CHAPTER II
The British Government assumed direct sovereignty over the territories of the East India Company in India in 1858 and a highly centralised administration was set up. However, in the field of financial administration, the Charter Act, 1833 had already introduced a very rigid centralised system, whereby Provincial revenues and expenditures were under the absolute imperial control.\(^1\) Under the Charter Act, 1833 ‘the supreme Government controlled the smallest detail of every branch of expenditure. Its authority was required for the employment of every person paid with public money, however small his salary; and its sanction was necessary for the grant of funds even for purely local works of improvement, for every local road, for every building howsoever insignificant’.\(^2\) The administrative responsibilities were on the provincial Governments but they were entirely dependent on the annual cash assignments from the Centre for the maintenance of administration. Since administrative responsibility was not coupled with financial power, the provincial governments could not deliver their social obligation to the subjects and it created many other

\(^1\) Before the Charter Act, 1833 the Presidencies of Madras, Bombay and Bengal were, in financial matters, totally independent of each other and they were more or less administered as independent units. Under the Charter Act, the Governor-General-in-Council was made responsible for the general and financial administration of India, the revenue in all the provinces was collected, and expenditure incurred in the name of Government of India. The Governors of the Presidencies were precluded by statute from creating any new office or granting any salary or gratuity or allowance without the previous sanction of the Governor-General-in-Council. Section 39 of the Charter Act, 1833 provided that “No Governor shall have the power of creating any new office, or granting any new salary, gratuity or allowance without the previous sanction of the Governor General” Under Section 65 of the Charter Act, the Provincial Governments were ordained to function as per the instructions issued by the Governor-General-in-Council

\(^2\) Report on Indian Constitutional Reforms (1918), Para. 105.
administrative difficulties. Firstly, the Provincial Governments were not responsible for the augmentation of their resources. On the other hand, they had unfettered discretion in the matter of giving remissions of revenues. Under this circumstance, deficits in the budget estimate were inevitable.

This highly centralised system was gradually transformed into a controlled Constitutional fiscal federalism over a period of ninety years mainly due to political compulsions arising out of the necessity of an alien force to rule a country, so vast and diverse, by protecting the imperialist interests, economic as well as political. The important aspect of financial decentralisation during the British rule is that it helped to develop the principles of federalism in other areas of administration also and converted the nation into a federal polity.

Based on the major developments during the period of 92 years, i.e., from the year 1858, when the British Crown assumed direct sovereignty over the Indian Territory, to the year 1950, when India became a Sovereign Republic, the evolution of fiscal federalism in India can be broadly divided into five periods as:

3 The situation was well described by Dr. B.R. Ambedkar in the following words: "The Imperial Government was responsible in law but did not administer the country. The Provincial Government administered the country but had no responsibility in law" See Paras Diwan, Union State Fiscal Relations (1981), p. 21.
5 From the year 1834, when the management of India became purely Governmental, to the year 1860 only seven years had surplus budgets while the remaining nineteen years exhibited large deficits. Consequently, the debt of the Government of India was keep on increasing during this period. M.A. Hussain, op. cit. at p.29.
6 The role of British rule in converting India into a federal polity was precisely said by a jurist as: "The history of the evolution of federal polity in India is in fact the history of a process of decentralization of finances which began informally in 1871, which was formalized by the Government of India Act 1919 and which was finally converted into federal set up by the Government of India Act 1935. The free India merely took over the set-up established by the Government of India Act 1935 with a hyphen here, with a dot there" Paras Diwan, op.cit., p.22.
1) Conceptualising decentralised finance: 1858 to 1871

The period from 1858 to 1871 did not make any significant contribution towards decentralising the financial administration in India. On the other hand, in the initial years, the principle of rigid centralisation got prominence and the same was implemented rigorously. Even though the imperial government realised the necessity of transferring certain fiscal powers to the provinces to streamline the fiscal administration, it remained only in the theoretical field. Neither the British Parliament nor the Government of India took any serious step to put these ideas into practice. In the history of fiscal federalism in India, this period is important for the reason that the idea of decentralisation of finance was conceived for the first time, which in fact set the stage for further action in this direction.

When the Crown took over the administration of India in 1858, the status of financial administration was alarming. Nothing like a budget existed and it hardly followed any standardized system of accounting. With the transfer of the Government of India to the British Crown in 1858, the tendency of centralisation in the financial fields began to stiffen.\(^7\)

\[^7\] Section 2 of the Government of India Act, 1858 declared that "all the territorial and other revenues of or arising in India and all tributes and other payments in respect of any territories which would have been receivable by or in the name of the said Company if this Act had not been passed, shall be received for and in the name of (Cont'd in p.36)
Mr. James Wilson was made the first financial member of the Governor General's Council and the task of salvaging the financial administration from the turmoil was assigned to him. He took certain serious initiatives, certainly within the permitted parameters of centralised financing, to rationalize the financial set up. He introduced a proper budget system and a uniform system of accounts for the first time. Under the system then introduced, the Central Government retained in its own hands the entire control of finance and made grants of money at its discretion to meet the demands of the Provincial Governments. The Provincial Governments were collecting the greater part of the revenue merely as the agents of the Central Government. The result was that the former was left with no direct interest in the result of collection as the whole amount went to the common fund, managed by the central authority, which controlled even the smallest details of every branch of the expenditure. This position of the subordinate Governments was most galling to the Central Government and the new system, with a view to strict economy, in fact led to extravagance. The Provincial Governments were tempted to ask for more than they expected to get and expended every pie that they received when they could have managed with less.8

James Wilson was succeeded by Samuel Laing. He was the first person who argued for the devolution of a certain amount of financial

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power including power of taxation to the Provinces in order to rationalize the finances of the Government of India. He observed that it was most desirable to break through the system of barren uniformity and pedantic centralisation which have tended in times past to reduce all India dependence on the bureaux of Calcutta, and to give to local Governments the power and responsibility of managing their own local affairs. However, Laing’s scheme could not make any headway.

The Indian Council Act was enacted in 1861 but the financial centralism continued and the approval of the Governor-General-in-Council was necessary for the provincial budgets. In that year, the Government of India seriously entertained the idea of giving to the Provincial Governments the powers of local taxation combined with local budgets and a great share of financial control.

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9 He proposed to give local Governments the power to raise money by taxation for financing public works, as the Imperial revenues were for the purpose inadequate. He observed: “It has long been a standing complaint with other Presidencies and Provinces that they were deprived of a fair share of self-government and kept in state of galling and humiliating dependence on the bureaux of Calcutta. ……..and as long as Local Governments are absolutely subservient to Calcutta in financial matters, it is evident that they can have no real independence. But if, without sacrificing in any way the unity of the Empire and Imperial control in Imperial matters, we give them local budgets, their position is altered. We propose to give them not only powers of local taxation but possibly to credit them with a liberal share of reductions of expenditure, which they may be able to make on the estimates of the general Budget.” Speech of Mr. Samuel Laing on April 16, 1862, while submitting the Budget for 1861-62 before the Supreme Council

10 Ibid

11 It restored the Legislatures to Madras, Bombay and Bengal.

12 Under the Indian Council Act, 1861, the previous sanction of the Governor General was made requisite for legislation by the local Councils in certain areas and all Acts of the local Council required the subsequent assent of the Governor General in addition to that of the Governor.

13 Samuel Laing vehemently argued for such a transfer. “Take what we are to give you and for the residue take certain powers of taxation,” he said. He further argued, “I am as strongly as ever in favour of the principle of local taxation for local purposes. In fact, if this great Empire is ever to have the roads, the schools, the local police and other instruments of civilisation which a flourishing country ought to have, it is simply impossible that imperial Government can find either the money of the management.” See Minutes of Select Committee on East India Finance dated 9th July 1872.
Like his predecessor, Finance Minister William Massey (1866-68) was also an ardent supporter of decentralisation of finance.\textsuperscript{14} However the then Governor-General of India, Sir John Lawrence, a strong believer of centralism, did not support the version of Massey and was opposed to any scheme of decentralization for political reasons. He apprehended that if the provinces were given power of taxation that would lead to discontent among the States and result in another mutiny.\textsuperscript{15}

The ideas of Massey were embodied in a scheme of decentralisation of finance formulated by Col. Strachey. According to Strachey scheme, roads, jails, education, and medical services should be transferred to the Provinces. It was further suggested that one-sixteenth of the land revenue and one-fourth of the proceeds of licence tax should be allotted to the provinces. The scheme recommended that the Provinces should be empowered to augment their revenue by imposing fresh taxes and cesses on the existing taxes.\textsuperscript{16} This scheme of decentralisation was in the line of federal set up of the United States. He himself maintained that his scheme purported to make gradually the

\textsuperscript{14} He had observed in 1867. "In the vast and various provinces which are united under the dominion of the Crown throughout the continent of India, there are many sources of revenue which might be made available for local purposes, but which could not be used for imperial objects without giving rise to just complaints of partial exaction or even breach of faith." He suggested the federal idea as "The Government of India, upon a review of the financial condition of the Empire and increasing demands upon its resources, have deemed it expedient to make provision for permanent addition of a million sterling to the existing resources. With this end in view, the Governor-General-in-Council had resolved that certain charges of a purely local character now borne by the revenues of India together with any further charges of a similar character shall in future be provided from the local resources." Finance Statement (1867-68), Legislative Council Proceedings p.154.

