowered by law to assign to the units the whole or part of the yield of salt duties, excise duties, other than those specifically assigned to the units, and export duties. They also suggested that in respect of certain taxes, including terminal taxes and death duties, while the power to levy the tax would be vested solely in the federation, the proceeds would be distributed to the Provinces; the federation would have the right to impose a surcharge for federal purposes.

19. *Joint Parliamentary Committee, 1933-34.*—The Joint Parliamentary Committee on Indian Constitutional Reforms, 1933-34, agreed generally with the proposals in the White Paper. They left the provincial share of income-tax to be prescribed by an Order-in-Council, but could not visualise any prospect of the Provinces' share of income-tax exceeding half of the net revenue from the source. The Committee did not favour the proposal to empower the Provinces also to impose surcharges on personal income-tax. The modified proposals relating to income-tax and other matters were incorporated in the Government of India Act, 1935.

20. It is interesting to note that the idea of devolving the whole of income-tax to the Provinces leaving the Centre to cover the consequent deficit by provincial contributions was abandoned, and a measure of elasticity in the distribution of income-tax was introduced by limiting the provincial share to a part of the net proceeds and giving the Centre power to retain, for a transitional period, a fixed amount out of the provincial share to give it time to adjust its finances.

21. *The position of former Indian States.*—We may take note at this stage of the position of the former Indian States in relation to the constitutional developments. These States had remained outside the fiscal and financial system of the rest of the country except for certain arrangements entered into with them by the Government of India regarding such matters as maritime customs, central excises, posts and telegraphs and railways. The scheme of the Government of India Act, 1935, contemplated the accession of these States to the Indian federation. Under it the Indian States were to accede in regard to foreign relations, defence and communications, with option to accede in regard to other Central subjects also. This followed an extensive examination of the problems connected with the assimilation of States of varying sizes and having different kinds of relationship with the Centre into a workable system of financial relations

with the proposed federation. As it happened, the provisions of the Government of India Act, 1935, relating to federation never came into operation. It was not until after Independence that the princely States were integrated into the fiscal system of the country.

22. *Government of India Act, 1935.*—Under the structure of financial arrangements embodied in the Government of India Act, 1935, agricultural income-tax was included in the list of Provincial subjects. Section 138 of the Act provided (a) for the assignment to Provinces and the States which acceded in respect of the subject of income-tax of a percentage of the net proceeds of taxes on income other than agricultural income, except in so far as these proceeds represented proceeds attributable to Chief Commissioners' Provinces or to taxes payable in respect of federal emoluments, and (b) for the distribution among the Provinces and States of their share. The Centre was, at the same time, empowered to retain for a period a sum out of the share of income-tax assigned to the Provinces and federated States. Section 140 of the Act provided that duties on salt, federal duties of excise and export duties, while levied and collected by the federation would, if an Act of the federal legislature so provided, be assigned wholly or in part to the Provinces and States and be distributed among them in accordance with principles to be formulated by such Act. The provision in respect of the export duty on jute was, however, specific. Section 140 (2) laid down that one-half or such higher proportion as might be determined by Order-in-Council of the net proceeds of the export duty on jute and jute products should be assigned to the Provinces or federated States in which jute was grown in proportion to the respective amounts of jute grown therein. Provision was made in Section 142 for the payment of grants-in-aid of the revenues of such Provinces as might be in need of assistance, the amounts of such grants to be prescribed, however, by Order. Further, the Act provided for the levy by central legislation of duties in respect of succession to property other than agricultural land, stamp duties, terminal taxes on goods and passengers carried by railway or air and taxes on railway fares and freights and for the distribution of the net proceeds, other than those attributable to the Chief Commissioners' Provinces, to the Provinces and federated States, the federal legislature having the right to levy a surcharge on these taxes for federal purposes.

THIRD PERIOD

23. *Enquiry by Sir Otto Niemeyer, 1936.*—The scheme of the Government of India Act left several questions to be decided before it could be put into operation. Sir Otto Niemeyer was appointed to make recommendations on matters which under Sections 138 (1) and (2), 140 (2) and 142 of the Government of India Act had to be prescribed or determined by Order-in-Council and on certain other

ancillary matters. The scope of the enquiry was made comprehensive by a supplementary reference which enabled it to be extended to cover a review of the existing liabilities of the Provincial Governments to the Centre.