\textsuperscript{15} He observed: "We are a handful of foreigners in this country. To tax the people least and to use taxes for beneficial administration is our best policy." See Paras Diwan, \textit{op.cit.},at p. 42.

financial position of the Government of India analogous to that of the federal Government of the United States.\textsuperscript{17} As in the case of earlier schemes, the Strachey scheme also was destined to remain only in the theoretical spectrum.

The labours of Laing and Strachey came to fruition when Lord Mayo became the Governor-General of India in 1870. He realised the rot\textsuperscript{18} in which Indian finances were, and was of the firm view that the remedy laid not in tightening the Central administration but in making the Provinces responsible. He perceived that the first condition precedent to any reform must be the creation of a sense of financial responsibility for the Provincial Governments and strongly argued for the transfer of certain services to the Provinces and "the obligation to find funds necessary for administrative improvement should rest upon the authority whose immediate duty it was to devise such measures".\textsuperscript{19} Thus came into being the Mayo Scheme of 1870. Referring to the natural reluctance of the Provinces to impose additional taxation, Lord Mayo pointed out that "increased taxation would be much more palatable if levied under control and sanction of local authorities, if the people who paid it were made sensible, by daily experience, of the benefits they derive from such taxation".\textsuperscript{20}

The period from 1858 to 1871 gave an impetus to the idea that some financial autonomy to the Provinces was unavoidable to induce a sense of responsibility in them. Accordingly, the schemes and plans during this period were mainly for inducing financial responsibilities on

\textsuperscript{17} Ibid.
\textsuperscript{18} The period immediately preceding his arrival was rather discouraging. The last three years from 1866 to 1869 had left behind deficits aggregating eleven millions sterling.
\textsuperscript{19} Resolution dated 14\textsuperscript{th} December 1870, Para 3.
\textsuperscript{20} Speech before the Legislative Council on 5\textsuperscript{th} April 1870. See Legislative Council Proceedings 1870, p.148
the Provincial Governments and to reduce the financial burden of the Central Government. During this period nothing significant has happened in the field of financial administration to transform it into a decentralised financial system. But there were serious searches in this direction. Hence, it is appropriate to call it as a period of ‘conceptualising decentralised finance’ in India.

INFORMAL DECENTRALISATION OF FINANCES: 1871 TO 1919

The period from 1871 to 1919 witnessed a progressive devolution of financial authority from the Central government to the Provincial governments. The first breakthrough in this direction was made when the resolution of Lord Mayo was issued on December 14, 1870. Though the Mayo Scheme was propounded on 14th December 1870, no steps were taken to give effect to this scheme till at last in 1871, Lord Mayo, the Governor General, took up the matter into his own hands as part of a plan for restoring equilibrium to the Imperial finances, which were in a state of chronic deficit. 21

Provincial Financial Settlements (Mayo Scheme)

Under the Mayo Scheme, which was known as “Provincial Financial Settlements”, certain heads of expenditure, of which the most important were, jails, police, education, registration medical services (except ‘medical establishments’), printing, roads, civil buildings and miscellaneous public improvements were assigned to the Provinces. 22 For meeting expenditure on these heads, the departmental receipts under the corresponding heads were assigned to the Provinces. Due to the inadequacy of these new heads of revenue,

22 Resolution on Provincial Finance, 1870 (No. 334, dated 14th December, 1870), Para 11.
the existing system of fixed grants from the Central revenues also continued and under the Provincial Financial Settlements, they were given a total grant of Rs. 468871/- in lump sum. This amount was distributed as between the several provinces by the Government of India, on the basis of the requirements of each province, as shown by the accounts of the Government of India. The scheme provided that the fixed cash assignment will continue and will not be reduced except in exceptional circumstances, that too with previous consultations with the Provincial Governments.

Actual experience revealed various defects of this system. The Mayo Scheme neither provided for adequate resources to the Provinces nor laid down the conditions for the progressive administration of the subjects transferred to them. Moreover, the system contemplated only fixed grants and did not take in to account the increase in the expenditure of the Provinces, which went on year after year. Since for the distribution of lump sum grant 1870-71 was made the base year, it imparted a certain amount of unreality to the Mayo scheme. It did not consider the gross disparities that existed among the Provinces. Between the provinces, there were gross inequalities of burden and grants and Lord Mayo’s scheme only served to perpetuate these inequalities. The allocation of grants was arbitrary owing to the ignorance of the Central Government with regard to the Provincial conditions. Moreover, the assignment made to each province was on the basis of the actual expenditure in each province under a given head. But

23 "Unless some fiscal misfortune, such as a heavy loss in the Opium Revenue, or national disaster such as war or severe famine, occurs, the Governor-General in Council will maintain for the future, the Assignments for "Provincial Services" at the amounts now fixed. They will not, in any case, be reduced without previous consultation with the Governments." Ibid., Para 17.
the underlying assumption that the actual expenditure represented the real needs was unfounded. The fixed Imperial grants for any year depended on the needs of the Central Government, and it had in fact been suggested that the real motive for this change was to afford relief to Imperial finance rather than to invest the provinces with larger powers and responsibilities. 24

The system did not provide any real motive for economy in the Provinces, as the Provinces were empowered to supplement their income by additional taxation, which under the existing arrangements, could only mean an increased burden on the poor. 25 In respect of this arrangement, Sir George Campbell, Lieutenant Governor of Bengal commented that the system “put the Local Governments in this position: that the Government of India tax the rich and we tax the poor, and, between us, we tax every one”. 26

John Strachey, who was assigned with the task of implementing the Mayo scheme, was aware of the constraints and frailties of the scheme. He argued for granting certain taxing powers to the Provinces in order to confer real financial responsibility upon them. However, the Government of India did not accept such a contention and was not ready for any transfer of taxing power to the provinces.

The system of decentralisation under the Mayo Scheme, however minor it was, was welcomed by the Provinces because with this arrangement the friction with the Central Government was obviated and the much useless correspondence avoided.

24 P.N. Banerjea, Provincial Finance in India (1939), p. 74.
26 P.N. Banerjea, op. cit. pp. 75-77.
However, in the history of fiscal federalism in India, the Mayo Scheme has a very prominent place for putting the process of decentralization of finances into motion, which could not be reversed.

**Provincial Financial Settlement widened**

In 1877, some steps in the direction of decentralisation of finance were taken by Lord Lytton with the help of his Finance Member, Sir John Strachey. Under the new scheme, further heads of expenditure such as Land Revenue, Excise, Stamps, Law and Justice, Stationery and Printing, General Administration etc., were transferred to provincial management. The Provinces were not given the power to tax these subjects but they were given a share in the Central revenues. Certain heads of revenue, such as Excise, Stamps, Law and Justice fees, Proceeds of the Licence Tax and some minor railway receipts were made over to the Provincial Governments. This arrangement stipulated that the revenue from these sources was to be taken in part by the Provincial Governments; but if they showed any surplus over an estimated figure in each of the Provinces, the Imperial Government were given one half of the surplus, In case of a deficit, the same authority agreed to bear half the loss.

Lord Lytton scheme, like the previous one, suffered from serious drawbacks. The major defects in this scheme were that (i) there was no uniformity in the transfer of subjects to the provinces and the transfer was not based on any scientific criteria and it became necessary to make separate agreements with each province; and (ii) the Provinces had no share in land revenue which was the largest source of revenue at

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Resolutions of Financial department No. 1709 of 22nd March 1877.
that time. However, by this arrangement, some sort of flexibility was introduced, for the first time, in the revenues of the Provinces. It was a great incentive for generating a sense of responsibility in the Provinces and encouraged them to enlarge their resources. Under this scheme about 20 per cent of the Central finances were assigned to the Provinces, which were, on the other hand, apparently insufficient to manage the affairs of the Provinces.

**Quinquennial Arrangement**

The 'Provincial Financial Settlements, under Mayo Scheme were subject to revision annually, but from 1882 they were made on quinquennial basis by Lord Ripon with the help of his Finance Member Major Baring.

The quinquennial settlements made in 1882 during the Viceroyalty of Lord Ripon, modified the system of assigned revenue and introduced the system of ‘divided heads’ or ‘shared revenues’. It abolished the system of fixed annual grants from the Centre to the Provinces and made a fresh arrangement in the field of resource sharing between the Central and Provincial Governments. The allocation of revenue under Ripon Scheme was as follows: - (i) **Imperial heads**:-

- Land revenue, Opium, Salt, Customs, Railways, Commercial

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28 The most important tax during that period was tax on land revenue. In 1858-59 Land Tax was as high as 50% of total tax revenue. Thirthankar Roy, *The Economic History of India 1857-1947* (2000), p. 249

29 In some cases this system, instead of creating a sense of financial responsibilities in the Provinces, resulted in extravagant. “At the end of every quinquenniel period there was wrangling between the supreme government and the provincial governments and the latter was tempted, with a view to making better contract, during the closing years of each settlement, to incur hasty and wasteful expenditure.” Vaman Govind Kale, *op.cit.* at p. 245.
undertakings, Post and Telegraph, Currency etc. (ii) **Provincial heads:** Civil Departments, Provincial works and Provincial rates (iii) **Divided heads:** Excise, Assessed taxes, Stamps, Forest, Registration, Irrigation etc. The Centre retained revenue from the Central heads and the Province from the provincial heads and the revenue from the divided heads were distributed between the two. However, with regard to divided heads no uniform criteria was made for the division of receipts; it was in accordance with the settlement reached between the Centre and each Province in this respect. Since the revenue from ‘divided heads’ was insufficient to meet the needs of the Provincial Governments, certain percentage of land revenue was made over to them, together with fixed cash assignments, recurring as well as non-recurring.

On the expiry of five years, a new settlement was made between the Provinces and the Centre. Under the scheme, at the end of five years the balances standing to the credit of Provinces were taken over by the Government of India. The apportionment of revenue was unfair between the Imperial Government and the Provinces and also between one Province and another; and, while Provincial interest in the collection of divided heads of revenue was secured along with some elasticity in the Provincial resources, the chief defect of the revision of the Provincial settlements every five years was want of continuity of financial policy, the provincial surpluses being appropriated by the Central Government for its own needs when the settlement expired.30 Moreover, if any Province economized, the reduced standard of its expenditure was taken as the basis of the next settlement. The

‘Provincial Financial Settlement’, to a great extent, pushed the Provincial Governments into a dilemma,\(^{31}\) which, at least in the cases of some provinces, worsened the economic crisis.\(^{32}\)

The Ripon scheme on the merit side meant that India was imperceptibly marching towards federalism and on the demerit side it put a discount on economy on the part of Provincial Governments since any reduction in local expenditure was used as a basis for a proportionately unfavourable settlement at the next revision in respect of the Province concerned.\(^3\)

The importance of the Ripon Scheme is that the Scheme (i) instead of granting a fixed annual grants from the Centre to the Provinces, the Provinces were given a share in certain growing sources of revenue like irrigation charges, excise duties, and stamp duties, (ii) divided the total resources of revenue under ‘Imperial heads’, ‘Provincial heads’ and ‘Divided heads’ and (iii) made the major source of the then revenue, i.e., land revenue, as a divisible income. Perhaps

\(^{31}\) In the words of Sir Alexander Mackenzie, “The Provincial sheep is summarily thrown on its back, close-clipped and shorn of its wool and turned out to shiver till its fleece grows again. The normal history of a Provincial contract is this: two years of screwing and saving and postponement of works; two years of resumed energy on a normal scale, and one year of dissipation of balances in the fear that, if not spent, they will be annexed by the Supreme Government at the time of revision” See P.N. Banerjea, \textit{op. cit.} at p. 114.

\(^{32}\) Under this scheme, even though there was an attempt to make the Provinces more responsible in the field of financial administration by allocating some heads of revenue to them, in reality there was no substantial variation from the policy of strict central control. The Centre retained the entire profits of the commercial departments and the proceeds from customs, salt and opium. Tax levied on the export of opium and tax on the sale of salt together accounted for 24% of the total tax revenue in 1858-59. See Thirthankar Roy, \textit{op. cit.} at p. 249. Under the system of ‘divided heads’, the Central government retained a portion of the proceeds of the main heads of revenue collected in the Provinces. The Imperial Government confiscated the accumulated balances of the Provincial Governments. Moreover, since 1884 each Province was required to maintain with the Government of India a prescribed minimum balance which was under no circumstances be drawn upon, which meant further draining of the provincial resources.

\(^{33}\) Paras Diwan. \textit{op. cit.} at p.26
the origin of resource sharing under different heads existing under the Constitution of India can be attributed to the Ripon Scheme.

When the next quinquennial settlement was due in 1887-88, the Government of India was facing financial difficulties\textsuperscript{34} and a Committee under the chairmanship of Sir Charles Elliot was appointed to propose an alternative scheme of devolution. The Committee recommended the permanent abolition of the system of divided heads and alternatively suggested an arrangement of securing the Provincial Governments absolutely half the normal growth of their revenues to enable them to keep up a continuous policy of internal improvements. However, the Government did not accept these recommendations.

The system of ‘Provincial Financial Settlements’ was followed in 1887, 1892, and 1897 without any change in principle. In the first settlement in 1887, the Centre collected seventy five percent proceeds of revenue from divided heads; the Provinces were given only the balance twenty five percent. It brought a net relief of rupees fifty-five lakhs a year to the Imperial Treasury from the increased provincial receipts. The share of the Provinces was further reduced in the second settlement of 1892-93 that only helped to worsen the financial crisis which almost all Provincial Governments were already confronting with. This settlement gave a relief over rupees forty-six lakhs a year to the Central Government. However, the third revision in 1896-97 increased the share of the Provinces. In this settlement, an estimate was made on the expenditure on provincialised services in each Province, and an adequate proportion of provincialised revenues was set-aside for the purpose. The Provincial Governments were allowed to retain almost

\textsuperscript{34} Mainly due to the falling exchange value of the rupee and the rising military expenditure.
all revenues from provincial rates, courts of law, jails, police, education, medical, local marine services, pension contributions, major and minor irrigation works, certain state railways, buildings and roads, and stationery. Apart from these revenues they were allotted with one-half of the stamps revenue, assessed taxes, forests and registration receipts and one-fourth of the excise and land revenue. Expenditure relating to most of these subjects and a share of cost of collection had to be met by the Provincial Governments.

The role of 'Provincial Financial Settlement' in decentralisation of finance was viewed with contempt as well as commendation. The real purpose of the 'Provincial Financial Settlements', was mainly to salvage the Imperial finance from the crisis which it was facing for more than three and a half decades. "The real motive of the scheme", as Banerjee puts it, "was to give relief to the Centre rather than to provide larger revenues to the Provinces".35 In the opinion of Gyan Chand, "the only consideration which really weighed with the Government of India was that of administrative convenience".36 A severe critic of the 'Provincial Financial Settlements', K.T. Shah, comments: "The governing principle in the thirty years of provincial finance, since its inauguration by Lord Mayo, had remained unaffected: administrative convenience- for the Government of India almost invariably. Government of India were absolute masters of the situation; they varied and re-formed the contracts at their discretion, or for their convenience. Neither borrowing on their own credit, nor additional or supplementary taxation on their own hook, was allowed to the

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35 P.N. Banerjea, *op. cit.* at p. 74.
Provinces, who therefore remained irretrievably tied to the apron strings of the Central Government.\textsuperscript{37}

**Quasi-Permanent Settlements**

The periodic revisions under the ‘Provincial Financial Settlement’ interfered not only with the continuity of provincial finance but also provided opportunities for extravagance. In order to avoid the defects that existed under the *quinquennial* arrangement and to introduce an element of permanency and stability into the settlements, Lord Curzon drew up a scheme of a quasi-permanent nature in 1904.\textsuperscript{38} The object of this system was to give the local Governments a more independent position and a more substantial and enduring interest in the management of their resources than had previously been possible.\textsuperscript{39}

New contracts were made with the Provinces on the basis of the principles of ‘Quasi-Permanent Settlements’. Even though the system of division of revenue resources under the previous *quinquennial* arrangement (*Imperial, Provincial, and Divided heads*) remained substantially unaltered, the share of the provinces was modified. The relative proportion of the Imperial (3/4) and the Provincial (1/4) expenditure, in the total expenditure of the country was taken as the basis of the distribution of revenue, with due regard to (a) the needs of backward Provinces, (b) the special projects of reform suggested by


\textsuperscript{38} The quasi-permanent settlement was based on the following principles: (1) The provinces must be given a more permanent interest in their revenue and expenditure. (2) The share of the revenue assigned to each province separately, and to all provinces collectively, should bear approximately the same ratio to the provincial expenditure, as the imperial share of growing revenues bears to the Imperial expenditure, and (3) The provincial assignment must include a slightly larger share of growing revenues.

\textsuperscript{39} *Report on Indian Constitutional Reforms* 1918, Para 107.
the Imperial Government, and, (c) the yield of the exclusive heads of revenue—Imperial or Provincial.

Under the quasi-permanent settlement, the whole revenue from railways, posts, mines, salt, customs, mint etc., were appropriated to the Government of India and the revenues from police, education, medical services, civil work etc., went to the Provincial exchequer. Land Revenue, excise and stamps were to be divided between the Central and Provincial Governments. Under the quasi-permanent settlements, revenues assigned to provincial Governments were definitely fixed and the power of revision reserved by the Supreme Government was to be exercised only if there was a substantive change in the original conditions or in the event of emergencies like famine and war. In case of grave Imperial necessity or in the event of experience proving the assignment made to have been materially disproportionate to normal provincial requirements, the Central Government had the discretion to make amendments in the allocation of revenues to the Provinces. The Provincial Government also secured lump-sum grants—`dole`s as they were called—from the wind falls of Central Revenues or Central Surpluses for specific objects like Police reform, education, sanitation etc. As the total expenditure on the departments made over to the provincial government for administration exceeded considerably the revenue assigned to them, the difference was made up by a fixed cash assignment under the Land Revenue. In addition to the above transfers of resources to the Provinces, provisions were made for Special initial grants and additional grants for specific purposes to the Provinces. Moreover, in respect of Famine Relief a more liberal arrangement was

40 During the first year of quasi-permanent settlement, special initial grants and the additional grants for specific purposes aggregated Rs. 150 and Rs.162.5 respectively.
made by the Central Government by setting aside some amount to meet any contingency.41

The Quasi-permanent Settlement system presented the following three main features:42

(i) The settlement would be revised only on the happening of certain conditions.43

(ii) Distribution of revenues between the Provincial and Central Government was made with direct reference to the outlay, which each Province might reasonably claim to incur upon the services, which it administered.

(iii) Deficiency in the Provincial Revenues was remedied by assessing a portion of Imperial share of land revenue.