24. In respect of income-tax, having regard to the dual considerations of the necessity of safeguarding the financial stability of the Centre and the obvious future needs of the Provinces, and "in order to maintain a reasonable adjustment of relative burdens between the various units", Sir Otto Niemeyer felt it was desirable that the maximum practicable distribution should be achieved. He recommended that 50 per cent. of the net proceeds of income-tax should be assigned to the Provinces. As regards the distribution of the provincial share, he expressed the view that the mere accident of place of collection was an unsuitable guide and that the residence of the individual, though it might be a convenient practical dividing line for the avoidance of double taxation between separate political units, was not in itself a very scientific criterion, particularly in a federation. Even supposing it were practicable to ascertain to what part of the country particular fractions of income and the incidence of the taxation burden properly adhered, it was, he pointed out, still arguable that in a federation other considerations also were involved, particularly if the benefits and incidence of other forms of common taxation were unequally divided as between the various partners. After a consideration of the various elements of the problem, he came to the conclusion that substantial justice would be done by fixing the scale of distribution partly on residence and partly on population. He recommended distribution among the Provinces according to the following fixed percentages:—

	<i>Per cent</i>
Madras	15
Bombay	20
Bengal	20
United Provinces	15
Punjab	8
Bihar	10
Central Provinces	5
Assam	2
North-West Frontier Province	1
Orissa	2
Sind	2
	<hr/> 100 <hr/>

Sir Otto Niemeyer also recommended that the Centre should retain for the first five years out of the provincial moiety a sum equivalent to the amount by which the central share plus the contribution from Railways fell short of Rs. 13 crores a year and that the amount retained from the provincial share should be surrendered to the Provinces over a further period of five years. As part of the assistance he contemplated for the jute-growing Provinces, Sir Otto Niemeyer recommended that the provinces' share of the jute export duty be raised by $12\frac{1}{2}$ per cent. to $62\frac{1}{2}$ per cent. of the net proceeds of the duty.

25. The following annual grants to the Provinces were also recommended by Sir Otto Niemeyer:—

	<i>(Rupees, lakhs.)</i>
United Provinces	25 for a fixed period of five years.
Assam	30
North-West Frontier Province	100 subject to consideration at the end of five years.
Orissa	40 with Rs. 7 lakhs additional in the first and Rs. 3 lakhs additional in each of the next four years.
Sind	105 for 10 years, with Rs. 5 lakhs additional in the first year, and thereafter falling until the grant ceased in about 45 years' time.

As part of the general scheme, Sir Otto Niemeyer recommended the cancellation of the outstanding debts to the Centre of Bengal, Bihar, Assam, North-West Frontier Province and Orissa, contracted prior to the 1st April 1936, and a reduction in the outstanding debt of the Central Provinces.

26. The above recommendations were accepted by the authorities and embodied in the Government of India (Distribution of Revenues) Order, 1936. This Order, subject to a change made in 1940, continued to regulate the allocation of resources between the Centre and the units until the partition of the country in August 1947. Following the outbreak of World War II, and the increasing expenditure it entailed on the Centre, steps had to be taken to strengthen Central finances. It was decided that for the duration of the war, the Centre should be permitted to retain a fixed sum of Rs. 45 crores out of the provincial share of income-tax. The Order-in-Council was amended accordingly to secure this and the modified provision regulated the distribution of the tax from 1940-41 to 1945-46. In each of the next four years the sum retained by the Centre from the provincial share was reduced by Rs. 75 lakhs a year over the previous year, and the full provincial share was restored to the Provinces in 1950-51.