The Quasi-Permanent Settlement failed to provide the Provinces with any independent power with regard to revenue generation or expenditure. They were not empowered to augment the revenue as the rates were being fixed in all cases exclusively by the Government of India. In respect of expenditure also, the Provinces were powerless to modify the recognized trend, or to impose charges on the provincial exchequer more than a prearranged figure, unless previous sanction by the supreme government had been obtained.

41 It set aside every year a sum roughly equal to the famine liabilities of each province to the credit of that province, and utilizing that accumulated reserve when a famine occurred, without affecting its normal resources. If this did not suffice to meet the particular liability, the Imperial and the provincial government concerned must meet the excess equally.

42 *The Government of India Resolution on Provincial Finance No. 27-F dated 18th May 1912.*

43 The settlement would be revised only when the variations from the initial relative standard of revenue and expenditure were, over a substantial term of years, great as to result in either to the Province itself, or to the Government of India, or in the event of the Government of India being confronted with the alternatives of either imposing general taxation, or by seeking assistance from the Provinces.
Despite all the in-built limitations, the quasi-permanent settlement facilitated the Provinces to move progressively towards a decentralised system of finance, which is evidenced by the later steps taken by the Central Government in this direction. The settlement made a departure from the earlier system of rigid centralisation, which was slightly diluted by the Mayo scheme and got further thinned by the Provincial Financial Settlements.  

In 1908, ‘Royal Commission on Decentralisation’ was appointed to go into the whole issue of financial relations, with particular reference to expenditure control. It submitted the report on 25th February 1909. Though the Commission was ‘generally satisfied’ with the financial relations existing between the Government of India and the Provincial Governments, it argued for a reorganization of the Indian financial system. It expressed itself in favour of separating the finances of the Centre and the Provinces in the interests of efficiency and harmony. The major points on which it relied were that-

(i) the system of ‘divided heads’ was injurious to provincial development;
(ii) the practice of the fixed assignment made the arrangements unduly rigid;
(iii) the spasmodic grant of lump sums for definite purposes, which did not admit any discretion to the provincial

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44 “Altogether the decentralization of finance, as it obtained between 1904 and 1912, afforded a spectacle of a conflict between the old principle of observing the convenience of the imperial government and the new ideal of encouraging the development of the provincialised services.” K.T. Shah, *Sixty Years of Indian Finance* (1927), pp. 455-456

governments, allowed a needless degree of interference by the Central Government;

(iv) several provincial settlements discriminated between the Provinces; and

(v) the absence of any powers of additional or extra taxation for the Provincial Government, or of borrowing, which precluded them from substantially improving their ordinary administration, or taking up more ambitious schemes of economic development.

The Commission, though it did not approve the existing system of divided heads, could not suggest any alternative system, as its terms of reference was narrowly interpreted. A notable recommendation of the Commission was to allocate the revenues from Excise and Forests to the Provinces.

The Government of India themselves perceived the force of some of the reasoning of the Commission and as a result, in the fresh settlements of 1911-12, they sought to convert the fixed assignment into completely provincialised revenues from heads which were till then divided. The settlement of 1911 wholly provincialised the forests revenue and expenditure. In respect of excise and land revenue, the allocation varied from Province to Province. Accordingly, cash assignments to the Provinces were reduced in proportion to the accretion in revenues from the above changes. About the provincial claim for independent powers of borrowing and taxation, while recognizing all the force of the provincial arguments, the Central

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46 N.R. Rao, Union State Financial Relations in India (1972), p. 16
47 Excise - Entirely in Bombay, and to the extent of ¾ in the Central and the United Provinces; Land Revenue – ½ in Punjab and 5/8 in Burma.
Government nevertheless could not agree to a further step in devolution in these respects. 48

**Permanent Settlements**

The 'quasi-permanent settlement' was converted to 'permanent settlement' in 1912 by Lord Hardinge, as in the opinion of the Government it was, “preferable to abide by the main lines of the system which had gradually been built up to meet the needs of the country than to look about for an untried scheme of greater abstract perfection”. 49 The new arrangement was declared to be rigid and permanent, subject to special emergencies, when the two Governments might look to each other for provisional aids. The system of grants was retained. The Government of India received the whole revenue under the heads of 'Opium, Salt, Customs, Tributes from Native States, Post Office, Telegraph, Railways, Mint and Military receipts'. It was responsible for the expenditure on the corresponding heads as well as for the 'Home charges' and the bulk of expenditure under the head 'Interest on debt'. Revenues and expenditure under other heads were divided between Imperial and Provincial or were wholly Provincial. Of the Provincial revenue, about two third was derived from the three divided heads of Land Revenue, Excise and Assessed Taxes. The control with regard to three heads was divided, and the Provincial Governments could not themselves adjust the revenue according to the fluctuating needs of their total expenditure. 50

48 *The Government of India Resolution on Provincial Finance No. 27-F dated 18th May 1912.*  
49 *The Government of India Resolution No. 27-F dated 18th May 1912.*  
50 Vaman Govind Kale. *op. cit.*, p.246
The 'Permanent Settlement' remained in operation till 1918-19. As a result, the share of Provinces in growing revenues was enlarged and the interferences of Central Government in the preparation of Provincial budgets were lessened. The Government of India relaxed its hold on the Provincial finances and granted the Provinces a system, which was more self-regulating.\

However, the decisive role of the Central Government in fixing the quantum of the Provinces did not get considerably altered; it remained as the underlying principle of Provincial Settlement. The Provincial Settlements were based, not on Provincial revenues, but on what the Central Government considered as the provincial needs. The Government of India continued to be constitutionally responsible for exercising the general executive supervision of the administration of the Provinces, in the collection of revenues, and in the administration of services assigned to them. The Provincial Governments were not allotted with any powers of independent taxation, direct or indirect and were not allowed to borrow even on their own credit in the open market. The provincial budgets needed the approval of the Supreme Government. However, notwithstanding the demerits of the scheme, in

51 "The intention of the Government in adopting this change was on the one hand to give more elasticity to the settlements and more freedom to Local Governments in working them, and, on the other hand, to protect the general taxpayer of India against possible mismanagement in any particular province, and to put an end to the frequent and undesirable controversies over the adequacy of the existing settlements" Report of Indian Taxation Enquiry Committee 1924-25 Vol. I, Para 513.

52 "The Provincial Governments, up to 1920, owed no responsibility to the people they governed. The Government of India were themselves an absolute and irresponsible bureaucracy; but they owed a shadow of responsibility to Parliament. They accordingly refused to concede any powers of independent taxation, direct or indirect, to the provinces, on political as well as financial grounds. And, lest provincial competition with the Government of India, committed to heavy projects of material development, requiring considerable annual borrowing, should prejudice the credit of the Central Government, they likewise declined to allow provinces to borrow on their own credit in the open market." K.T. Shah, (1929), op. cit., p.100
this system of division of financial administration, the seeds of decentralisation of finances were sown.

The period from 1871 to 1919 witnessed certain significant steps in the direction of decentralisation of finances. Some important subjects of administration as well as certain sources of revenues were brought under the Provincial jurisdiction. These measures were only to meet the political and financial expediencies of the Imperialist rule and to reduce the burden of Central finances. The Centre developed the system and decided the principles regulating the financial devolution and they were superimposed upon the Provinces. They were modified from time to time to suit the financial requirements of the Centre. The Provinces did not have any role in the process of decision-making. The devolution of administrative subjects and finances was highly informal and it did not provide the Provinces with any special status or power. However, the steps taken during this period had helped to develop a two tier financial administration in India.

PERIOD OF FORMAL DECENTRALIZATION: 1919 TO 1935

The period from 1919 to 1935 is very important in the history of fiscal federalism in India for the reason that during this era the administrative and financial standing of the Provinces were reviewed and redefined. For developing a better financial relation between the Union and the Provinces, some attempts were made during this period. To identify the problem areas in the financial administration of the country and to make suggestions regarding the financial relations between the Union and the Provincial Governments, different
Committees and Commissions were constituted. These committees and commissions made a lot of recommendations regarding financial decentralisation in India and these recommendations certainly helped the British Government to develop a better and decentralised financial administration in India. An overview of the major recommendations of these agencies and the steps taken on the basis of those recommendations are given below.


In the history of Centre-State financial relations in India, the Montague-Chelmsford Report on Constitutional Reforms, which led to the passing of the Government of India Act, 1919 has a very prominent status.

Lord Chelmsford was appointed as the Governor General of India in 1916 and soon after his arrival, he declared: “The endowment of British India as an integral part of the British Empire with self-government was the goal of British rule.” In order to achieve this goal, he was of the opinion that, the Constitution of India required major and radical reforms. The policy of the Imperial Government, in his view, was to achieve increasing association of Indians in every branch of the administration and the gradual development of self-

53 To begin with, the Montague-Chelmsford Report on Constitutional Reforms was submitted in 1918, which led to the passing of the Government of India Act, 1919. It was followed by Indian Taxation Enquiry Committee, 1924-5, Indian Statutory Commission, 1930, First Peel Committee, 1931, White Paper on Indian Constitutional Reforms, 1931, Percy Committee, 1932, Second Peel Committee, 1932, and Parliamentary Committee, 1934.

54 E.S. Montague, the then Secretary of State, came to India in 1917 on an invitation made by the Governor General to make a study and submit report with regard to the constitutional reforms in India. In 1918, the Montague-Chelmsford Report on Constitutional Reforms was submitted.

governing institutions with a view to the progressive realization of responsible government in India as an integral part of the British Empire.\textsuperscript{56}

The declared aim of the Mont-Ford Report was to find some means of entirely separating the resources of the Central and Provincial Governments.\textsuperscript{57} The Report was of the view that provincial autonomy could be achieved only if the Provinces were made independent of the Union for the means of provincial development and consequently the Report made certain serious searches for an alternative system of division of financial resources between the Centre and the Provinces.

A major proposal of the Report was to dispense with the system of ‘\textit{divided heads}’ and to allot the residuary power of taxation to the Provinces.\textsuperscript{58} In respect of the ‘\textit{divided heads}’, the proposal was to allocate the revenue from Income tax and General stamps to the Union and the revenue from Judicial stamps, Excise on alcoholic goods, Land revenue and Irrigation to the Provinces exclusively.\textsuperscript{59} Thus, revenue heads like income tax, non-alcoholic excises including salt, customs, currency and mint, contributions from railways and post and telegraphs came to the share of the Central Government, while relatively inelastic sources of revenue like land revenue, alcoholic excises, irrigation charges, judicial stamps, forest receipts, and registration fee were assigned to the Provinces. The Provincial subjects were divided into

\begin{itemize}
\item Montague’s declaration in the House of Commons on August 20, 1917
\item Montague-Chelmsford Report, \textit{c.p.c.i.t.}, Para 200.
\item \textit{Ibid.}, Para 201. It proposed that “an estimate be first made of the scale of expenditure required for the upkeep and development of the services which clearly appertain to the Indian sphere; that resources with which to meet this expenditure should be secured to the Indian Government; and that all other revenues should then be handed over to the Provincial Governments, which will thenceforth be held wholly responsible for the development of all provincial services.”
\item \textit{Ibid.}, Para 207.
\end{itemize}
‘Reserved’ and ‘Transferred’ and the Governor in Council controlled the ‘Reserved Subjects’ while the Governor acting with the Ministers controlled the ‘Transferred Subjects’.⁶⁰ Finance, Land Revenue, Famine relief, Irrigation and Waterways, Mines, Electricity etc., were included in the ‘Reserved Subjects’ while the ‘Transferred Subjects’ included local self government, education, public works, alcoholic excise etc. The division of Provincial Governments into two parts, ‘Reserved’ and ‘Transferred’, defeated the basic principle of the unity of government, paralysed its working and destroyed efficiency.⁶¹ Both the parts overlapped, and by isolating them from each other, their smooth articulation was choked. The experiment of dyarchy proved as an absolute failure.⁶²

The sources of revenue of the provinces included the receipts from provincial subjects, a share in the income-tax and taxes on specific items. Along with the new sources of revenue, the Provinces were asked to be liable for the expenditures of the departments that came under it including the cost of collection of revenue. The expenditures in famine relief and protective irrigation works, which were taken care of by the Union, were also to be handed over to the Provinces. The Report also provided for a complete separation of Central and Provincial budgets, which were till then interlinked and any surplus in the Provincial exchequer could be made use of by the

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⁶⁰ The Executive Government of a Province consisted of two parts: one comprising the Governor and his Executive Council, and the other consisting of the Governor acting with his Ministers.


⁶² This system of dyarchy did not work well due to political and administrative reasons and the Government was forced to replace it with a unitary government in each province under the Government of India Act, 1935.
Central Government. However, despite these recommendations, the Report very categorically argued for a general over-riding power of legislation to be vested upon the Government of India and insisted that the Provincial legislative power should be subservient to the Union’s power. With regard to provincial taxation, the report recommended for limited powers to the provinces. In respect of provincial borrowings also, the Report could not recommend anything novel. It was of the opinion that Provinces’ power of borrowing should be exercised only with the previous sanction of the Government of India even if such borrowings were to be effected locally. Since the ‘divided heads’ had been proposed to be abolished and resources re-arranged, it was calculated that the Provinces would have a surplus of Rs. 15.64 crores and the Government of India would have a deficit of Rs. 13.63 crores. This deficit was proposed to be made good by fixed contributions by the Provinces, which would form the first charge upon the Provincial revenues. The contributions by the Provinces were to be on the basis of their normal surplus, i.e., the difference between the estimated gross revenue under the new scheme and the estimated normal expenditure. To advise on the amounts of Provincial contributions, the ‘Financial Relations Committee’ was appointed under the chairmanship of Lord Meston.

64 Ibid., Para 212 and 213
66 Montague-Chelmsford Report, op. cit., Para 211.
67 This was based on the budget figures for 1917-18, subject to some adjustments.
68 87 percent of gross provincial surplus was proposed to be contributed to the central Government.
69 The Committee was to advise on: (a) the contributions by various provinces for the year 1921-22; (b) modifications to be made in the provincial contributions; (Cont’d p.61)
Meston Committee opposed the division of proceeds of Income Tax between the Union and the Provinces and recommended for the Provinces levying direct tax on industrial and commercial earnings and making general Stamp Duties as provincial subjects. In respect of the scheme of provincial contributions, it was of the opinion that the contribution should not be based on the estimated budgetary surplus of the Provinces but should be based on the increased spending power of the Provinces. The Committee recommended for an initial contribution for the year 1921-22 on the basis of the assured increase in the spending power of the provinces and for a standard contribution from each province. The standard contributions were computed on the basis of the relative taxable capacity of the Provinces and other economic factors.

The Meston Settlement was severely criticised by the provinces for the inelastic nature of sources of revenue allocated to them and for the burden of contribution to the Centre. Governments of Madras, Bombay and Bengal came out sharply and said that the recommendations were prejudicial to the financial future of the Provinces. The fundamental defect of the Meston Settlement was that while it professed to follow the theoretical idea of federal finance, in the functional sphere it provided a strict unitary pattern of financial administration. Contributions under the Meston Award increased the

(c) future financing of the provincial loan account; and (d) share of income tax to the Government of Bombay. Meston Committee submitted its report in March 1920 endorsing generally the recommendations of the Montague-Chelmsford Report.

Provincial contributions under the Meston Settlement during the 1920s provides, perhaps, the only example of transfer of funds from the Provinces to the Centre in the long history of fiscal federalism in India. M.M. Sury, “Centre-State financial Relations in India: 1870-1990”, Journal of Indian School of Political Economy, 1992, Vol. 4, Jan-Mar. No. 1 p.16

S.M. Veeraraghavachar, Union-State Financial Relations in India (1969), pp.40-41

burden of the Provinces, which were already facing budgetary deficits. The financial crisis of the Provinces made the demand for abolition of contributions stronger and the system was abolished from 1928-29.

The Government of India Act, 1919 marked the beginning of formal decentralisation of finances in India. It totally abolished the system of ‘divided heads’ of revenue and provided for separate heads of revenue both for the Union and the Provinces. Moreover, conferring the right of taxation and power of borrowing on the Provinces, however small it was, commenced a landmark development in the evolution of the finances. The Act divided the subjects of legislations into two; ‘Central’ and ‘Provincial.’ Certain specific heads were given wholly to the Provinces and the Centre retained the remaining sources. Thus, among the principal heads of revenue, land revenue, alcoholic excise and judicial stamps, and out of the commercial departments, irrigation, were given to the Provinces, while customs duties, income tax, non-alcoholic excise duties, duties on general stamps, salt and opium were retained by the Centre.

With regard to the subjects listed in Schedule I, the Provinces could levy taxes without the previous sanction of the Governor-

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73 For the period 1921-22 to 1926-27 Rs. 4880.36 crores were contributed to the Centre of which the contribution of Madras was Rs. 1779.17 crores and of U.P. was Rs. 1299.68 crores and Punjab made the contribution of Rs. 899.57 crores.

74 The Central subjects included military, naval and aerial matters, foreign relations and relations with native states, railways, communications of military importance, post and telegraphs, currency and coinage, public debt, sources of imperial revenue, criminal and civil law and procedure, ecclesiastical administration and All-India services, central institutions of Scientific and industrial research and all other matters not specifically declared as provincial subjects. The Provincial subjects included local self government, education, medical administration, sanitation and public health, public works, agriculture, development of industries, excise, civil veterinary department, fisheries, cooperative societies, famine relief, land revenue administration, irrigation, forests, administration of justice, police, prisons, inspection of factories, labour questions, provincial borrowings and agency functions.
General. The taxes mentioned in Schedule I were: (a) tax on land put to uses other than agricultural, (b) tax on succession, (c) tax on any form of betting or gambling permitted by law, (d) tax on advertisement, (e) tax on amusements, (f) stamp duty, (g) registration fee, and (h) stamp duties other than duties of which the amount was fixed by the Indian Legislation. In respect of the subjects of Schedule II, the Provinces could permit local bodies to levy tax, without prior sanction of the Governor-General. However, under the Rules, the Governor-General-in-Council had power to add any new tax to either Schedule.

Although under the Government of India Act, 1919, the control of the Provinces over the subjects allotted to them was almost full, the allotted sources of revenue could not cater to the needs of the Provinces. This was mainly because the Central sources of taxation were elastic, and ever expanding, while the Provincial sources were inelastic and inadequate to meet their expanding needs for services such as education, medical services, public health, maintenance of public roads and conveyance etc. The arrangement was neither unitary nor federal but a halfway house between both.