27. *The Partition: Adjustments in Financial Arrangements, 1947.*—

The partition of the country in August 1947 necessitated an adjustment in financial arrangements which affected the scheme of distribution of both income-tax and jute export duty. In regard to income-tax the basic scheme of Sir Otto Niemeyer was retained. The Government of India reduced the shares of the divided Provinces of Bengal and the Punjab in proportion to population and the released percentages as well as the percentages of Sind and North-West Frontier Province were pooled for redistribution. The provincial shares were refixed after distributing the lapsed quota among the Indian Union Provinces, including West Bengal and Punjab, according to population, with a readjustment in favour of West Bengal and a minor adjustment in favour of Assam. The provincial shares thus fixed, which governed the distribution between the 15th August 1947 and 31st March 1950, were as follows:—

	<i>Per cent</i>
Bombay	21
Madras	18
West Bengal	12
Uttar Pradesh	19
Madhya Pradesh	6
Punjab	5
Bihar	13
Orissa	3
Assam	3

As regards the jute duty, the provincial share was reduced from 62½ per cent to 20 per cent, roughly in proportion to the jute-growing area which came to be included in Pakistan, but the basis of distribution of the share among the Provinces was left undisturbed.

28. *Expert Committee on Financial Provisions of the Constitution, 1947.*—The financial relations between the Centre and the units came up for review in connection with the drafting of the new Constitution. The financial provisions in the Draft Constitution were referred by the President of the Constituent Assembly to an Expert Committee of three, under the chairmanship of Shri N. R. Sarker. This Committee recommended that the whole of income-tax, including corporation tax and income-tax on federal emoluments, should be shared between the Centre and the units except to the extent of the tax attributable to Centrally administered areas. They suggested that the provincial share should be fixed at 60 per cent and allocated among the Provinces in the following manner: 20 on the basis of population and 35 on the basis of collection, the remaining 5 being used for mitigating hardships that might arise as a result of

the application of the other two criteria. As regards the jute export duty, the Committee recommended that the existing arrangements for the sharing of the net proceeds with the Provinces should be terminated as, in their view, export duties were unsuitable for sharing with the Provinces. In order, however, to avoid hardship to the four jute-growing Provinces which were receiving a share of the duty they proposed that fixed grants-in-aid of Rs. 1 crore to West Bengal, Rs. 15 lakhs to Assam, Rs. 17 lakhs to Bihar and Rs. 3 lakhs to Orissa be given every year as "compensation" for a period not exceeding ten years or till the export duties on jute were abolished. Another recommendation of the Committee, which is of interest in the present context, relates to central excise duties. The Committee remarked that the Provincial Governments had been almost unanimous in demanding some share of excises and considered the problem as being not only one of finding more resources for the units but also one of imparting a better balance to their revenue structure. The Committee suggested that the Provincial Governments should be given a share of one of the important central excises on a commodity not receiving tariff protection, viz., tobacco, and accordingly recommended that 50 per cent of the net proceeds of the excise duty on tobacco be distributed to the Provinces on the basis of estimated consumption. Pursuant to the recommendations of the Committee, export duties were made exclusively Central under the Constitution. Provision was made for the payment of grants-in-aid to the States of West Bengal, Bihar, Assam and Orissa in lieu of their share of the jute export duty; the amounts were, however, left to be prescribed by the President. The Committee were also responsible for the suggestion that a Finance Commission should be set up to deal, among other things, with matters connected with the division of revenues between the Centre and the units and the distribution among the units of their shares.

FOURTH PERIOD

29. *The Constitution of India, 1950.*—The scheme of division of sources of revenue and powers of taxation embodied in the Constitution of India is substantially the same as in the Government of India Act, 1935, differing from it only in regard to a few matters. Financial relations between the Centre and the States become for the first time a matter certain aspects of which are to be regulated after considering the recommendations of a Finance Commission. The percentage of the net proceeds of income-tax to be assigned to the States and the distribution of the States' share among them are left to be prescribed by an Order of the President. It is also provided that after a Finance Commission is constituted the President should take the recommendations of the Commission into consideration before making the Order. Provision is made specifically

for the payment of grants-in-aid for the purpose of promoting the welfare of the scheduled tribes and raising the level of administration of the scheduled areas in the States. In this connection, the Constitution provides for special grants-in-aid for raising the level of administration of the tribal areas of Assam and for schemes of development in such areas. Lastly, export duties have ceased to be divisible.