The framework set up under the Government of India Act, 1919, however, remained unaltered till the passing of the Government of India Act, 1935, which came into operation in 1937. During this long period, there were serious attempts to make out a suitable structure of financial relations between the Centre and the Provinces. With a principal objective to equip the Provincial Governments with larger financial resources, frequent enquiries and deliberations were conducted. Various committees and commissions were constituted to
enquire into the working of the system prevailed and to make suggestions to make appropriate changes in it.

Reforms Enquiry Committee, 1924

The arrangement under the Government of India Act, 1919 had become a matter of controversy mainly due to the inadequacy of resources allotted to the Provinces. Resolutions were passed in the Assembly demanding, *inter alia*, appointment of a Commission to make necessary recommendations to ensure provincial autonomy.\(^75\) Even though the Government did not accept the resolution, it expressed its willingness to investigate into the working of the Government of India Act, 1919 and if the enquiry showed the feasibility and possibility of any advance within the Act, that is to say, by the rule making power under the Act, the Government of India would make a recommendation to that effect.\(^76\) In pursuance of this declaration, the Government of India appointed a Reforms Enquiry Committee in 1924, under the chairmanship of Sir Alexander Muddiman.\(^77\) Muddiman Committee examined, among other matters, division of sources of revenue and the structure of financial relations between the Centre and the Provinces. The Committee submitted its Report on December 3, 1924\(^78\) and in respect of resource sharing the Committee preferred to maintain status

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\(^75\) On February 5, 1924, Diwan Bahadur T. Rangachariar moved a resolution to this effect, which was subsequently amended by a resolution moved by Pandit Motilal Nehru on February 8, 1924 and the amended resolution was adopted by the Assembly on February 18, 1924.

\(^76\) *Legislative Assembly Debates (1924)*, Vol. IV, Pt. I, p. 765.

\(^77\) The terms of reference of the Muddiman Committee were, in brief, to enquire into the difficulties arising from, or defects inherent in, the working of the Government of India Act, 1919, and to investigate the feasibility of securing remedies for such difficulties or defects, consistent with the structure, policy and purpose of the Act.

\(^78\) Tej Bahadur Sapru, Sivaswami Aiyer, M.A. Jinnah and R.P. Paranjpe wrote separate Minority Report and emphasised that the existing system completely failed because of its defects, and therefore, required radical alterations. *Report of the Reforms Enquiry Committee (1924)*, pp. 201-203.
quo except for transferring the excise duty on foreign liquors to the Centre. However, with regard to the income tax there were some recommendations with far reaching results.

Major recommendations of Muddiman Committee were:

1) General stamps, excise duty on foreign liquors manufactured in the country and opium should be transferred to the Centre;
2) Provinces should not be given the power to levy and administer income tax;
3) There should be no surcharge on income tax for the benefit of Provinces;
4) If any division of taxes is to be made, income tax should be the main balancing factor;
5) A share of income tax may be assigned to the Provinces and it should be distributed on the basis of domicile; and
6) A small portion of the receipts of the corporation profits tax might be distributed to each Province on the basis of origin.

Due to administrative difficulties involved, the recommendation regarding transfer of excises on liquor and opium was not accepted by the Government. Similarly, the proposal to centralise general stamps was dropped due to stiff opposition from the Provinces, and only duties on documents of commercial nature were transferred to the Central Government. The proposal of the Committee to give the provinces a small share of the receipts of the corporation tax was also rejected by the Government. Ultimately, it can be seen that the Reforms Enquiry Committee, 1924 could not make any substantial change in the fiscal relations between the Union and the Provincial Governments.
Indian Statutory Commission, 1930

In November 1927, Parliament appointed the Indian Statutory Commission\(^79\) to enquire into the working of the system of Government of India Act, 1919, and to submit a report regarding the desirability of establishing, extending, modifying or restricting the degree of responsible government in British India.

The Commission recommended the abolition of dyarchy in the Provinces and the establishment of unitary administration by doing away with the classification of subjects into ‘reserved’ and ‘transferred’.\(^80\) With regard to the legislative powers, the Commission suggested that the existing arrangement for the distribution of legislative matters between the Central and Provincial Legislatures should be maintained.\(^81\) The Commission proposed for the creation of a Provincial Fund to ensure adequate resources to the Provinces. The system of allocation of sources of revenues under the Montague-Chelmsford Reforms, they thought, had proved insufficient and inelastic. The Commission did not favour the system of grants-in-aid as it involved some measure of control and this ran counter to the whole trend of constitutional development embodied in the recommendations of the Commission.\(^82\) The Provincial fund, they thought, would ensure the most satisfactory means of securing adequate resources for the Provinces without infringing their autonomy. This fund was to “be fed

\(^{79}\) It consisted of seven Members of Parliament including Sir John Simon as its chairman. Indian Statutory Commission, 1930, commonly known as Simon Commission was boycotted by the major political parties in India for excluding Indians from the membership of the Commission and this boycott was converted into an all India agitation. The Indian Statutory Commission Report was published on May 27, 1930


\(^{81}\) Ibid., p. 82 Para 96.

\(^{82}\) A.C. Kapur, op. cit. at p. 288
by products of taxes, voted by the Federal Assembly representing provincial units, but collected centrally.\textsuperscript{83} 

With regard to the division of resources between the Centre and the Provinces, the Financial Advisor to the Commission, Sir Walter Layton made certain recommendations, which were accepted by the Commission.\textsuperscript{84} Principal recommendations of Sir Walter Layton pertaining to the subjects of taxation were that (i) Customs duty on imported liquor should be brought into relation with the excise policy of each province and the provinces should be given the power to impose further duties in the form of excises on such liquor in accordance with their excise policy; (ii) Revenue from commercial stamps should be transferred to the Centre; (iii) One-half of the proceeds of the income tax paid by the residents of a province should be assigned to the concerned province; (iv) Exemption granted to agricultural income tax should be abolished by definite stages; (v) Super tax should remain entirely central; and (vi) There should be a Provincial Fund fed by specially designated taxes, including the following: (a) excise on cigarettes, (b) excise on matches, and (c) duty on salt. The resources of this Fund should be automatically distributed to the Provinces on a \textit{per capita} basis when the Central Budgetary position permitted.\textsuperscript{85}

\textsuperscript{83} \textit{The Indian Statutory Commission Report 1930, op.cit.}, at p. 133, Para 163.

\textsuperscript{84} He recommended for a re-allocation of resources between the Central Government and the Provincial Governments. According to his recommendations, the total tax revenue should be categorised into four such as- (i) Wholly Centre, i.e., taxes collected and spent by the Centre; (ii) Wholly provincial, i.e., taxes collected and spent by the Provinces; (iii) Taxes collected by the Centre and distributed among the Provinces on the basis of origin; and (iv) Taxes collected by the Centre and distributed among the Provinces on the basis of population.

\textsuperscript{85} \textit{The Indian Statutory Commission Report 1930, op.cit.} at pp. 274-275
Meanwhile, the Working Committee of the Indian National Congress convened an All-Party Conference to draft a Swaraj Constitution for India and appointed a Committee in May 1928 with Motilal Nehru as its Chairman to consider and determine, the principles of the Constitution. The Committee submitted its Report on August 10, 1928, which recommended for the establishment of full responsible governments both at the Centre and in the Provinces. The Provinces were to be assigned enumerated functions whereas residuary powers were to be assigned to the Government of India. In March 1929, the Muslim League passed a resolution, which, *inter alia* proposed that the form of the future constitution of India should be federal in structure with residuary powers vested in the Provinces and a uniform measure of autonomy should be granted to all provinces.

The recommendations of the Indian Statutory Commission were considered in connection with the proposals for constitutional changes, which were discussed at the Round Table Conferences in London. At the First Round Table Conference,\(^8^6\) various sub-committees were constituted to look into the different aspects of the future governance of the country, out of which one was a sub-committee on the Federal Structure. The Reports of the various Sub-Committees were received by the whole Conference and were noted together with the members’ observations on each. However, the First Round Table Conference, due to its inherent weaknesses, failed to contribute anything for the progressive development of federalism.

\(^8^6\) The First Round Table Conference commenced on November 12, 1930, which included leading members of the three political parties in England and members of every community and every organisation in India, except the Indian National Congress.
First Peel Committee, 1931

In the Second Round Table Conference, which commenced on September 1, 1931, a Committee presided over by Lord Peel (First Peel Committee) was appointed to investigate into the fiscal relations between the Union and the Provincial Governments and make necessary suggestions. The First Peel Committee suggested that:

1) Income tax should be levied and collected by the federal government, but the entire proceeds of it should be assigned to the Provinces;
2) Federal tax revenues should be mostly derived from indirect taxation;
3) Any resultant federal deficit should be met from Provincial contributions which should not continue beyond fifteen years;
4) If after fifteen years there was any surplus in the federal finances, the federal government should allocate the surplus to the units instead of reducing taxation;
5) Constitution itself should lay down the proportions in which such funds should be divided among the units; and
6) An expert committee should be appointed to lay down the criteria by which the proceeds of income tax should be allocated among the Provinces.

Percy Committee, 1932

As recommended by the First Peel Committee, an Expert Committee under the Chairmanship of Lord Percy was appointed. Major consideration of Percy Committee was the basis of distribution of proceeds of revenue between the Union and the Provincial Governments. With regard to the distribution of proceeds, the
Committee at the outset declared that the procedure must be simple, easily understood and administratively workable. The distribution must be compatible with the idea of a federation of autonomous Provinces and must be fair among all the units of the federation. The existing system of distribution based on ‘origin’, ‘population’ and ‘collection’ was rejected for not being equitable. The Committee opined that the allocation based on ‘origin’ was theoretically commendable but would result into arbitrariness. Distribution based on ‘population’ was not fully scientific but could be adopted in certain circumstances and the criteria of ‘collection’ would be prejudicial to some Provinces. The Committee made the following principal recommendations:

1) Income tax should be shared between the Centre and the Provinces. Corporation tax, tax paid by residents of the federally administered areas and taxes on the salaries of federal officers should go to the Federal Government and the rest to the Provinces.

2) The Provinces should get an estimated amount of proceeds of personal income tax of local incidences, personal super tax on the basis of collection from their residents, and a share of the tax on non-residents and undistributed profits of companies on the basis of population.

3) Share of the Provinces should not be altered from year to year but should be fixed for a term of years, subject to a revision every five years in the light of actual receipts.
4) The federal government should have power to levy surcharge on any tax levied and collected by it for its own purposes.

5) Federal grants should be distributed to the Provinces on the basis of population.

White Paper on Indian Constitutional Reforms, 1931

The British Government in December 1931 issued a White Paper containing proposals for the Indian Constitutional Reforms. It also contained certain financial proposals. The principal financial proposals contained in the White Paper were:

1) An amount of not less than 50 per cent and not more than 75 per cent of the net revenue derived from taxes on income other than agricultural income should be assigned to the Provinces on a prescribed basis;

2) The federal and the Provincial Government should have power to levy surcharges on income tax for their individual purposes;

3) The proceeds of agricultural income tax and of corporation tax should go to the Provinces and the Federal Government respectively;

4) The federal Government should be empowered by law to assign to the Provinces the whole or a part of the proceeds of salt duty, excise duty on commodities included in Central List and export duties; and

5) Terminal taxes and Death duties should be levied and collected by the Union Government but the proceeds of which should be distributed among the Provinces.
Second Peel Committee, 1932

The Reports of the First Peel Committee and Percy Committee and proposals in the White Paper were considered by the Federal Structure Committee and concluded that the subject relating to financial allocation and devolution should be reconsidered de novo. For this purpose, another Sub-Committee was constituted, which was headed by Lord Peel. However, the second Peel Committee merely endorsed the recommendations of the Percy Committee without making any significant suggestions.

The Reports of all these Committees and Sub-Committees were conflicting and none was satisfactory from the point of view of viability. In view of this, in 1933-34, the Joint Parliamentary Committee on the Indian Constitutional Reforms examined the question of allocation and devolution of resources. The committee came in favour of proposals made in the White Paper with some modifications. On the basis of these recommendations the financial provisions of the Government of India Act 1935 were enacted.

The 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 Centre and the Provinces respectively.

Parliamentary Committee, 1934

The Joint Parliamentary Committee on Indian Constitutional reforms, 1934 generally agreed with the proposals made in the White Paper and suggested that:

1) Provincial share of income tax should be prescribed by an Order-in-Council;
2) Share of the Provinces might not exceed half of the net revenue from income tax; and
3) Provinces should not be empowered to impose surcharges on personal income tax.

The Joint Parliamentary Committee's proposals relating to income tax were incorporated in the Government of India Act, 1935.

Before the passing of the Government of India Act, 1919, certainly there had been many attempts by the Imperial Government to allocate revenue resources between the Centre and the Provinces. But the historical significance of the Government of India Act, 1919 is that it marked the beginning of a formal decentralisation of finance between the Centre and the Provinces. Strict control of the Union over the Provincial finances was, to some extent, avoided and a sense of autonomy could be infused in the Provincial Governments. The system was certainly not based on the principles of federalism, but was merely an arrangement of political expediency. Although, under the Government of India Act, 1919 the resources were distributed constitutionally between the Union and the Provinces and the possibilities of overlapping between them were minimised, the power of the Union Government was so elaborate and extensive that it could seize the provincial powers of taxation at any time without the approval of the provinces. Such a system could not, however, be considered as a federal system. But, that is not a reason to undermine the contribution made by Government of India Act, 1919 in setting up a definite federal system in the long run. The role of the Government of India Act, 1919 in the history of the fiscal federalism of India is that it formalised the devolution of finances between the different Governments, which
accelerated the process of establishing a constitutional fiscal federalism. All the subsequent committees and commissions could only tinker with the system perceived by the Government of India Act, 1919. The recommendations of the successive commissions were only modifications of the suggestions originally made by the Mont-Ford Report.

**DECENTRALIZATION TO FEDERAL FINANCES: 1935 TO 1947**

**The Government of India Act, 1935**

By the enactment of the Government of India Act, 1935 the division of legislative powers between the federal Government and the provincial Governments became more tangible.

The Government of India Act, 1935 was passed into law and received the Royal assent on August 4, 1935 and came into force on April 1, 1937 except Part II (Federation) and Part II (Federal Railway Authority). From the political point of view, it was completely reactionary, and was received with indignation and resentment from all shades of public opinion in India. However, it was a turning point in the evolution of Centre-State financial relations. It laid the foundations for the structure of Centre-State relations as incorporated in the present Constitution of India. “While under all the previous Government of India Acts, the Government of India was unitary, the Act of 1935 prescribed a federation, taking the Provinces and the Indian States as Units.” The Act was a step towards consolidation and enhancement of Provincial autonomy in matters of resources and functions.

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87 Nehru condemned it as a legislation “not worth the paper on which it had been printed” and Jinnah denounced it as “fundamentally bad, thoroughly rotten and entirely unacceptable.” See S.L. Sikri, *A Constitutional History of India* (1979), op.cit. p. 129.

notwithstanding the fact that the Federation envisaged by the Act of 1935 never came into being owing to the repudiation of it by the Rulers of the Indian States. For the purpose of demarcation and distribution of Legislative powers between the Federal and Provincial Governments, three Lists were provided in the Seventh Schedule to the Act. Federal Government and the Provincial Governments had exclusive power to legislate upon the subjects of List I and List II respectively. In the case of subjects contained in List III, both the levels of government could legislate with dominance to federal legislation over the regional legislation in case of conflict. Lists I and II contained subjects of taxation whereas List III contained hardly any tax entry.

The Government of India Act, 1935 did not make any major change in the distribution of heads between the Centre and the Provinces but only revived the earlier principle of dividing the proceeds of certain central heads of revenue. It provided for a system of sharing of taxes and devolution of resources. The scheme of distribution of resources between the Federal and Provincial Governments could be classified into six as follows:

1) **Taxes levied, collected and retained by the Federal Government:** - In this category, corporation tax, currency and coinage, receipts from railways and post and telegraphs, import and export duties and military receipts were included.

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89 The Indian Constitution, 1950 also follows the same pattern in the case of legislative powers of the Union and the State Governments.

90 The present Constitution has, at least in the field of fiscal federalism, very closely followed the provisions of the Government of India Act, 1935. A scrutiny of the legislative lists of the Government of India Act, 1935 and the Constitution of India shows that in many cases the latter is the verbatim reproduction of the entries enumerated in the former.
2) **Taxes levied, collected and retained by the Provincial Governments:** - Excise duties on alcoholic liquors, opium, Indian hemp and other narcotic drugs, narcotic and non-narcotic drugs, medicinal and toilet preparations manufactured and produced in the Provinces, land revenue, irrigation, duties in respect of succession to agricultural land, taxes on mineral rights, capitation taxes, taxes on professions, trades, callings and employments, taxes on animals and boats, taxes on sale of goods and on advertisement, cesses on the entry of goods into the local area, taxes on luxuries, entertainments, amusements, betting and gambling, stamps and registration, duties on passengers and goods carried on inland waterways, tolls, fees in respect of any of the matters in the provincial list but not including fees taken in any court were the major subjects assigned exclusively to the Provinces.

3) **Taxes levied and collected by the Federal government but assigned to the Provinces:** - Duties on succession to property other than agricultural land, stamp duty on bills of exchange, cheque, promissory notes, bills of lading, letters of credit, insurance policies, proxies, receipts, terminal taxes on goods or passengers carried by railway or air and taxes on railway fares and freights were proposed to be levied and collected by the Federal Government but net proceeds of such duties and taxes would be assigned to the Provinces.

4) **Taxes levied and collected by the Federal Government but shared with the Provinces:** - A percentage of the net proceeds of taxes on income other than agricultural income, salt duties,
excise duties on tobacco and other goods not included under the State excise duties and export duty on jute and jute goods were distributed among the Provinces. However, the Centre could retain, for a period, a sum out of the share of income tax assigned to the units. Duties on salt, federal duties of excise and export duties would, if an act of the Federal Legislature so provided, be assigned wholly or in part to the units and be distributed among them in accordance with principles to be formulated by such an Act. One half or such higher proportion, as might be determined by the Order-in-Council, of the net proceeds of the export duty on jute and jute products could be assigned to the units in which jute was grown. As to the mode of distribution of shared taxes, the Government of India Act 1935 laid down that initially it would be made by an executive order of the Government of India but later on it would be determined by the federal legislature.

5) **Grant-in-aid:** - Provinces were to be supported with grant-in-aid whenever they were in need of assistance to balance their budget.

6) **Borrowings:** - The States could borrow from the open market on the security of their revenues. Prior sanction of Government of India was necessary if a Province wanted to float a loan outside India or owed any debt to, or guaranteed by, the Government of India.