30. *The Deshmukh Award, 1950.*—As a Finance Commission could not be set up immediately, the States' share of income-tax and its distribution and the payment of grants-in-aid under Articles 273 and 275 of the Constitution had to be regulated by Order of the President for the period between the commencement of the Constitution and the appointment of the Commission. Some of the States had expressed dissatisfaction with the arrangements regarding the allocation of income-tax and the jute export duty made by the Government of India immediately after the partition. It was, therefore, decided that the matters should be referred to an impartial authority for reconsideration. Towards the end of 1949, Shri C. D. Deshmukh was requested by the Government of India to enquire into and decide these two questions. It was agreed that his decision would be in the nature of a binding award. Shri Deshmukh's enquiry did not cover the determination of the States' share of the tax nor was he requested to deal comprehensively with the problem of the distribution of the States' share among *all* the States. He confined himself to the reallocation of the percentages released as a result of the partition from the share of the divided Provinces and the Provinces wholly included in Pakistan. He did not concern himself with determining the shares of the Part B States or the shares allocable in respect of the territories of the former Indian States merged in the Part A States. There were thus two aspects of the problem before him:—

- (a) to determine the shares to be taken from Bengal, Punjab and Assam in respect of parts of these Provinces included in Pakistan and
- (b) to reallocate among the Part A States in the Indian Union these lapsed percentages, as well as the percentages formerly prescribed for Sind and North-West Frontier Province.

31. In approaching his task, Shri Deshmukh first attempted to estimate as nearly as possible the percentages that might have been allotted by Sir Otto Niemeyer to parts of the Provinces now included in Pakistan had they been in existence as separate Provinces at the time. Having thus determined the aggregate quota available for redistribution, he distributed it largely on the basis of population, making minor adjustments for the purpose of rounding off and

giving a small weightage in favour of the weaker States. In taking population as the basis of reallocation he was influenced by the consideration that any award which gave additional weightage to residence would hinder progress towards a general equalisation of the levels of administration which, in the prevailing circumstances, he thought was a desirable end. The table below indicates the percentage distribution among the States of their share of income-tax (i) before the partition, (ii) under the arrangements made by the Government of India immediately after partition and (iii) under the award given by Shri Deshmukh:—

Province	Pre-partition share, per cent.	Share under Government of India allocation, per cent.	Share under Deshmukh Award, per cent.
Madras	15	18	15
Bombay	20	21	21.0
West Bengal	20*	12	13.5
Uttar Pradesh	15	19	18.0
Punjab	8*	5	5.5
Bihar	10	13	12.5
Madhya Pradesh	5	6	6.0
Assam	2*	3	3.0
Orissa	2	3	3.0

* relates to the undivided Provinces.

32. In regard to grants-in-aid in lieu of a share in the export duty on jute and jute products, Shri Deshmukh observed that the provision in the Constitution "alters completely the constitutional rationale of the old arrangement", the grants being in effect "compensation payments" "constituting a means of financial assistance to the four Provinces". He recommended that the following grants-in-aid be paid each year to the four States mentioned in Article 273 of the Constitution, until the Finance Commission proposed any revision:

Province.	(Rupees, lakhs)
West Bengal	105
Assam	40
Bihar	35
Orissa	5

The Deshmukh Award was given effect to from the 1st April 1950 and remained in force for the two years ending with the 31st March 1952.

33. *Financial Integration of former Indian States.*—We mentioned earlier the position of the Indian States in the fiscal and financial set-up of the country. During the period between the achievement of Independence and the framing of the Constitution, a great step forward was taken in the unification of the country by the integration of these States. Within less than two years from the date of Independence, all the Indian States had been either formed into sizeable units, or merged in the neighbouring Provinces or constituted into separate Centrally administered Chief Commissioners' Provinces. The political integration had to be followed by financial integration with the Centre and in October 1948 the Indian States Finances Enquiry Committee were set up under the Chairmanship of Shri V. T. Krishnamachari to consider this problem. The Committee were asked to examine and report upon, among other matters, the desirability and feasibility of integrating federal finance in the Indian States and Unions of States with the rest of India; the extent to which the process of integration should be gradual and the manner in which it ought to be brought about; the results of a policy of integration upon the finances of the States and the Unions of States and the consequential financial adjustments between the Governments of these States and Unions of States and the Government of India; and the measures necessary to revise the structure of "provincial" finance and the levels and sources of "provincial" revenue in these States and Unions of States. While the scope of this Committee's work was limited to what are now Part B States, they were also requested to advise on similar problems arising out of the merger of Baroda with Bombay. The recommendations of the Committee were accepted by the Government of India and the Governments of the States concerned, with certain agreed modifications, and embodied in agreements entered into by the Government of India with them.