A significant difference between the earlier Acts and the Government of India Act, 1935, was that under the latter, the revenues and accounts of the Provincial Governments were detached from the Government of India. The Provinces were responsible for their ways and means position and they could frame their own budgets. In the field
of spending, the Provinces had no restriction except in respect of statutory-charged expenditure.

However, fiscal arrangements of the Act of 1935 left a number of questions unattended. With regard to certain serious aspects, such as devolution of income tax and grant-in-aid, the Act did not contain any specific provision. In order to get through these problems, in January 1936, Sir Otto Niemeyer was appointed to make recommendations about (a) the percentage of shared taxes to be assigned to the Provinces and to evolve the principles on which the amount so determined should be distributed among the Provinces, and (b) grant-in-aid to the provinces to overcome their debt liabilities. In his recommendations, to determine the share of the Provinces, a methodology was developed in which the population and residence were two important factors. He made the following recommendations:

1) 50 per cent of the net proceeds of income tax, excluding corporation tax, should be assigned to the Provinces;

2) Share of jute-growing provinces in the jute export duty should be raised by 12.5 per cent to 62.5 per cent of the net proceeds of the duty;

3) Outstanding debts (to the Centre) contracted before 1st April 1936 by Bengal, Bihar, Assam, North-West Frontier Province, and Orissa, should be cancelled, and the outstanding debt of the Central Provinces should be substantially reduced; and

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91 Indian Financial Enquiry Report 1936
92 Since the White Paper directed that the Provinces should not be given less than 50 per cent of the proceeds of the income tax there was no option for him other than to make such a recommendation.
4) Annual grants-in-aid of different amounts should be given to United Provinces, Assam, North-West Frontier Province, Orissa, and Sind.

The recommendations of Sir Otto Niemeyer were accepted by the Federal Government without any change and they were embodied in the Government of India (Distribution of Revenues) Order, 1936. This Order, subject to a change made in 1940 in the wake of World War II, continued to regulate the allocation of resources between the Centre and the Provinces until the partition of the country in 1947. During the Second World War the Niemeyer Award was modified to enable the Government of India to meet its war commitments. Following the outbreak of the Second World War and the consequent increase in Central expenditure, steps had to be taken to strengthen the Central finances. It was decided that, for the duration of the war, the Centre should be permitted to retain a fixed sum of Rs. 4.5 crores out of the Provincial share of income tax. This continued from 1940-41 to 1945-46.

The Labour Government, which was elected to power in Britain in 1946, declared Indian independence as an item of priority and for exploring the possibilities of an immediate solution to the Indian problem, a Cabinet Mission was constituted in March 1946 with three cabinet ministers.93 The Cabinet Mission arrived in India in March 1946 and a conference was held in Shimla with the representatives of the Indian National Congress and the Muslim League. As no settlement could be arrived at, the decision of the Mission was announced on May

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93 Lord Pethick Lawrence, the Secretary of State for India, Sir Stafford Cripps, the President of the Board of the Trade and Mr. A.V. Alexander, the First Lord of Admiralty.
16, 1946. The Cabinet Mission recommended that the Constitution should take the following form:

"(1) There should be a Union of India, embracing both British India and the States, which should deal with the following subjects: foreign affairs, defence, and communications; and which should have the powers necessary to raise the finances required for the above subjects.

(2) xxxxxx

(3) All subjects other than the Union Subjects and all residuary powers should vest with the Provinces.

(4) The States will retain all subjects and powers other than those ceded to the Union."

The proposals of the Cabinet Mission were accepted by all parties, and the election to the Constituent Assembly took place in July, 1946 and an interim Government of fourteen members was formed. First session of the Constituent Assembly began on 6th December 1946. The Resolution of Aims and Objects of the Constitution was piloted by Jawaharlal Nehru on 13th December 1946 which stated that the States "shall possess and retain the status of autonomous units, ..... and exercise all powers and functions of government and administration, save and except such powers and functions as are vested in or assigned to the Union, or as are inherent or implied in the Union or resulting there from."94

It is clear that during the time of independence and in the initial phase of constitution making, it was decided to give more powers to the States. It was conceived that the residuary power of legislation should

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94 C.A.D. Vol. I. p. 59
go to the States. The declaration of the Cabinet Mission and the Resolution of Aims and Objects of the Constitution in the Constituent Assembly corroborates this view. However, when the process of Constitution making was progressing it was decided to draft a Constitution with more unitary leaning.

**STARTING OF CONSTITUTIONAL FISCAL FEDERALISM: 1947 TO 1950**

The partition of the country in 1947 necessitated fresh approach to financial adjustments between the Union and the Provinces. With regard to the share of income tax and jute export duty, though the scheme of distribution as suggested by Sir Otto Niemeyer, was retained, the shares of the divided Provinces of Bengal, and Punjab were reduced in proportion to population. However, so far as income tax was concerned the shares of Sind, and North-West Frontier Province were pooled for distribution. The Provincial share of jute export duty was reduced from 62.5 per cent to 20 per cent, which was roughly in proportion to the jute growing area that went to the Pakistan.

The financial relations between the Centre and the States under the new constitution was a matter of serious discussion in the Constituent Assembly. The provisions in the Draft Constitution relating to Centre-State financial relations were referred to an Expert Committee under the chairmanship of Nalini Ranjan Sarker, with V.S. Sundaram and M.V. Rangachari as members. The Committee after serious deliberations recommended a scheme of distribution of tax resources between the Union and States, which was finally adopted in the Constitution with some changes.
recommendations of the Expert Committee can be summarized as follows:

1) The net proceeds of income tax, including corporation tax, should be shared between the Centre and the Units in the ratio of 40:60.

2) The sharing of the net proceeds of jute export duty with the Provinces should be done away with.

3) For balancing the revenue structure of the Provincial Governments, some share of central excise duties should be given to the Provincial Governments.

4) A Finance Commission should be constituted to deal with the matters connected with the distribution of revenue between the Centre and the States and the States inter se.

With regard to the distribution of fiscal powers between the Union and the State Governments, the Constituent Assembly depended heavily on the Government of India Act, 1935. The pattern of fiscal devolution formulated by the Government of India Act, 1935 was absorbed almost fully in the Constitution and only the provision relating to the Finance Commission was newly added.

Since a Finance Commission could not be appointed immediately after the commencement of the Constitution, arrangements were to be made for the distribution of income tax and payment of grant-in-aid during the interim period. For the period between the commencement of the Constitution and the appointment of a Finance Commission, the above areas were regulated by the Order of the President. The arrangements for the allocation of income tax and jute export duty made by the Government of India immediately
after the partition of the country caused dissatisfaction among the States. In December 1945, these matters were referred to C.D. Deshmukh, and he was requested to give an award as to the devolution of income tax among Part A States.\(^95\) The Deshmukh Award was given effect to from 1 April 1950 and remained in force for two years ending with 31 March 1952.\(^96\) The First Finance Commission was constituted under Article 280 of the Constitution of India by a Presidential Order dated 22 November 1951, under the chairmanship of K.C. Neogy.

From the foregoing analysis it is obvious that the scheme of fiscal federalism under Indian Constitution is neither accidental nor creation of any indigenous intelligence. It is mainly historical in nature. All the previous Constitutional forms, by and large, tried to incorporate the principle of sharing of finances between the Central and Provincial Governments, of course to the extent suitable to the imperialist rule.\(^97\) When it came to the Government of India Act, 1935, greater degree of autonomy was granted to the Provinces in the field of fiscal administration.

\(^95\) Former British Indian Province.

\(^96\) There was no comprehensive scheme of redistribution under the Deshmukh award. It only recommended for a reallocation of the sums released on partition. Accordingly, there was no change in the percentage share of Assam, Bombay and Orissa; reduced the shares of Madras by 0.5 percent, of U.P. by 1 percent and of Bihar by 0.5 percent; augmented the share of West Bengal by 1.5 percent, of Punjab by 0.5 percent. West Bengal was granted Rs. 105 lakhs, Assam Rs. 40 lakhs, Bihar Rs. 35 lakhs and Orissa Rs. 5 lakhs in lieu of Jute and Jute Goods Export Duty.

\(^97\) Efficient fiscal administration, delivering optimal services to the subjects, scientific fiscal strategy and management etc., which are the expected results of a genuine federal fiscal scheme, might not have been in the agenda of the foreign rulers. For obvious political and economic reasons, they opted for a fiscal setup which was mainly federal in character.
In the evolution of fiscal federalism in India, the importance of the Government of India Act, 1935 needs no emphasis. The Constitution of India owes much to the Government of India Act, 1935 in respect of Centre-State financial relations. The subjects of taxation under the jurisdiction of Union and State Governments under the Constitution as well as under the Government of India Act, 1935 are almost similar. The system of levy, collection and distribution of taxes by the Union and State Governments under the Constitution are identical to the system followed by the Government of India Act, 1935. In the case of Grants-in-Aid to the States also this similarity can be observed. A comparative study of the subjects of taxation under the Constitution of India and the Government of India Act, 1935 supplies enough evidences regarding the uniformity between both.\footnote{A scrutiny of the legislative lists of the Government of India Act, 1935 and the Constitution of India shows that the latter is almost a verbatim reproduction of the entries enumerated in the former. A comparative table of fiscal subjects under the Constitution of India and the Government of India Act, 1935 is given in APPENDIX-I.}