34. It is sufficient for our purpose to indicate only the broad features of these agreements which affect the allocation of resources between the Centre and the States. As a result of the integration, the Centre took over from these States the subjects and services falling in the Union List of the Constitution with the related assets and liabilities. Viewed in the light of the distribution of subjects adopted by the Constitution some of the States had, in effect, been financing services falling in the State field from the surplus from Union subjects. Some form of financial assistance thus became necessary to enable them to meet the dislocation caused by the disappearance from their budgets following integration of the revenue and expenditure relating to Union subjects. It was, therefore, agreed that the centre should make good to such States for a transitional period the difference between the revenue lost to them from Union subjects and the expenditure

saved to them on Union subjects and services as a result of financial integration, the computation being made with reference to the actual revenue and expenditure during an agreed basic period immediately preceding the integration. The payments made to these States under this arrangement, generally called "revenue gap grants", were guaranteed in full for the first five years and on a gradually diminishing scale for a further period of five years, at the end of which the grants would reach roughly 60 per cent of the original figure. After integration all the Part B States would be entitled to a share in divisible sources of Central revenue like income-tax on the same footing as the Part A States, the Part B States getting their share of revenue or the "revenue gap grant" whichever might be larger.

35. Of the seven Part B States, four States, *viz.*, Hyderabad, Mysore, Travancore-Cochin and Saurashtra received "revenue gap grants". Three States, *viz.*, Rajasthan, Madhya Bharat and Patiala and East Punjab States Union did not qualify for this grant because the expenditure saved to them by integration was more than the revenue lost to them. For a transitional period the States falling in this category were to make a limited and progressively decreasing contribution to the Centre in respect of the payments made by the Government of India on account of the privy purses of the former Rulers. In computing the financial effects of integration on the States the privy purses of the former Rulers were treated as an item of expenditure saved to the States, as the privy purses were payable to the Rulers by the Government of India. In regard to income-tax, which is at present the only tax divided between the Centre and the States, it was agreed that the share of each Part B State should be 50 per cent. of the net proceeds of the taxes on income other than agricultural income levied and collected by the Government of India in that State in each year.

36. *Income-tax Concessions in Part B States.*—The pattern of Central taxation is now uniform throughout the country, except in Jammu and Kashmir with which there has been no financial integration and which is governed by special provisions in the Constitution. It is, however, necessary to add that while the rates of income-tax are uniform throughout the country, provision has been made for the grant of rebate on a progressively diminishing scale for a short transitional period in some of the Part B States. It was considered undesirable to bring the Indian rates into operation immediately, either because these States had no income-tax prior to integration or because their rates of taxation were lower. The rebates will disappear in Hyderabad from 1953-54, in Mysore from 1954-55 and in Saurashtra, Rajasthan and Madhya Bharat from 1955-56. It may also be mentioned that in four Part B States (Hyderabad, Rajasthan,

Madhya Bharat and Saurashtra), which before integration relied to a substantial extent for their revenue on internal customs duties, inter-State transit duties have been allowed to be levied instead for a short period of four or five years, to give these States time to replace them by alternative taxes like the sales tax.

37. "*Merged Areas*" in Part A States.—The financial dislocation caused to some of the Part A States by the merger of former Indian States in their territory was also dealt with on the same lines as for the Part B States, although the Constitution does not contemplate any agreements with them on this account. All the Part A States affected by the merger receive 50 per cent of the net proceeds of the taxes on income other than agricultural income levied and collected in the merged territories within the States each year or the "revenue gap grant" whichever might be larger. Four Part A States, namely, Bombay, Bihar, Madhya Pradesh and West Bengal are now in receipt of "revenue gap grants". The other States affected by the merger (Madras, Uttar Pradesh, Punjab and Orissa) do not receive "revenue gap grants" but get instead their share of income-tax in respect of the merged territories.